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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 301

[REG-105495-19]

RIN 1545-BP21

Guidance Related to the Allocation and Apportionment of Deductions and Foreign Taxes, the Definition of Financial Services Income, Foreign Tax Redeterminations Under Section 905(c), the Disallowance of Certain Foreign Tax Credits Under Section 965(g), and the Application of the Foreign Tax Credit Limitation to Consolidated Groups

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance relating to the allocation and apportionment of deductions and creditable foreign taxes, the definition of financial services income, foreign tax redeterminations, availability of foreign tax credits under the transition tax, and the application of the foreign tax credit limitation to consolidated groups.

DATES: Written or electronic comments and requests for a public hearing must be received by [**INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER**].

ADDRESSES: Send electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-105495-19) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (the "Treasury Department") and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-105495-19), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-105495-19), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under §§1.861-8, 1.861-9(b), 1.861-12, 1.861-14, 1.861-17, and 1.954-2(h), Jeffrey P. Cowan, (202) 317-4924; concerning §§1.704-1, 1.861-9(e), 1.904-4(e), 1.904(b)-3, 1.904(g)-3, 1.1502-4, and 1.1502-21, Jeffrey L. Parry, (202) 317-4916; concerning §§1.861-20, 1.904-6, 1.960-1, and 1.960-7, Suzanne M. Walsh, (202) 317-4908; concerning §§1.904-4(c), 1.905-3, 1.905-4, 1.905-5, 1.954-1, 301.6227-1, and 301.6689-1, Larry R. Pounders, (202) 317-5465; concerning §§1.965-5 and 1.965-9, Karen J. Cate, (202) 317-4667; concerning submissions of comments and requests for a public hearing, Regina Johnson, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On December 7, 2018, the Treasury Department and the IRS published proposed regulations (REG-105600-18) relating to foreign tax credits in the **Federal Register** (83 FR 63200) (the "2018 FTC proposed regulations"). Those regulations addressed several significant changes that the Tax Cuts and Jobs Act (Pub. L. 115-97, 131 Stat. 2054, 2208 (2017)) (the “TCJA”) made with respect to the foreign tax credit rules and related rules for allocating and apportioning deductions in determining the foreign tax credit limitation. The preamble to those proposed regulations requested comments on how to modify the existing approaches for allocating and apportioning deductions, including in particular the rules under §1.861-17 for allocating and apportioning research and experimentation (“R&E”) expenditures. The 2018 FTC proposed regulations are finalized in the Rules and Regulations section of this issue of the **Federal Register** (the “2019 FTC final regulations”).

On June 25, 2012, the **Federal Register** published a notice of proposed rulemaking at 77 FR 37837 (the “2012 OFL proposed regulations”) proposing rules for the coordination of the rules for determining high-taxed passive income with required adjustments to the foreign tax credit limitation in respect of capital gains and the allocation and recapture of overall foreign losses and overall domestic losses, as well as the coordination of the recapture of overall foreign losses on certain dispositions of property and other rules concerning overall foreign losses and overall domestic losses. The 2012 OFL proposed regulations are finalized in the 2019 FTC final regulations.

On November 7, 2007, the **Federal Register** published temporary regulations (T.D. 9362) at 72 FR 62771 and a notice of proposed rulemaking by cross-reference to the temporary regulations at 72 FR 62805 relating to sections 905(c), 986(a), and 6689. Portions of these temporary regulations are finalized in the 2019 FTC final regulations.

This document contains proposed regulations (the “proposed regulations”) addressing the following issues: (1) the allocation and apportionment of deductions under sections 861 through 865, including new rules on the allocation and apportionment of R&E expenditures and certain deductions of life insurance companies; (2) the definition of financial services income under section 904(d)(2)(D); (3) the allocation and apportionment of creditable foreign taxes; (4) the interaction of the branch loss and dual consolidated loss recapture rules with sections 904(f) and (g); (5) the effect of foreign tax redeterminations of foreign corporations on the application of the high-tax exception described in section 954(b)(4) (including for purposes of determining tested income under section 951A(c)(2)(A)(i)(III)), and required notifications under section 905(c) to the IRS of foreign tax redeterminations and related penalty provisions; (6) the definition of foreign personal holding company income under section 954; (7) the application of the foreign tax credit disallowance under section 965(g); and (8) the application of the foreign tax credit limitation to consolidated groups.

Explanation of Provisions

I. Allocation and Apportionment of Deductions and the Calculation of Taxable Income for Purposes of Section 904(a)

A. Stewardship expenses, litigation damages awards and settlement payments, net operating losses, and interest expense

1. Stewardship expenses

Under §1.861-8(e)(4)(i), stewardship expenses are definitely related and allocable to dividends received or to be received from related corporations. This reflects a determination that stewardship expenses are, at least in part, intended to protect the shareholder’s capital investment and thus are factually related to the income that arises from the investment. Before the enactment of the TCJA, taxpayers with foreign subsidiaries often included in their income foreign source income only when that income was distributed to the taxpayer. However, as a result of the enactment of sections 951A and 245A, a significant portion of the foreign source income of foreign subsidiaries is included in income on a current basis or not at all. The Treasury Department and the IRS are aware that some taxpayers may be interpreting the “dividends received, or to be received” phrase in §1.861-8(e)(4)(ii) to exclude the gross up amount treated as a dividend under section 78 (the “section 78 dividend”), as well as inclusions under section 951(a)(1), section 951A, and similar provisions, even though the stewardship expenses may be factually related to such gross income.

With respect to the allocation of stewardship expenses, income arising because of one’s capital investment in a foreign corporation’s stock ordinarily includes not only dividends, but also inclusions under sections 951 and 951A, as well as amounts included under sections 1291, 1293, and 1296 (the “passive foreign investment company provisions”). Therefore, the proposed regulations provide that stewardship expenses are allocated to dividends and inclusions received or accrued, or to be received or accrued, from related corporations.[1] Thus, stewardship expenses are also allocated to inclusions under sections 951 and 951A, section 78 dividends, and all amounts included under the passive foreign investment company provisions.

With respect to apportionment, the current regulations do not provide an explicit rule but instead provide examples of permissible methods. The Treasury Department and the IRS have determined that an explicit rule would provide certainty for taxpayers and the IRS on the appropriate methodology for apportioning stewardship expenses while ensuring that stewardship expenses are apportioned to gross income in a manner

[1] Duplicative activities or shareholder activities giving rise to stewardship expenses can only be performed with respect to members of a controlled group as described in §1.482-9(l)(3)(iii)-(iv). Accordingly, relatedness in the context of stewardship expenses includes taxpayers that are members of the same controlled group as defined in §1.482-1(i)(6). A taxpayer could incur stewardship expenses with respect to a related foreign corporation that is a passive foreign investment company (in addition to a related foreign corporation that is a controlled foreign corporation).

that reflects the purpose of the expenses to protect capital investments or to facilitate compliance with reporting, legal, or regulatory requirements. Therefore, the proposed regulations provide that stewardship expenses are apportioned based upon the relative values of a taxpayer's stock assets, as determined and characterized under §1.861-9T(g) (and, as relevant, §§1.861-12 and 1.861-13) for purposes of allocating and apportioning the taxpayer's interest expense. Therefore, a taxpayer will be required to use the same method to characterize and value its stock assets for purposes of allocating and apportioning its interest and stewardship expenses, and, in some cases as described in Part 1.A.2 of this Explanation of Provisions, certain damages payments. Accordingly, since the fair market value method may not be used for interest allocation and apportionment, it may also not be used for stewardship and certain damages payments. Conforming changes are also proposed with respect to §1.861-14T(e)(4), which provides rules for the treatment of stewardship expenses with respect to an affiliated group. See also §1.861-8(g)(18) (Example 18) for an example illustrating the application of the proposed rules for stewardship expenses.

The Treasury Department and the IRS are aware that stewardship expenses that are incurred to facilitate compliance with reporting, legal, or regulatory requirements may be more appropriately treated as definitely related to the gross income produced by the particular asset, or assets, whose ownership required the stewardship expenditure. For example, the owner of an entity in a particular jurisdiction might have unique reporting requirements not triggered by the ownership of a similar entity in a different jurisdiction. The Treasury Department and the IRS request comments regarding exceptions to the general rule for the allocation and apportionment of stewardship expenses where it is more appropriate to treat stewardship expenses as definitely related to a more limited class of gross income. Comments are also requested on whether it is more appropriate in certain cases to allocate and apportion stewardship expenses on a separate entity, rather than an affiliated group, basis.

The proposed regulations maintain the definition of stewardship expenses as a duplicative activity (as defined in §1.482-9(l)(3)(iii)) or a shareholder activity (as defined in §1.482-9(l)(3)(iv)). See proposed §1.861-8(e)(4)(ii)(A). In particular, shareholder activities are those that preserve the shareholder's capital investment or facilitate compliance with reporting, regulatory, or legal requirements. See §1.482-9(l)(3)(iv). However, the Treasury Department and the IRS are aware that it may be difficult for taxpayers to distinguish between stewardship expenses that result from oversight functions and expenses that are supportive in nature, as described in §1.861-8(b)(3), and are concerned that expenses may be misclassified as either stewardship or supportive expenses in certain cases. For example, day-to-day management activities do not give rise to stewardship expenses and are typically more supportive in nature. However, the distinction between day-to-day management and oversight may change over time as a taxpayer's investments change. Given these concerns, the Treasury Department and the IRS request comments regarding the definition of stewardship expenses and how to readily distinguish such expenses from supportive expenses that are allocated and apportioned under §1.861-8(b)(3).

The proposed regulations extend the treatment of stewardship expenses to cover expenses incurred with respect to a partnership. See proposed §1.861-8(e)(4)(ii)(D).

Rules similar to those with respect to corporations apply to allocate and apportion stewardship expenses incurred with respect to partnerships.

Finally, the Treasury Department and the IRS are considering whether additional changes to the rules for allocating and apportioning stewardship and similar expenses are appropriate in light of the enactment of the TCJA, and in order to better reflect modern business practices that are increasingly global and mobile in nature. Comments are requested on this topic.

2. Litigation damages awards, prejudgment interest, and settlement payments

The current rule for the allocation and apportionment of legal and accounting fees and expenses in §1.861-8(e)(5) does not specifically address damages awards, prejudgment interest, or settlement payments arising from product liability and similar claims. The Treasury Department and the IRS are aware that large, unplanned, and relatively rare expenses can have a significant effect on the calculation of a taxpayer's taxable income and foreign tax credit limitation, and, in the absence of clear rules, disputes have arisen regarding the proper treatment of such expenses. Proposed §1.861-8(e)(5) provides that deductions for damages awards, prejudgment interest, and settlement payments arising from product liability and similar or related claims are allocated to the class or classes of gross income produced by the specific sales of products or services that gave rise to the claims for damage or injury. Damages, prejudgment interest, and settlement payments related to events incident to the production of goods or provision of services, such as damages for injuries caused by industrial accidents, are allocated to the class of gross income produced by the assets involved in the event and, if necessary, apportioned between groupings based on the relative value of the assets in such groupings. In the case of claims made by investors that arise from corporate negligence, fraud, or other malfeasance, the proposed regulations provide that damages, prejudgment interest, and settlement payments paid by the corporation are allocated and apportioned based on the value of all the corporation's assets. In general, the deductions are allocated and apportioned to the statutory or residual groupings to which the related income would be assigned if recognized in the taxable year in which the deductions are allowed.

3. Net operating loss deductions

Under current rules, a net operating loss deduction is allocated and apportioned in the same manner as the deductions giving rise to the net operating loss deduction. However, the rule does not specify how the statutory and residual grouping components of a net operating loss are determined. See §1.861-8(e)(8). The proposed regulations provide that a net operating loss is assigned to the statutory and residual groupings by reference to the losses in each statutory or residual grouping (determined without regard to adjustments made under section 904(b)) that are not allocated to reduce income in a different grouping in the taxable year of the loss. See proposed §1.861-8(e)(8)(i). Furthermore, the proposed regulations clarify that a net operating loss deduction for a taxable year is allocated and apportioned by reference to the statutory and residual grouping components of the net operating loss that is deducted in the taxable year. See proposed §1.861-8(e)(8)(ii). Finally, the proposed regulations provide that except as provided in regulations, for example, in §1.904(g)-3, a partial net operating loss deduction is treated as ratably comprising the components of the net operating loss.[2] See id.

In connection with the proposed regulations under section 250, comments requested clarification on the application of §1.861-8(e)(8) with respect to net operating losses arising prior to the enactment of the TCJA when the net operating loss is deducted in a post-TCJA year for purposes of applying section 250 as the operative section. See 84 FR 8188 (March 6, 2019). These comments will be addressed as part of finalizing those proposed regulations.

4. Application of the exempt income/asset rule to insurance companies in connection with certain dividends and tax-exempt interest

As explained in Part II.B.2 of the Summary of Comments and Explanation of Revisions to the 2019 FTC final regulations, one comment to the 2018 FTC proposed regulations suggested that insurance companies reduce exempt income and assets to reflect prorated amounts of dividends and tax exempt interest. See sections 805(a)(4), 807, 812, and 832(b)(5)(B). The 2019 FTC final regulations do not address this issue, and the proposed regulations do not adopt this comment.

Under subchapter L, a nonlife insurance company includes in income its underwriting income, which consists of premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. The proration rules reduce the company's losses incurred by the "applicable percentage" of tax exempt interest or deductible dividends received. See section 832(b)(5)(B). For a life insurance company, the proration rules apply in the case of tax exempt interest by reducing the

[2] A partial net operating loss deduction occurs when the full net operating loss is not deductible in the carryover year.

closing balance of reserve items by the “policyholder’s share” (currently a fixed percentage, originally intended to be the portion of tax favored investment income used to fund the company’s obligations to policyholders) of tax exempt interest. See sections 807(b)(1)(B) and 812. Similarly, a life insurance company is allowed a dividends received deduction (DRD) for intercorporate dividends from non-affiliates only in proportion to the “company’s share” of the dividends, but not for the policyholder’s share. See section 805(a)(4)(A). Fully deductible dividends from affiliates are excluded from proration for life insurance companies if the dividends are not themselves distributions from tax exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer.

While the mechanics of the proration rules differ depending on whether a company is a life or nonlife insurance company and whether the amount relates to dividends or tax exempt interest, the purpose of those provisions is the same. That is, the policyholder’s share or applicable percentage of dividends and tax exempt interest should not create a double benefit by reason of a DRD or section 103 tax exemption for interest in the first instance and a reduction to income (via increases in unpaid losses and reserves during the taxable year) in the second. Regardless of the mechanics, however, the policyholder’s share and applicable percentage adjustments do not change the fact that tax exempt interest and (for a nonlife insurance company) the applicable percentage of dividends eligible for DRDs remain exempt from U.S. tax. Including those exempt amounts and the corresponding exempt assets in the apportionment formula in allocating expenses under §1.861-8T(d)(2)(i)(B), as the comment suggests, would effectively apportion reserve deductions (which already do not include the disallowed deductions deemed to be attributable to the exempt income, except in the case of the policyholder's share of life insurance DRDs) to exempt U.S. source income, with the result that those deductions would reduce unrelated U.S. source income, in contravention of the rule in §1.861-8T(d)(2)(i)(B). See also Travelers Insurance Company v. United States, 303 F.3d 1373 (2002).

The current regulations already provide the appropriate rules in this area. Section 1.861-8T(d)(2)(ii)(B) provides that the policyholder's share of dividends received by a life insurance company is treated as tax exempt income notwithstanding the partial disallowance of the DRD, and §1.861-14T(h) provides for the direct allocation to the dividends of an amount of reserve expenses equal to the disallowed portion of the DRDs. The current regulations do not provide a special rule for either tax exempt interest of a life insurance company or DRDs and tax exempt interest of a nonlife insurance company because, when a policyholder's share or applicable percentage is accounted for as either a reserve adjustment or a reduction to losses incurred, no further modification to the generally applicable rules is required to ensure that the appropriate amount of expenses are apportioned to U.S. source income.

Nevertheless, in order to provide greater clarity, the proposed regulations provide in proposed §1.861-8(d)(2)(ii)(B), (d)(2)(v), and (e)(16) the effect of certain deduction limitations on the treatment of income and assets generating dividends received deductions and tax exempt interest held by insurance companies. More specifically, the proposed regulations provide that in the case of insurance companies, the term exempt income includes dividends for which a deduction is provided by sections 243(a)(1) and (2) and 245, without regard to the proration rules disallowing a portion of the deduction.

Similarly, the term exempt income includes tax exempt interest without regard to the proration rules. These provisions apply on a company wide basis and therefore include each separate account of the company. Two examples are provided in proposed §1.861-8(d)(2)(v)(B) that illustrate the application of these rules.

5. Other requests for comments on expense allocation

The Treasury Department and the IRS continue to study the rules for allocating and apportioning interest deductions. In addition, the Treasury Department and the IRS expect the implementation of section 864(f) (which is effective for taxable years beginning after December 31, 2020) will have a significant impact on the effect of interest expense apportionment and will necessitate a reexamination of the existing expense allocation rules. Therefore, the Treasury Department and the IRS are studying whether further guidance with respect to allocation and apportionment of interest expense, taking into account the changes made by the TCJA and the future implementation of section 864(f), is required. Comments are requested on this topic.

The Treasury Department and the IRS are also considering whether rules providing for the capitalization and amortization of certain expenses solely for purposes of §1.861-9 may better reflect asset values under the tax book value method. For example, solely for purposes of §1.861-9, research and experimental expenditures and advertising expenses could be treated as if they were capitalized and amortized. Comments are requested on this topic.

As noted in Part III.B.4.iii of the Summary of Comments and Explanation of Revisions to the 2019 FTC final regulations, the Treasury Department and the IRS are studying whether additional rules for allocating and apportioning expenses to foreign branch category income or limiting the amount of the gross income reallocated as a result of certain disregarded payments are appropriate. Comments are requested on whether such special rules would more accurately reflect the business profits of a foreign branch, while maintaining administrability for taxpayers and the IRS.

B. Certain loans made by partnerships to partners

The 2018 FTC proposed regulations included rules addressing the source and separate category of interest income and expense related to loans to a partnership by a U.S. person (or a member of its affiliated group) that owns an interest (directly or indirectly) in the partnership. These rules were finalized in the 2019 FTC final regulations. See §1.861.9(e)(8).

As discussed in Part II.C.1 of the Summary of Comments and Explanation of Revisions of the 2019 FTC final regulations, several comments to the 2018 FTC proposed regulations requested that the rules under §1.861-9(e)(8) with respect to specified partnership loans be expanded to cover loans made by a partnership to a partner (an "upstream partnership loan"). The Treasury Department and the IRS agree with comments that rules addressing upstream partnership loans would reduce distortions that could otherwise affect the foreign tax credit limitation. Therefore, the comments are adopted in proposed §1.861-9(e)(9)(ii), which generally provides that, to the extent the borrower in an upstream partnership loan transaction takes into account both interest expense and interest income with respect to the same loan, the interest income is assigned to the same statutory and residual groupings as those groupings from which the matching amount of interest expense is deducted, as determined under the allocation and apportionment rules in §§1.861-9 through 1.861-13. Additionally, proposed §1.861-9(e)(9)(i) provides that, for purposes of applying the allocation and apportionment rules, the borrower does not take into account as an asset its proportionate share of the loan, as otherwise provided under §1.861-9(e)(2) and (3). Proposed §1.861-9(e)(8)(iv) also applies the upstream partnership loan rules to transactions that are not loans but that give rise to deductions that are allocated and apportioned in the same manner as interest expense under §1.861-9T(b). An anti-avoidance rule similar to the rule in §1.861-9(e)(8)(iii) is included to cover back-to-back third-party loans that are intended to circumvent the purposes of the rules. See proposed §1.861-9(e)(8)(iii). These rules are being proposed in order to provide taxpayers an additional opportunity to comment on the rule.

Additionally, the Treasury Department and the IRS are aware that some taxpayers may be converting existing partnership debt structures that were used to increase a taxpayer's foreign tax credit limitation before the issuance of §1.861-9(e)(8) from partnership debt into partnership equity that provides for guaranteed payments for the use of capital. The taxpayer then takes the position that the guaranteed payments are neither allocated and apportioned under the rules in §1.861-9 nor included in subpart F income by reason of §1.954-2(h).

Guaranteed payments for the use of capital are similar to a loan from the partner to the partnership because the payment is for the use of money and is generally deductible. See section 707(c). Because these arrangements raise the same policy concerns as ordinary debt instruments, the proposed regulations revise §1.861-9(b) and §1.954-2(h)(2)(i) explicitly to provide that guaranteed payments for the use of capital described in section 707(c) are treated similarly to interest deductions for purposes of allocating and apportioning deductions under §§1.861-8 through 1.861-14 and are treated as income equivalent to interest under section 954(c)(1)(E). No inference is intended as to whether or not §1.861-9T(b) or §1.954-2(h)(2) include guaranteed payments for taxable years before the proposed regulations are applicable.

C. Treatment of assets connected with capitalized, deferred, or disallowed interest

Section 1.861-12T(f)(1) provides that, in certain circumstances, where interest expense that is capitalized, deferred, or disallowed under a provision of the Code, the adjusted basis or fair market value of the asset to which the interest expense is connected is reduced by the principal amount of the interest that is capitalized, deferred, or disallowed. One comment with respect to the 2018 FTC proposed regulations recommended that the Treasury Department and the IRS consider narrowing the scope of the rule in §1.861-12T(f)(1) to prevent taxpayers from taking overly expansive views of the rule in order to minimize the value of controlled foreign corporation ("CFC") stock that attracts interest expense to reduce the foreign tax credit limitation. In response to the comment, the proposed regulations clarify what it means for an asset to be connected with indebtedness, modify the existing example, and add a new example. See proposed §1.861-12(f).

D. Treatment of section 818(f) reserve expenses for consolidated groups

Section 818(f)(1) provides that the deduction for life insurance reserves and certain other deductions ("section 818(f) expenses") are treated as items which cannot definitely be allocated to an item or class of gross income. Therefore, when a life insurance company computes its foreign tax credit limitation, its section 818(f) expenses generally reduce its U.S. source income and foreign source income ratably. However, issues arise as to how to allocate and apportion section 818(f) expenses if the life insurance company is a member of an affiliated group of corporations (including both life and nonlife members) (the group, "life-nonlife consolidated group") that join in filing a consolidated return.

The Treasury Department and the IRS are aware of at least five potential methods for allocating section 818(f) expenses in a life-nonlife consolidated group. First, the expenses might be allocated solely among items of the life insurance company that has the reserves ("separate entity method"). Second, to the extent the life insurance company has engaged in a reinsurance arrangement that constitutes an intercompany transaction (as defined in §1.1502-13(b)(1)), the expenses might be allocated in a manner that achieves single entity treatment between the ceding member and the assuming member ("limited single entity method"). Third, the expenses might be allocated among items of all life insurance members ("life subgroup method"). Fourth, the expenses might be allocated among items of all members of the consolidated group (including both life and non-life members) ("single entity method"). Fifth, the expenses might be allocated based on a facts and circumstances analysis ("facts and circumstances method").

In response to the request for comments in the 2018 FTC proposed regulations, the Treasury Department and the IRS have received comments advocating for certain of the aforementioned allocation methods. One comment recommended an allocation method similar to the single entity method. The comment proposed that, if all members of a consolidated group were treated as a single corporation, and if that corporation would constitute a life insurance company, then section 818(f) expenses might be allocated and apportioned to all members of the consolidated group, including nonlife members of a life-nonlife consolidated group.

Two other comments disagreed with the single entity method. These comments proposed that section 818(f) expenses generally be allocated on the separate entity method. However, if the facts and circumstances demonstrate a sufficient factual relationship between the expense and the income of more than one life insurance company, these comments proposed that such expenses might be allocated based on the facts and circumstances method. The comments did not provide examples of when facts and circumstances would demonstrate a sufficient relationship to qualify for this treatment.

The Treasury Department and the IRS decline to adopt the single entity method in the proposed regulations. Section 818(f) only applies to a life insurance company; thus, section 818(f) expenses should not be allocated to nonlife members of a consolidated group. The Treasury Department and the IRS also decline to adopt the facts and circumstances method because a broad facts and circumstances approach would introduce substantial uncertainty into the tax system and would be difficult to administer.

The Treasury Department and the IRS considered adopting the life subgroup method in the proposed regulations. This method would reflect a single entity approach for life insurance companies that operate businesses and manage assets and liabilities on a group basis. Under this paradigm, section 818(f) expenses would be treated as not definitely related to an item or class of gross income of the entire life subgroup for purposes of calculating the foreign tax credit limitation, and therefore generally ratably reduce U.S. source income and foreign source income of the life subgroup.

The Treasury Department and the IRS also considered adopting the separate entity method. The separate entity method would allocate and apportion section 818(f) expenses on a separate company basis. This method is consistent with the Code because section 818(f) expenses generally are computed on a separate company basis and relate to the liabilities of a specific life insurance company. In addition, this method is consistent with the treatment of reserves when members of a consolidated group engage in an intercompany transaction. Under §1.1502-13(e)(2)(ii)(A), direct insurance transactions between members of a consolidated group are accounted for by both members on a separate entity basis. For example, if one member provides life insurance coverage for another member with respect to its employees, the premiums, reserve increases and decreases, and death benefit payments are determined and taken into account by both members on a separate entity basis (rather than on a single entity basis under the general rules of §1.1502-13). See also §1.1502-13(e)(2)(ii)(B)(2) (providing that reserves resulting from intercompany reinsurance transactions are determined on a separate entity basis).

After considering both methods, proposed §1.861-14(h)(1) adopts the separate entity method. As noted previously, this method generally is consistent with section 818(f) and with the separate entity treatment of reserves under §1.1502-13(e)(2). Nevertheless, the Treasury Department and the IRS are concerned that this method may create opportunities for consolidated groups to use intercompany transactions to shift their section 818(f) expenses and achieve a more desirable foreign tax credit result. Accordingly, the Treasury Department and the IRS request comments on whether a life subgroup method more accurately reflects the relationship between section 818(f) expenses and the income producing activities of the life subgroup as a whole, and whether the life subgroup method is less susceptible to abuse because it might prevent a consolidated group from inflating its foreign tax credit limitation through intercompany transfers of assets, reinsurance transactions, or transfers of section 818(f) expenses. The Treasury Department and the IRS also request comments on whether an anti-abuse rule may be appropriate to address concerns with the separate entity method, and regarding the appropriate application of §1.1502-13(c) to neutralize the ancillary effects of separate-entity computation of insurance reserves, such as the computation of limitations under section 904.

E. Allocation and apportionment of R&E expenditures

Part I.G of the Explanation of Provisions of the 2018 FTC proposed regulations discussed the interaction between the current rules for allocating and apportioning R&E expenditures and the changes made to section 904(d) by the TCJA, and requested comments on how the regulations should be revised to account for the new category in section 904(d)(1)(A) (the "section 951A category"). The comments received are addressed in this Part I.E.

1. Relevant class of gross income and application of the gross income method

Several comments to the 2018 FTC proposed regulations recommended that the regulations for allocating and apportioning R&E expenditures under §1.861-17 be revised to preclude allocation and apportionment of R&E expenditures to the section 951A category. The comments stated that R&E expenditures are incurred by a U.S. taxpayer to develop intangible property that cannot generate income in the section 951A category, which is limited to inclusions under section 951A ("GILTI inclusions") and the related section 78 dividend in respect of deemed paid taxes. Further, to the extent a GILTI inclusion is attributable to a CFC's income derived from intangible property developed by the worldwide group, the comments stated that the intangible property must have either been developed by the CFC or a CFC affiliate (in which case the R&E expenditures were not borne by the U.S. taxpayer), or licensed or acquired by the CFC from a U.S. affiliate, which would require that the U.S. affiliate take into account an arm's length royalty, gain on transfer, or a deemed income amount under section 367(d) to which its R&E expenditures should be allocated.

The Treasury Department and the IRS agree with the comments that the rules under §1.861-17 should be modified to reflect the fact that R&E expenditures that are deductible under section 174 generally give rise to intangible property, and that under the rules in sections 367(d) and 482, the person incurring such R&E expenditures must be compensated properly when such intangible property gives rise to income. Therefore, proposed §1.861-17(b) provides that the rules in that section are premised on the fact that successful R&E expenditures ultimately result in the creation of intangible property (as defined in section 367(d)(4)) and, therefore, R&E expenditures ordinarily are considered deductions that are definitely related to all gross intangible income reasonably connected with the relevant Standard Industrial Classification Manual code ("SIC code") category (or categories) of the taxpayer and so are allocable to all items of gross intangible income related to the SIC code category (or categories) as a class. Gross intangible income is defined as all gross income earned by a taxpayer that is attributable, in whole or in part, to intangible property derived from R&E

expenditures and does not include dividends or any amounts included under section 951, 951A, or 1293. See proposed §1.861-17(b)(2). As a result, when applying §1.861-17 to section 904 as the operative section, because a U.S. taxpayer's gross intangible income, as defined in the proposed regulations, does not include income assigned to the section 951A category, none of its R&E expenditures are allocated or apportioned to the section 951A category.

Under §1.861-17(c) and (d), a taxpayer may elect to apportion R&E expenditures, in excess of amounts exclusively apportioned to the place the R&E is performed under §1.861-17(b), on the basis of either sales or gross income. In contrast to the sales method, the gross income method of apportioning R&E expenditures (1) limits taxpayers to exclusively apportion only 25 percent of R&E expenditures based on the place of research activities (instead of 50 percent under the sales method), and (2) requires the apportionment to or among the statutory groupings to be at least half of what would have been apportioned under the sales method. These limits reflect concerns that the gross income method could produce inappropriate results in cases where the types of gross income recognized by the taxpayer in the statutory and residual groupings in a SIC code category are different. For example, if a taxpayer sells products incorporating its intangible property in the United States but earns royalties from licensing its intangible property used by others to make sales abroad, comparing the gross income from sales, which includes value attributable to other factors in addition to intangible property, to the gross royalty income will generally distort the extent to which the R&E expenditures produce U.S. and foreign source income from intangible property. In such cases, the gross income method is inconsistent with the general principle under §1.861-8T(c) that the method of apportionment "reflect to a reasonably close extent the factual relationship between the deduction and the grouping of gross income." In comparison, the sales method requires that taxpayers use a single, consistent measure -- gross receipts from sales and services -- to attribute R&E expenditures to their various groupings and, therefore, more clearly reflects the anticipated income expected to be derived from successful R&E expenditures.

Therefore, the proposed regulations eliminate the optional gross income method and require R&E expenditures in excess of the amount exclusively apportioned under §1.861-17(b) to be apportioned among the statutory and residual groupings within the class of gross intangible income on the basis of the relative amounts of gross receipts from sales and services in each grouping. See proposed §1.861-17(d). For this purpose, gross receipts are assigned to the grouping to which the gross intangible income attributable to the sale or service is assigned. For example, where the taxpayer licenses intangible property to a CFC which, in turn, sells products or services incorporating the intangible property, the gross receipts of the CFC are assigned to a grouping based on the source and character of the related royalty included by the taxpayer. Proposed §1.861-17(d)(1)(iii). This rule addresses concerns that the Treasury Department and the IRS have had since before the TCJA's enactment that taxpayers would assign the gross receipts from CFC sales to U.S. customers to the residual grouping for U.S. source income while arguing that the related royalty income earned by the U.S. company that owns the intangible property can be treated as foreign source income, with the mismatch resulting in an inflation of R&E expenditures apportioned to U.S. source income. The proposed regulations also clarify that the sales method applies to income from services.

Under §1.861-17(a)(2)(ii), the relevant SIC code categories are determined by reference to the three digit classification of the SIC code. Proposed §1.861-17(b)(3)(iv) clarifies the rules relating to goods or property that are described in the SIC code category for "wholesale trade" or "retail trade." The purpose of this rule is to match R&E expenditures with a taxpayer's core business and minimize the number of a taxpayer's SIC code categories. This rule provides that vertically integrated taxpayers that perform upstream activities (for example, extraction or manufacturing) before downstream wholesale and retail functions must aggregate their wholesale and retail R&E expenditures and sales with their R&E expenditures and sales in the most closely related three-digit SIC code category. A taxpayer cannot use a SIC code category within the wholesale or retail trade divisions unless its business is generally limited to sales-related activities. Taxpayers engaged in both wholesale and retail trade, but not related upstream activities, are not required to aggregate their wholesale and retail R&E expenditures and sales.

Comments are requested on whether a different classification method that takes into account more recent changes in the economy and business practices should be used. For example, comments are requested on whether NAICS codes would be more appropriate.

Comments to §1.861-17 were also received in connection with the proposed regulations under section 250. See 84 FR 8188 (March 6, 2019). Further changes to the rules for allocating and apportioning R&E expenditures will be considered as part of addressing comments in finalizing those regulations.

2. Elimination of legally mandated R&E and increased exclusive apportionment of R&E

Under §1.861-17(a)(4), R&E expenditures that are undertaken solely to meet legal requirements ("legally mandated R&E") imposed by a political entity and that cannot reasonably be expected to generate amounts of gross income (beyond de minimis amounts) outside a single geographic source are allocated directly to gross income within the geographic source imposing the requirement. A rule similar to the legally mandated R&E rule existed in regulations issued in 1977 that allocated and apportioned R&E expenditures ("the 1977 regulations").

Since the adoption of the legally mandated R&E rule in the 1977 regulations, the Treasury Department and the IRS have observed that taxpayers rarely rely on the legally mandated R&E rule. In particular, legal requirements for certain products may significantly overlap between multiple jurisdictions because those jurisdictions have similar legal requirements that relate to areas such as consumer safety, pollution, or pharmaceutical products. In addition, multiple jurisdictions may have similar legal requirements because of multilateral trade and investment agreements or because taxpayers choose to sell their products only in markets with similar requirements. See, for example, IRS Coordinated Issue Biotech and Pharmaceutical Industries Legally Mandated R&E Expense (June 18, 2003) (discussing the International Conference on Harmonization, subsequently the International Council for Harmonization, and its role in rationalizing and harmonizing pharmaceutical regulations in multiple jurisdictions). To reflect the changing international business environment and simplify the regulations with respect to R&E, the proposed regulations eliminate the legally mandated R&E rule.

Under §1.861-17(b), an exclusive apportionment of R&E expenditures is made if activities representing more than 50 percent of the R&E expenditures were performed in a particular geographic location, such as the United States. Under §1.861-17(b)(1)(ii), for taxpayers electing the gross income method, 25 percent of R&E expenditures is exclusively apportioned to the geographic location where the R&E activities accounting for more than 50 percent of the deductible expenses were incurred. Under §1.861-17(b)(1)(i), for taxpayers electing the sales method, 50 percent of R&E expenditures are exclusively apportioned to the geographic location where the R&E activities accounting for more than 50 percent of the deductible expenses were incurred. After this initial exclusive apportionment, the remainder of the taxpayer's R&E expenditures are apportioned under either the sales or gross income methods.

The 1977 regulations also included a rule similar to a rule in the current regulations at §1.861-17(b)(2). Under this rule, taxpayers may demonstrate to the satisfaction of the Commissioner that an even higher amount of R&E expenditures should be exclusively apportioned to a geographic location. According to the current regulations, the exclusive apportionment rules are based on the understanding that R&E may be more valuable where it is undertaken because R&E benefits products all of which may be sold in the nearest market but only some of which may be sold in foreign markets, and R&E is often used in the nearest market first before it is used in other markets. Therefore, under the increased exclusive apportionment rule, a taxpayer may establish to the satisfaction of the Commissioner that one or both of these conditions are satisfied—that is, its research is expected to have a particularly limited or long delayed application outside the geographic area where the research is performed, such that a greater amount of R&E expenditures should be initially exclusively apportioned.

Similar to the legally mandated rule, the Treasury Department and the IRS have observed that taxpayers have rarely used the current increased exclusive apportionment rule since the issuance of the 1977 regulations. Moreover, when it has been used, the facts and circumstances nature of the analysis has caused hard-to-resolve disagreements between the Commissioner and taxpayers. Changes in the international business environment have also contributed to the decreased utilization of this rule. Accordingly, the proposed regulations eliminate the increased exclusive apportionment rule.

Finally, proposed §1.861-17(b) clarifies that the exclusive apportionment rule applies only to section 904 as the operative section. <u>See also</u> Part I.E.1 of this Explanation of Provisions (noting that comments were received in connection with proposed regulations under section 250 and that further changes will be considered as part of addressing comments in finalizing those regulations).

3. Sales made by other entities

The sales method for apportioning R&E expenditures provides that gross receipts from sales of products or provision of services within a relevant SIC code category by controlled parties of the taxpayer are taken into account in apportioning the taxpayer's R&E expenditures if the controlled party is reasonably expected to benefit from the taxpayer's research and experimentation. Under §1.861-17(c)(3)(iv), the sales of controlled parties that enter a valid cost sharing arrangement ("CSA") with a taxpayer are excluded from the apportionment formula because the controlled party is not expected to benefit from the taxpayer's remaining R&E expenditures.

Proposed §1.861-17 clarifies the treatment of CSAs in two respects. First, consistent with §1.482-7, the taxpayer's R&E expenditures allocated and apportioned under §1.861-17 do not include any amounts that are not deductible by reason of the second sentence under §1.482-7(j)(3)(i) (relating to cost sharing transaction payments from a controlled party). Second, the proposed regulations clarify that the exclusion of the controlled party's gross receipts applies only for purposes of apportioning those R&E expenditures that are intangible development costs with respect to the CSA. If a taxpayer who enters a CSA also incurs R&E expenditures that are not intangible development costs with respect to the CSA, then those expenses would be apportioned under the generally applicable rules, including the rules concerning controlled party sales. See proposed §1.861-17(d)(4)(v).

One comment suggested that §1.861-17 be modified to provide that a taxpayer's R&E expenditures that are funded by a foreign affiliate under a contract research arrangement should be directly allocated to the taxpayer's income from such arrangements. The terms of the contract research arrangement are not clear from the comment, and it is unclear whether the described expenditures that are reimbursed by a foreign affiliate are paid or incurred by the taxpayer to develop or improve a product in connection with the taxpayer's trade or business. See §§1.174-1 and 1.174-2. If the expenditures are not paid or incurred by the taxpayer to develop or improve a product in connection with its trade or business, the taxpayer may not deduct them under section 174. As a result, §1.861-17 would not apply to these expenditures. The expenditures would instead be allocated and apportioned under the general rules in §1.861-8 on the basis of the factual relationship of deductions to gross income. See §1.861-8(a)(2). The Treasury Department and the IRS request comments on whether contract research arrangements involving expenditures reimbursed by a foreign affiliate are generally paid or incurred by the taxpayer in connection with its trade or business such that a deduction under section 174 is allowable, and whether a special rule for such expenditures should be considered.

Another comment suggested a special rule for "licensor models" whereby CFCs pay royalties to compensate for a taxpayer's R&E expenditures. The comment suggested that in order to avoid allocation and apportionment of R&E expenditures to the section 951A category, the activities of the licensee CFC should be excluded for purposes of apportioning the licensor's R&E expenditures and should be treated similarly to cost sharing arrangements. The comment suggested in the alternative that if the CFC sales are not excluded entirely, that R&E expenditures should be netted against the royalty income to which the R&E expenditures are apportioned.

The Treasury Department and the IRS agree that R&E expenditures should be allocated and apportioned solely with respect to the gross intangible income of the taxpayer rather than the net income of a licensee, and therefore not allocated and apportioned to the section 951A category. See Part I.D.1 of this Explanation of Provisions. Unlike in the case of a CSA, however, a licensor earns royalties or other forms of gross intangible income from the use of its intangible property, and it would not be appropriate to exclude such royalties in allocating R&E expenditures of the licensor. The proposed regulations require the use of the sales method, which would effectively attribute R&E expenditures to the taxpayer's royalty income based on the proportion of the gross receipts of the licensees over the total gross receipts of the taxpayer and its licensees. This approach is preferable to the comment's alternative recommendation of netting R&E expenditures against the amount of royalties because taxpayers may earn different types of gross intangible income (for example, from sales of property as well as royalties) and comparing such amounts could lead to distortive results.

Finally, under §1.861-17(c)(3)(ii) and (f)(3), sales made by controlled corporations and partnerships taken into account to apportion R&E expenditures are reduced to reflect the taxpayer's percentage ownership of such entities. This reduction is inappropriate because the taxpayer's gross intangible income is not dependent on its percentage ownership of the entity to which it transfers intangible property. The proposed regulations, therefore, eliminate the rule reducing sales of controlled corporations that are taken into account and include partnership sales to the same extent as those made by controlled corporations.

F. Application of section 904(b) to net operating losses

The 2018 FTC proposed regulations included a rule in §1.904(b)-3(d) coordinating the application of section 904(b)(4) with sections 904(f) and 904(g), which apply after section 904(b)(4). This rule is finalized substantially as proposed in the 2019 FTC final regulations. However, the 2018 FTC proposed regulations did not coordinate any of the adjustments required under section 904(b) with the net operating loss provisions. Therefore, the proposed regulations include a coordination rule. Under proposed §1.904(b)-3(d)(2), for purposes of determining the source and separate category of a net operating loss, the separate limitation loss and overall foreign loss rules of section 904(f) and the overall domestic loss rules of section 904(g) are applied without taking into account the adjustments required under section 904(b). The Treasury Department and the IRS have determined this rule is appropriate because the amount of the net operating loss eligible to be carried to another year under section 172 is not affected by the adjustments required by section 904(b).

II. Foreign Tax Credit Limitation Under Section 904

A. Definition of financial services entity

Section 904(d)(2)(D) provides that financial services income can only be received by a person "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business." Under current law, the principal significance of this provision is that under section 904(d)(2)(C), passive income of such a person is not assigned to the passive category. The preamble to the 2018 FTC proposed regulations noted that the Treasury Department and the IRS were considering modifications to the gross income-based test for determining financial services entity ("FSE") status and requested comments in this regard. One comment was received requesting that any future modifications not affect the classification of income derived by a substantial (and genuinely active) financial services group. The Treasury Department and IRS agree that a substantial and genuinely active financial services group should be included in the definition of an FSE.

However, numerous places in the Code use similar concepts and, at times, the same terms, but provide different definitions (even when largely overlapping in application). The Treasury Department and IRS have determined that interpretive guidance should be simplified and made consistent where possible and appropriate. For example, section 954(h) in the subpart F rules defines "predominantly engaged in the active conduct of a banking, financing, or similar business" (which in the case of a lending or finance business, requires more than 70 percent of the gross income be derived directly from transactions with unrelated customers); section 1297(b)(2)(B) in the passive foreign investment company ("PFIC") rules defines "active conduct of an insurance business by a qualifying insurance corporation"; and section 953(e)(3) defines the term "qualifying insurance company" in order to determine the amount of passive income excluded from subpart F income as income derived in the active conduct of an insurance business under section 954(i).

In order to promote simplification and greater consistency with other Code provisions that have complementary policy objectives, proposed §1.904-4(e)(2) modifies the definition of an FSE by adopting a definition of "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" and "income derived in the active conduct of a banking, insurance, financing, or similar business" that is generally consistent with sections 954(h), 1297(b)(2)(B), and 953(e). Conforming changes are made to the rules for affiliated groups in proposed §1.904-4(e)(2)(ii) and partnerships in proposed §1.904-4(e)(2)(i)(C).

Comments are requested on whether additional guidance is needed with respect to section 954(h) (including in particular section 954(h)(2)(B)(ii), which authorizes the Treasury Department to issue regulations regarding corporations not licensed as a bank in the United States) and section 952(c)(1)(B)(vi) (defining a qualified financial institution for purposes of the qualified deficit rules).

In addition, when the regulations defining an FSE were originally promulgated in 1988, section 904(d)(1)(C) assigned financial services income to its own separate category. This separate category was repealed in 2004, effective for taxable years beginning after 2006, but the rules in section 904(d)(2)(C) and (D) were retained. The proposed regulations make additional clarifying changes to reflect the repeal of the separate category for financial services income.

Finally, in 2004, a definition of financial services group was added in section 904(d)(2)(C)(ii) which was based on the definition of an affiliated group under section 1504(a) but expanded to include insurance companies and foreign corporations. While the current regulations already include foreign corporations as part of an affiliated group, proposed §1.904-4(e)(2)(ii) conforms the definition of an affiliated group to also include insurance companies referenced in section 1504(b)(2).

B. Allocation and apportionment of foreign income taxes

As explained in Part III.G of the Summary of Comments and Explanation of Revisions to the 2019 FTC final regulations, the Treasury Department and the IRS have determined that additional guidance regarding the allocation and apportionment to separate categories of creditable foreign income taxes in §1.904-6 is warranted. As a result of changes made by the TCJA, the accurate allocation and apportionment of foreign income taxes to the gross income to which they relate has taken on increased importance. See, for example, sections 245A(d), 960, 965(g), and §1.861-8(e)(6) (allocating the deduction for foreign income taxes, including at the level of a CFC, to statutory and residual groupings). Therefore, taxpayers will benefit from increased certainty on how to match foreign income taxes with income, particularly in the case of differences in how a U.S. taxable base and foreign taxable base are computed with respect to the same transaction. Furthermore, because these rules are relevant in numerous contexts outside of section 904, the general rules in §1.904-6 (which address allocating and apportioning taxes to separate categories) have been moved to new proposed §1.861-20 and generalized to apply for purposes of allocating and apportioning foreign income taxes to statutory and residual groupings. Rules specific to the allocation and apportionment of foreign income taxes to separate categories remain in proposed §1.904-6. Conforming changes are proposed to §§1.704-1(b)(4)(viii)(d)(1) and 1.960-1(d), which currently rely on the "principles of" §1.904-6, as well as §1.965-5(b)(2) (in the case of foreign corporation taxable years beginning after December 31, 2019).

Current §1.904-6 provides that the allocation and apportionment of foreign tax expense to a section 904 separate category is made on the basis of the income as computed under foreign law on which the tax is imposed; foreign tax is allocated to the separate category to which the income included in the foreign tax base would be assigned under Federal income tax principles. See 1.904-6(a)(1). If the foreign tax base includes income in more than one separate category, the tax is apportioned among the separate categories on the basis of the relative amounts of foreign taxable income in each category. In making this determination, foreign law rules apply, with certain modifications, to determine the foreign law deductions that reduce the foreign law gross income to compute the foreign law amount of taxable income in each separate category. See §1.904-6(a)(1)(ii).

Proposed §1.861-20 adopts the principles of §1.904-6 but provides more detailed guidance on how to apply those principles, which are illustrated by several examples. Proposed §1.861-20(c) provides that foreign tax expense is allocated and apportioned among the statutory and residual groupings by first assigning the items of gross income under foreign law ("foreign gross income") on which a foreign tax is imposed to a grouping, then allocating and apportioning deductions under foreign law to that income, and finally allocating and apportioning the foreign tax among the groupings. See proposed §1.861-20(c).

Proposed §1.861-20(d)(1) provides a general rule for assigning foreign gross income to a statutory or residual grouping. Under this rule, a foreign gross income item is assigned to a grouping by characterizing the item under Federal income tax law. If an item of gross income or loss arises under Federal income tax law from the same transaction or realization event from which the foreign gross income item arose (a "corresponding U.S. item"), the foreign gross income item is assigned to the same statutory or residual grouping as the corresponding U.S. item. In the case of a corresponding U.S. item that is an item of loss (or zero), the foreign gross income is assigned to the same grouping to which an item of gain would be assigned had the transaction or realization event given rise to an item of gain under Federal income tax law. See proposed §1.861-20(d)(1).

Proposed §1.861-20(d)(2) sets forth rules for assigning a foreign gross income item to a grouping if there is no corresponding U.S. item in the U.S. taxable year in which the taxpayer paid or accrued the foreign income tax imposed on foreign taxable income that includes the foreign gross income item. Proposed §1.861-20(d)(2)(i) generally addresses the circumstance in which there is no corresponding U.S. item either because the event giving rise to the foreign gross income is a nonrecognition event under Federal income tax law or because the recognition event giving rise to the foreign gross income occurred under Federal income tax law in a different U.S. taxable year. In both cases, proposed §1.861-20(d)(2)(i) assigns the foreign gross income to the grouping to which the corresponding U.S. item would be assigned if the event giving rise to the foreign gross income resulted in the recognition of gross income or loss under Federal income tax law in the same U.S. taxable year in which the foreign income tax is paid or accrued.

Proposed §1.861-20(d)(2)(ii) provides guidance regarding the treatment of foreign gross income items that are either excluded from gross income under Federal income tax law or attributable to base differences. Under §1.861-20(d)(2)(ii)(A), with the exception of base difference items, foreign gross income that is a type of income expressly excluded from gross income under Federal income tax law is assigned to the grouping to which the gross income would be assigned if it were included in U.S. gross income. Proposed §1.861-20(d)(2)(ii)(B) provides an exclusive list of items that are excluded from U.S. gross income and that, if taxable under foreign law, are treated as base differences. The items are death benefits described in section 101, gifts and inheritances described in section 102, contributions to capital described in section 118 and the receipt of property in exchange for stock described in section 1032, the receipt of property in exchange for a partnership interest described in section 721, returns of capital described in section 301(c)(2), and distributions to partners described in section 733. The Treasury Department and the IRS have determined that foreign tax on these items, which are excluded from U.S. gross income, is particularly difficult to associate with a particular type of U.S. gross income. Accordingly, foreign tax on base difference items is assigned to the residual grouping, with the result that no credit is allowed if the tax is paid by a CFC, and the tax is assigned to the separate category described in section 904(d)(2)(H)(i) if paid (or treated as paid) by a taxpayer claiming a direct credit under section 901. Comments are requested on whether the list should be expanded to include other items that have no logical analogue to items included in U.S. gross income, or whether a different assignment of any of these types of foreign gross income would be more appropriate.

Proposed §1.861-20(d)(3) sets forth special rules that apply for purposes of assigning certain items of foreign gross income to a grouping, including rules for distributions that both Federal income tax law and foreign law recognize, certain foreign law distributions such as consent dividends, inclusions under foreign law CFC regimes, disregarded payments, inclusions from reverse hybrids, and gain on the sale of a disregarded entity.

In the case of a distribution from a non-hybrid corporation that is recognized for both Federal income tax law and foreign tax law purposes, proposed §1.861-20(d)(3)(i)(B) treats foreign gross income arising from the distribution as a dividend and as capital gain to the extent of the portions of the distribution that are, under Federal income tax law, characterized as a dividend and capital gain, respectively. The foreign gross income is assigned to the same statutory and residual groupings as the corresponding amounts of dividend and capital gain as computed for U.S. tax purposes. Foreign gross income arising from the portion of the distribution that is a return of capital under Federal income tax law is treated as a base difference under proposed §1.861-20(d)(2)(ii)(B).

If foreign law, but not Federal income tax law, recognizes a deemed distribution or consent dividend (a “foreign law distribution”), proposed §1.861-20(d)(3)(i)(C) assigns the resulting foreign gross income to a statutory or residual grouping by applying proposed §1.861-20(d)(3)(i)(B) as though Federal income tax law recognized the distribution in the U.S. taxable year in which the taxpayer paid or accrued tax with respect to the foreign law distribution. For example, if a taxpayer recognizes foreign gross income arising from a foreign law distribution, and proposed §1.861-20(d)(3)(i)(B) (as applied for purposes of section 904 as the operative section) would treat the distribution as made out of general category section 965(a) previously taxed earnings and profits if the distribution had also occurred under Federal income tax law, the foreign gross income is assigned to the general category.

If a taxpayer (including an upper-tier CFC) includes an item of foreign gross income by reason of a foreign law regime similar to the subpart F provisions under sections 951 through 959 (a "foreign law subpart F regime"), proposed §1.861-20(d)(3)(i)(D) assigns that item to the same statutory or residual grouping as the gross income (determined under the foreign law subpart F regime) of the foreign law CFC that gave rise to the foreign gross income of the taxpayer. The taxpayer's gross income included under the foreign law subpart F regime is, in other words, treated as the foreign gross income of the foreign law CFC, and the general rules of proposed §§1.861-20(d)(1) and (2) apply to characterize that foreign gross income and assign it to the statutory and residual groupings. For example, in applying proposed §1.861-20(d)(3)(i)(D) in applying section 960 as the operative section where an upper-tier CFC is the taxpayer, the upper-tier CFC's foreign law subpart F inclusion is treated as the foreign gross income of the foreign law CFC, which is treated as if it were the taxpayer. If the foreign law CFC has a corresponding U.S. item of subpart F income for which its United States shareholder elects to apply the high tax exception under section

954(b)(4), the foreign gross income and the associated foreign tax paid by the upper-tier CFC are assigned to a residual income group under §1.960-1(d). In addition, §1.904-6(f) includes a special rule assigning certain items of foreign gross income recognized by a United States shareholder of a CFC that is also a foreign law CFC to the section 951A category for purposes of applying section 904 as the operative section.

Proposed §1.861-20(d)(3)(ii) addresses the assignment of foreign gross income arising from disregarded payments between a foreign branch (as defined in §1.904-4(f)(3)) and its owner. If the foreign gross income item arises from a payment made by a foreign branch to its owner, proposed §1.861-20(d)(3)(ii)(A) generally assigns the item to the statutory and residual groupings by deeming the payment to be made ratably out of the after-tax income, computed for Federal income tax purposes, of the foreign branch, and deeming the branch income to arise in the statutory and residual groupings in the same ratio as the tax book value of the assets, including stock, owned by the foreign branch. If the item of foreign gross income arises from a disregarded payment to a foreign branch from its owner, proposed §1.861-20(d)(3)(ii)(B) generally assigns the item to the residual grouping. However, proposed §1.861-20(d)(3)(ii)(C) assigns an item of foreign gross income attributable to gain recognized under foreign law with respect to the receipt of a disregarded payment in exchange for property under the rule in §1.861-20(d)(2)(i). In addition, proposed §1.904-6(b)(2) includes special rules assigning foreign gross income items arising from certain disregarded payments for purposes of applying section 904 as the operative section.

Proposed §1.861-20(d)(3)(iii) addresses the assignment to a statutory or residual grouping of foreign gross income that a taxpayer includes by reason of its ownership of a reverse hybrid. Under this rule, the foreign gross income that a taxpayer recognizes from a reverse hybrid is assigned to the statutory and residual groupings by treating that foreign gross income as the income of the reverse hybrid and applying the general rules of proposed §1.861-20(d). However, §1.904-6(f) includes a special rule assigning certain items of foreign gross income recognized by a United States shareholder of a controlled foreign corporation that is a reverse hybrid to the section 951A category for purposes of applying section 904 as the operative section. The Treasury Department and the IRS request comments on whether additional rules are needed to address other fact patterns in which the U.S. and a foreign country tax different persons on the same item of income, for example, in the case of a sale-repurchase agreement.

Finally, under proposed §1.861-20(d)(3)(iv), if a taxpayer recognizes an item of foreign gross income that is gain from the sale of a disregarded entity, and Federal income tax law characterizes the transaction as a sale of the assets of the disregarded entity, the foreign gross income is assigned to the statutory and residual groupings in the same proportion as the gain that the taxpayer would have recognized if foreign law also treated the transaction as a sale of assets.

Changes to §1.904-6 and §1.960-1 are proposed to clarify and, in certain cases, modify the application of proposed §1.861-20 for purposes of computing the foreign tax credit limitation under section 904 and foreign income taxes deemed paid under section 960.

Proposed §1.904-6(b)(1) assigns foreign gross income that is attributable to a base difference, and the associated tax, to the separate category described in section 904(d)(2)(H)(i). Proposed §1.904-6(b)(2)(i) generally provides that if a foreign branch makes a disregarded payment to another foreign branch or to its owner that causes the taxpayer’s gross income under Federal income tax law that is otherwise attributable to the foreign branch to be attributed to another foreign branch or to the foreign branch owner under §1.904-4(f)(2)(vi)(A) or §1.904-4(f)(2)(vi)(D), the foreign gross income that arises by reason of the disregarded payment is assigned to the same category as the reattributed U.S. gross income. Under proposed §1.904-6(b)(2)(ii), items of foreign gross income that a taxpayer includes solely by reason of the receipt by a foreign branch of a disregarded payment from its foreign branch owner that is a United States person are generally assigned to the foreign branch category (or, in the case of a foreign branch owner that is a partnership, to the partnership’s general category income that is attributable to the foreign branch). However, items of foreign gross income attributable to gain recognized under foreign law with respect to the receipt of a disregarded payment in exchange for property are characterized and assigned under the rules of §1.861-20(d)(2)(i). Under proposed §1.904-6(b)(3), if a taxable disposition of property acquired in a disregarded sale results in the recognition of U.S. gross income that is reattributed to or from a foreign branch under §1.904-4(f)(2)(vi)(A) or §1.904-4(f)(2)(vi)(D), any foreign gross income arising from that disposition of property under foreign law is assigned to the same separate category as the corresponding U.S. item of gain under §1.861-20(d)(1) without regard to the reattribution of U.S. gross income. This rule is intended to better match income and taxes in situations where the foreign country only taxes gain that arises during the period that follows the disregarded sale.

Finally, §1.904-6(f) addresses the circumstance in which a United States shareholder pays or accrues foreign income tax with respect to foreign gross income that it recognizes because it owns a foreign law CFC or a reverse hybrid. The foreign income tax is allocated and apportioned to a category by treating the foreign gross income of the United States shareholder as the foreign gross income of the foreign law CFC or reverse hybrid under proposed §§1.861-20(d)(3)(i)(D) or 1.861-20(d)(3)(ii)(B). Proposed §1.904-6(f) reassigns to the section 951A category the foreign gross income that, if the foreign law CFC or reverse hybrid recognized the foreign gross income instead of the United States shareholder, would be assigned to the general category tested income group of the foreign law CFC or reverse hybrid to which an inclusion under section 951A is attributable. The amount of the foreign gross income that is reassigned is based upon the inclusion percentage, as defined in §1.960-2(c)(2), of the United States shareholder.

The Treasury Department and the IRS are continuing to study the allocation and apportionment of foreign income tax that is imposed on foreign gross income that is associated with the general category tested income group of a foreign law CFC or reverse hybrid under proposed §§1.861-20(d)(3)(i)(D) and 1.861-20(d)(3)(ii)(B), respectively. Comments are requested on the proper treatment of such foreign income tax in the circumstance in which some or all of the tax is not assigned to the section 951A category under proposed §1.904-6(f) because no inclusion is attributable to the tested income group, or the inclusion percentage of the United States shareholder is less than 100 percent. In particular, comments are requested on the interaction of proposed §1.904-6(f) with sections 245A(g) and 909.

Proposed §1.960-1(d)(3)(ii) makes conforming changes and in addition clarifies that, if proposed §1.861-20 would otherwise apply to assign foreign gross income to a PTEP group that is not increased as a result of a distribution described in section 959(b), the foreign taxable income is assigned to the income group to which the income, computed under Federal income tax law, that gave rise to the PTEP would be assigned if recognized under Federal income tax law in the year in which tax was imposed.

The Treasury Department and the IRS are also studying whether additional guidance should be provided on allocating and apportioning foreign taxes described in section 903 (tax in lieu of income tax), and foreign income taxes for which the foreign taxable base is computed formulaically with respect to a unitary business. The Treasury Department and the IRS are also studying whether the rules in §1.861-8(e)(6) for allocating and apportioning state income taxes should be revised in light of changes made by the TCJA and changes to state rules for taxing foreign income. Comments are requested on these topics.

C. Overall foreign loss recapture on property dispositions

One comment was received with respect to the 2012 OFL proposed regulations, which recommended addressing dispositions that result in additional income recognition under branch loss recapture and dual consolidated loss recapture rules. The comment pointed out that these additional income recognition amounts are determined after first determining the additional recognition amount under section 904(f)(3) and therefore recommended adding the coordination of these rules as a new Step Nine in the ordering rules of §1.904(g)-3. The comment recommended that the additional income recognition amounts resulting from branch loss recapture and dual consolidated loss recapture should not be subject to the overall foreign loss (OFL) recapture rules.

The branch loss recapture rules under section 367(a) referenced by the comment letter were repealed by the TCJA (subject to a special savings clause that applies with respect to losses incurred before January 1, 2018) and replaced with a new set of branch loss recapture rules in section 91. One of the principal differences between the two regimes is that previously the branch loss recapture amounts were treated as foreign source income, whereas under new section 91(d) they are treated as U.S. source income. Accordingly, although the branch loss recapture amounts for losses incurred after December 31, 2017, are no longer subject to the OFL recapture rules or separate limitation loss (SLL) recapture rules, they are now potentially subject to the overall domestic loss (ODL) recapture rules, and therefore ordering rules are still needed for the application of the branch loss recapture rules, including the rules for losses incurred before January 1, 2018, that are subject to the special savings clause.

The Treasury Department and the IRS agree with the recommendation to add a new Step Nine to §1.904(g)-3 to clarify that additional income amounts recognized by reason of branch loss recapture and dual consolidated loss recapture are not taken into account for purposes of the ordering rules until after the section 904(f)(3) amounts are determined. However, the Treasury Department and the IRS do not agree that those additional income amounts should not be subject to the OFL or ODL recapture rules. The fact that a loss recapture rule may provide that the additional income amount is treated as U.S. source income does not mean it should be treated any differently than any other U.S. source income that is subject to the ODL recapture rules. The same reasoning applies to additional income amounts that are treated as foreign source income and therefore subject to the OFL recapture rules. Accordingly, Step Nine in proposed §1.904(g)-(3)(j) provides that like section 904(f)(3) recapture amounts addressed in Step Eight, the additional income recognized by reason of branch loss and dual consolidated loss recapture will be subject to the first seven steps of the ordering rules. However, Step Nine applies only to additional income amounts with respect to branch loss and dual consolidated loss recapture that are determined after taking into account an offset for a section 904(f)(3) recapture amount. For example, if a taxpayer has a dual consolidated loss recapture in a year in which there is no section 904(f)(3) recapture, then there is only one application of Steps One through Seven, which takes into account the additional income, and Steps Eight and Nine will not apply.

When Step Nine applies, the proposed regulations provide that for purposes of determining how much of the additional income with respect to branch loss and dual consolidated loss recapture will be subject to the ODL, OFL or SLL recapture rules, any increases to an ODL, OFL or SLL account balance in the current year due to the original application of Steps One through Seven (prior to the application of Steps Eight or Nine) are taken into account.

In addition, if any additional income with respect to a branch loss or dual consolidated loss recapture is foreign source income in a separate category for which there is a remaining OFL account balance after Steps One through Eight, a special rule applies for purposes of determining the OFL recapture amount under §1.904(f)-2(c) (the lesser of the maximum potential recapture or 50 percent of total foreign source income). The special rule provides that a taxpayer must first determine a hypothetical OFL recapture amount, which is the OFL recapture amount that would have been determined in the original application of Steps One through Seven (prior to the application of Steps Eight and Nine) if the additional income in Step Nine were also taken into account. From that hypothetical OFL recapture amount, the taxpayer subtracts the actual OFL recapture amount that was determined in the original application of Steps One through Seven (without taking into account the additional income in Step Nine). The remainder is then the OFL recapture amount with respect to the additional income in Step Nine. This special rule is necessary because a simple reapplication of the OFL recapture amount rules in §1.904(f)-2(c) to just the additional income in Step Nine could result in requiring an excessive amount of recapture, because the same amount of foreign source income in other separate categories may be used twice to increase the OFL recapture amount (once in the original calculation and again in the second calculation with respect to the additional income).

III. Foreign Tax Redeterminations Under Section 905(c)

As discussed in Part III of the Background section of the 2019 FTC final regulations, portions of the temporary regulations relating to sections 905(c), 986(a), and 6689 (TD 9362) (the “2007 temporary regulations”) are being reproposed in order to provide taxpayers an additional opportunity to comment on those rules in light of the changes made by the TCJA. References in this preamble to the 2007 temporary regulations are understood to refer to the corresponding provisions of the accompanying proposed regulations, which were issued by cross-reference to the 2007 temporary regulations at 72 FR 62805.

In particular, the rules being reproposed are: (1) §1.905-3T(d)(2), which addresses foreign tax redeterminations that affect foreign taxes deemed paid under section 960, (2) §1.905-4T, which in general provides the procedural rules for how to notify the IRS of a foreign tax redetermination, and (3) §301.6689-1T, which provides rules for the penalty for failure to notify the IRS of a foreign tax redetermination. In addition, the proposed regulations contain a transition rule in proposed §§1.905-3(b)(2)(iv) and 1.905-5 to address foreign tax redeterminations of foreign corporations that relate to taxable years before the amendments made by the TCJA. See Part III.D of this Explanation of Provisions.

A. Adjustments to foreign taxes paid by foreign corporations

Section 1.905-3T(d)(2) of the 2007 temporary regulations reflects the law in effect before the TCJA, which generally required foreign tax redeterminations of foreign corporations to be taken into account by prospectively adjusting the foreign corporations' pools of post-1986 undistributed earnings and post-1986 foreign income taxes, rather than by adjusting the calculation of deemed-paid taxes and the United States shareholder's ("U.S. shareholder") U.S. tax liability in the prior year or years in which the adjusted foreign tax was included in the calculation of foreign taxes deemed paid. Section 1.905-3T(d)(3) of the 2007 temporary regulations provides exceptions to the pooling adjustment rules that required redeterminations of the U.S. shareholder's U.S. tax liability in situations where refunds or other downward adjustments to a foreign corporation's foreign tax liability would otherwise cause a substantial overstatement of deemed paid taxes. With the repeal of the pooling regime and related amendments to section 905(c) in the TJCA, the statute now requires U.S. tax redeterminations to reflect all foreign tax redeterminations, including those that result in adjustments to foreign taxes deemed paid. Accordingly, proposed §1.905-3(b)(2)(i) provides that a U.S. tax redetermination is required in all cases to account for the effect of a foreign corporation's foreign tax redetermination.

Section 1.905-3T(d)(3)(ii), illustrated by an example in §1.905-3T(d)(3)(iii), provides that the required U.S. tax redetermination is made by taking the foreign tax redetermination into account in the prior year to which the redetermined foreign tax relates, and further provides that a U.S. tax redetermination is also required for any subsequent year in which the domestic corporate shareholder received or accrued a distribution or inclusion from the foreign corporation, which under pre-TCJA law would have resulted in foreign taxes deemed paid. Under these rules, the amount of the adjusted foreign tax was deemed to “relate back” and adjust the foreign corporation’s earnings and profits, as well as its creditable foreign taxes, in the adjusted year.

In any case where a U.S. tax redetermination and adjustment to deemed paid taxes is required, an adjustment to the foreign corporation’s taxable income and earnings and profits in the functional currency amount of the adjusted foreign tax (whether upward to reflect a refund or downward to reflect an additional payment of foreign tax) in the relation-back year is necessary in order to coordinate the computation of the U.S. shareholder’s inclusions with the amount of the section 78 dividend in the amount of the adjusted foreign taxes deemed paid. This is because under sections 954(b)(5) and 951A(c)(2)(ii), the creditable foreign tax reduces the foreign corporation’s subpart F income, tested income, and earnings and profits, so that the amount included in the U.S. shareholder’s income under sections 951 and 951A is an after-foreign-tax amount; the section 78 dividend prevents the effective allowance of both a deduction and a credit for an amount of foreign tax that both reduces the inclusion and is allowed as a deemed paid foreign tax credit. If the foreign corporation’s deduction from income and earnings and profits in respect of foreign taxes were adjusted in a different year than the year in which its creditable foreign taxes were adjusted, the amount of foreign tax that reduces the U.S. shareholder's inclusion and the amount added to income under section 78 in respect of the deemed paid tax would not match, such that the U.S. shareholder's income would be understated or overstated by the amount of the foreign tax adjustment.

Accordingly, proposed §1.905-3(b)(2)(ii) clarifies that the required adjustments by reason of a foreign tax redetermination of a foreign corporation include not only adjustments to the amount of foreign taxes deemed paid and related section 78 dividend, but also adjustments to the foreign corporation's income and earnings and profits and the amount of the U.S. shareholder's inclusions under sections 951 and 951A in the year to which the redetermined foreign tax relates. The TCJA amendments, by eliminating deemed paid taxes under section 902 with respect to dividends and basing deemed paid taxes under section 960 with respect to subpart F and GILTI inclusions on current year income and taxes rather than multi-year pools, will require more redeterminations of U.S. tax liability to adjust deemed paid credits under section 960, but fewer adjustments to intervening years, since a foreign tax adjustment to one year will generally no longer affect the calculation of deemed paid taxes with respect to inclusions in other years. New examples at proposed §1.905-3(b)(2)(v) illustrate these rules.

Section 905(c)(1)(B) and (C) require a redetermination of U.S. tax if accrued taxes remain unpaid after two years, or if any tax paid is refunded in whole or in part. These provisions are not limited to cases in which the foreign tax redetermination reduces the amount of the foreign tax credit. Accordingly, proposed §§1.905-3(a) and

1.905-3(b)(2)(ii) also provide that the rules under section 905(c) apply in cases in which foreign tax redeterminations affect U.S. tax liability even though there may be no change to the amount of foreign tax credits originally claimed. For example, under the proposed regulations a redetermination of U.S. tax liability is required when a foreign tax redetermination affects whether or not a taxpayer is eligible for the high-tax exception under section 954(b)(4) (the "subpart F high-tax exception") in the year to which the redetermined foreign tax relates. Similarly, a foreign tax redetermination could affect the subpart F income, tested income, and earnings and profits of a CFC in the year to which the tax relates, see proposed §1.905-3(b)(2)(ii), and therefore affect the amount of a U.S. shareholder's inclusion under section 951 or section 951A with respect to the adjusted year. Corresponding amendments are proposed to the rules in §§1.904-4(c)(7) and 1.954-1(d).

B. <u>Foreign tax redeterminations of successor entities</u>

The proposed regulations at §1.905-3(b)(3) add a rule clarifying that if at the time of a foreign tax redetermination the person with legal liability for the tax (the "successor") is a different person than the person that had legal liability for the tax in the year to which the redetermined tax relates (the "original taxpayer"), the required redetermination of U.S. tax liability is made as if the foreign tax redetermination occurred in the hands of the original taxpayer. This could occur, for example, if a disregarded entity is sold to a different taxpayer, or if a CFC liquidates into another CFC that has transferee liability for the liquidated CFC's foreign tax. The proposed regulations further provide that Federal income tax principles apply to determine the tax consequences if the successor remits, or receives a refund of, a tax that in the year to which the redetermined tax relates was the legal liability of, and thus considered paid by, the original taxpayer. Thus, for example, when the original taxpayer owns the successor which remits a tax that was the legal liability of, and considered paid by, the original taxpayer (for example, if a controlled foreign corporation that was formerly a disregarded entity pays additional tax after a foreign audit), then a distribution can result from the successor to the original taxpayer. See Herbert Enoch, 57 T.C. 781 (1972) (finding constructive dividend when a corporation discharged its shareholder's personal liability on debt). The Treasury Department and the IRS request comments on whether additional rules are required to address situations involving predecessors or successors.

C. Notification to the IRS of foreign tax redeterminations and related penalty provisions

Proposed §1.905-4 contains rules for notifying the IRS of a foreign tax redetermination. Proposed §301.6689-1 contains rules regarding the penalty for failure to notify the IRS of a foreign tax redetermination. This Part III.C describes changes made to §§1.905-4 and 301.6689-1 relative to the rules that were contained in the 2007 temporary regulations.

1. Notification through amended returns

Section 1.905-4T(b)(1)(iv) of the 2007 temporary regulations provides that, if more than one foreign tax redetermination requires a redetermination of U.S. tax liability for the same taxable year of the taxpayer (the affected year) and those redeterminations occur within two consecutive taxable years, the taxpayer generally may file for the affected year one amended return, Form 1118 (Foreign Tax Credit – Corporations) or Form 1116 (Foreign Tax Credit), and one statement under §1.905-4T(c) with respect to all of the redeterminations. Proposed §1.905-4(b)(1)(iv) clarifies that, if more than one foreign tax redetermination requires a redetermination of U.S. tax liability for the same affected year and those redeterminations occur within the same taxable year or within two consecutive taxable years, the taxpayer may file for the affected year one amended return and one statement under proposed §1.905-4(c) with respect to all of the redeterminations. Proposed §1.905-4(b)(1)(iv) also provides that the due date of the amended return and statement varies depending on whether the net effect of the foreign tax redeterminations reduces or increases the U.S. tax liability in the affected taxable year.

Section 1.905-4T(b)(1)(v) of the 2007 temporary regulations provides that, if a foreign tax redetermination requires a redetermination of U.S. tax liability that otherwise would result in an additional amount of U.S. tax due, but such amount is eliminated as a result of a carryback or carryover of an unused foreign tax under section 904(c), the taxpayer may, in lieu of applying the rules of §§1.905-4T(b)(1)(i) and (b)(1)(ii), notify the IRS of such redetermination by attaching a statement to the original return for the taxpayer's taxable year in which the foreign tax redetermination occurs. Section 1.905-4T(b)(1)(v) of the 2007 temporary regulations does not apply if the foreign tax redetermination does not change the U.S. tax liability for the taxable year to which the tax relates for a reason other than the carryback or carryover of an unused foreign tax. Section 1.905-4T(b)(1)(v) of the 2007 temporary regulations also does not apply if more than one foreign tax redetermination occurring within the same taxable year or two consecutive taxable years requires a redetermination of U.S. tax liability for the same taxable year but, taking into account all such foreign tax redeterminations on a net basis, results in no additional amount of U.S. tax liability due for such taxable year.

Proposed §1.905-4(b)(1)(v) provides that, if a foreign tax redetermination (either alone or in combination with certain other foreign tax redeterminations as provided in proposed §1.905-4(b)(1)(iv)) does not result in a change to the amount of U.S. tax due for a taxable year, for reasons including but not limited to a carryover or carryback of unused foreign taxes under section 904(c), no amended return is required for such year. Instead, appropriate adjustments are made to the amounts carried over from that year (for example, unused foreign taxes). If no amended return is required for any year, the taxpayer must attach a statement containing the information described in §1.904-2(f) to the taxpayer's timely filed (with extensions) original return for the taxpayer's taxable year in which the foreign tax redetermination occurs.

2. Foreign tax redeterminations of pass-through entities

The 2007 temporary regulations did not specifically provide guidance for pass-through entities that report creditable foreign taxes to their partners, shareholders, or beneficiaries and subsequently have a foreign tax redetermination with respect to such foreign taxes. The proposed regulations provide rules whereby these entities can satisfy their obligations under section 905(c). Proposed §1.905-4(b)(2) generally provides that a pass-through entity that reports creditable foreign income tax to its partners, shareholders, or beneficiaries, is required to notify the IRS and its partners, shareholders, or beneficiaries if there is a foreign tax redetermination with respect to such foreign income tax. See proposed §1.905-4(c) for the information required to be provided with the notification.

Additionally, in 2015, Congress introduced the centralized audit partnership regime, which requires that certain adjustments be made at the level of the partnership, rather than by partners. <u>See</u> sections 6221 through 6241 (enacted in §1101 of the Bipartisan Budget Act of 2015, Public Law 114-74 ("BBA") and as amended by the Protecting Americans from Tax Hikes Act of 2015, Public Law 114-113, div Q, and by sections 201 through 207 of the Tax Technical Corrections Act of 2018, contained in Title II of Division U of the Consolidated Appropriations Act of 2018, Public Law 115-141). Under this regime, in order to make an adjustment to a partnership-related item (as defined in section 6241(2)), the partnership must file an administrative adjustment request ("AAR"). Sections 6227(d) and 6235(a) contemplate that these rules will be coordinated with the application of section 905(c).

On June 14, 2017, the Treasury Department and the IRS published in the **Federal Register** (82 FR 27334) a notice of proposed rulemaking and on November 30, 2017, the Treasury Department and the IRS published in the **Federal Register** (82 FR 56765) another notice of proposed rulemaking. Each notice of proposed rulemaking requested comments on how a partnership subject to the centralized partnership audit regime should fulfill the requirements of section 905(c). One comment was received with respect to this issue and it recommended that partnerships satisfy their obligations under section 905(c) by filing an AAR under section 6227 and by following the procedures under that section to take necessary adjustments into account. Consistent with this request and with sections 6227(d) and 6235(a), proposed §1.905-4(b)(2)(ii) provides that if a redetermination of U.S. tax liability would require a partnership adjustment as defined in §301.6241-1(a)(6), the partnership must file an AAR under section 6227 without regard to the time restrictions on filing an AAR in section 6227(c). <u>See also</u> §1.6227-1(g).

The use of the AAR process, even if the period under section 6227(c) is closed, is intended to further the purpose of sections 905(c), 6227(d), 6235(a), and 6241(11). An AAR is analogous to an amended return, which is required from other taxpayers who have a foreign tax redetermination, and provides an administrable process whereby a partnership, and its partners, can satisfy their obligations under section 905(c). The Treasury Department and the IRS request comments on any further coordination that may be required between sections 905(c) and 6227 in order to carry out the purposes of the foreign tax credit and the centralized partnership audit regime.

3. Alternative notification requirements

Proposed §1.905-4(b)(3) provides that an amended return and Form 1118 (Foreign Tax Credit--Corporations) or Form 1116 (Foreign Tax Credit), is not required to notify the IRS of a foreign tax redetermination and redetermination of U.S. tax liability if the taxpayer satisfies alternative notification requirements that may be prescribed by the IRS through forms, instructions, publications, or other guidance. For example, as provided in Notice 2016-10, 2016-1 I.R.B. 1, the Treasury Department and the IRS intend to issue regulations providing for alternative notification procedures in the case of tax refunds received by regulated investment companies making the election to pass through foreign tax credits under section 853. The Treasury Department and the IRS request comments on additional alternative approaches to complying with the notification requirements in section 905(c) that minimize burdens to both taxpayers and the IRS.

4. Foreign tax redeterminations of LB&I taxpayers

Section 1.905-4T(b)(3) of the 2007 temporary regulations provides a special rule for U.S. taxpayers under the jurisdiction of the Large and Mid-Size Business Division. The proposed regulations reflect the organization's name change to Large Business and International Division (LB&I).

Under the special rule for U.S. taxpayers under LB&I jurisdiction ("LB&I rule"), such taxpayers are required, in limited circumstances, to provide to their examiners notice of a foreign tax redetermination that requires a redetermination of U.S. tax, in lieu of filing an amended return. One of the threshold requirements of §1.905-4T(b)(3) of the 2007 temporary regulations is that the taxpayer must provide the statement describing the foreign tax redetermination no later than 120 days after the latest of (1) the date the foreign tax redetermination occurs, (2) the opening conference of the examination for the affected taxable year, or (3) the hand-delivery or postmark date of the opening letter concerning the examination. In no case, however, can the alternative notification procedure apply if the 120-day period within which notification must be made would start after the due date of the return for the taxable year in which the foreign tax redetermination occurs.

The LB&I rule contained in the proposed regulations is generally the same as the rule in the 2007 temporary regulations, and the Explanation of Provisions of the 2007 temporary regulations contains an explanation of the rules. However, one change has been made with respect to §1.905-4T(b)(3) of the 2007 temporary regulations. Section 1.905-4T(b)(3) provides that, if that provision applies to permit notification during an audit, in lieu of filing an amended return a taxpayer must provide to the examiner the statement described in §1.905-4T(c) of the 2007 temporary regulations, which contains information that enables the IRS to verify and compare the original computations with respect to a claimed foreign tax credit, the revised computations resulting from the foreign tax redetermination, and the net changes resulting therefrom. In order to satisfy the requirements of §1.905-4T(c), a taxpayer is required to recompute its U.S. tax liability during the course of an examination, rather than only at the conclusion of the audit. To minimize administrative burdens, the statement requirement at proposed §1.905-4(b)(4)(iii) requires the taxpayer to provide to the examiner the original amount of foreign taxes paid or accrued in the year to which the foreign tax redetermination relates, the revised amount of foreign taxes paid or accrued, and documentation with respect to the revisions, including exchange rates and dates of accrual and/or payment. This information must be provided with a penalties-of-perjury declaration signed by a person authorized to sign the return of the taxpayer.

In order to clarify when the special rules for LB&I taxpayers apply, the proposed regulations reorganize certain portions of the 2007 temporary regulations into a list of conditions, all of which must be met in order for §1.905-4(b)(4) to apply. These conditions are as follows: (1) a foreign tax redetermination occurs while the U.S. taxpayer is under the jurisdiction of LB&I (or a successor division); (2) the foreign tax redetermination results in a downward adjustment to the amount of foreign tax paid or accrued, or included in the computation of foreign taxes deemed paid; (3) the foreign tax redetermination requires a redetermination of U.S. tax liability and accordingly, but for §1.905-4(b)(4), the taxpayer would be required to notify the IRS of such foreign tax redetermination under §1.905-4(b)(1)(ii) by filing an amended return; (4) the return for the taxable year for which a redetermination of U.S. tax liability is required is under examination; and (5) the due date specified in §1.905-4(b)(1)(ii) for providing notice of such foreign tax redetermination is not before the latest of the opening conference or the hand-delivery or postmark date of the opening letter concerning the examination of the return for the taxable year for which a redetermination of U.S. tax liability is required by reason of such foreign tax redetermination.

5. Penalty provisions

Section 6689 provides that a taxpayer may be subject to a penalty if it fails to notify the IRS of a foreign tax redetermination on or before the date prescribed by regulations. Section 301.6689-1T(a) (issued in TD 8210 on June 22, 1988) states that the penalty may apply if a taxpayer fails to notify the IRS of a foreign tax redetermination "on or before the date prescribed in regulations." However, the preamble of the 2007 temporary regulations, in describing section 6689, provides that, "Under section 6689, a taxpayer that fails to notify the IRS of a foreign tax redetermination in the time <u>and manner</u> prescribed by regulations for giving such notice is subject to a penalty." (Emphasis added.) Because it is implicit in section 6689 that the required notification must comply with the requirements of section 905(c), the proposed regulations conform to the preamble description in the 2007 temporary regulations. Accordingly, proposed §301.6689-1(a) provides that the penalty may apply if a taxpayer fails to notify the IRS of a foreign tax redetermination "on or before the date and in the manner prescribed in regulations."

The penalty under section 6689 is generally computed by reference to the amount of the deficiency resulting from a foreign tax redetermination. If a partnership fails to timely file an AAR as required under proposed §1.905-4(b)(2)(ii) such that the penalty under section 6689 is applicable there is ambiguity regarding the correct base upon which the penalty is computed because partnerships do not generally have deficiencies in chapter 1 tax. Under the centralized partnership audit regime enacted by the BBA, if an adjustment is made to a partnership-related item of a partnership that is subject to the BBA (either by the IRS or by the partnership upon the filing of an AAR), the default rule is that the partnership is liable for an imputed underpayment calculated on the adjustments, which is an approximate substitute for the amount of chapter 1 tax that would have been owed by its partners. See sections 6221(a) and 6225. The fact that section 6689 is silent as to the proper base for calculating a section 6689 penalty for a partnership that is subject to BBA creates a special enforcement consideration and requires clarification. Therefore, consistent with the principles of section 6233(a)(3) (which treats the imputed underpayment as an understatement or underpayment for purposes of computing a penalty) and the requirement in section 6227(d) that regulations coordinate the application of sections 905(c) and 6227, proposed §301.6689-1 provides that in computing the amount of the penalty imposed under section 6689, the penalty is calculated on a deficiency or by reference to the amount of the imputed underpayment that results from the foreign tax redetermination.

Finally, because section 6662 may apply if a taxpayer's U.S. tax liability is understated on an original return even if section 6689 applies to a failure to notify the IRS of a subsequent foreign tax redetermination, the proposed regulations eliminate the reference in §301.6689-1(b) to section 6653(a) (the predecessor to section 6662).

D. Transition rule relating to the TCJA

The TCJA repealed the pooling rules of section 902 and related provisions of section 905(c) that mandated prospective pooling adjustments to account for redeterminations of foreign taxes paid by foreign corporations that were eligible to be deemed paid by domestic corporate shareholders of the foreign corporations. Proposed §§1.905-3(b)(2)(iv) and 1.905-5 provide a transition rule providing that post-2017 redeterminations of pre-2018 foreign income taxes must be accounted for by adjusting the foreign corporation's taxable income and earnings and profits, post-1986 undistributed earnings, and post-1986 foreign income taxes (or pre-1987 accumulated profits and pre-1987 foreign income taxes, as applicable) in the pre-2018 year to which the redetermined foreign taxes relate. A redetermination of U.S. tax liability is required to account for the effect of the foreign tax redetermination on foreign taxes deemed paid by domestic corporate shareholders of the foreign corporation in the relation-back year and any subsequent pre-2018 year in which the domestic corporate shareholder computed a deemed-paid credit under section 902 or 960 with respect to the foreign corporation, as well as any year to which unused foreign taxes from any such year were carried. The proposed regulations generally apply the currency translation rules applicable under prior law and the notification requirements of proposed §1.904-4 to redeterminations of U.S. tax liability required by proposed §1.905-3(b)(2)(iv) in these circumstances.

The Treasury Department and the IRS request comments on whether an alternative adjustment to account for post-2017 foreign tax redeterminations with respect to pre-2018 taxable years of foreign corporations, such as an adjustment to the foreign corporation's taxable income and earnings and profits, post-1986 undistributed earnings, and post-1986 foreign income taxes as of the foreign corporation's last taxable year beginning before January 1, 2018, may provide for a simplified and reasonably accurate alternative.

IV. Foreign Income Taxes Taken Into Account Under Section 954(b)(4)

As discussed in Part III.A of this Explanation of Provisions, proposed §1.905-3(b)(2) provides that a U.S. tax redetermination is required when a foreign tax redetermination affects whether or not a taxpayer is eligible for the subpart F high-tax exception. Proposed §1.954-1(d)(3)(iii) therefore provides that the subpart F high-tax exception is applied by taking into account the redetermined foreign tax in the adjusted year.

The proposed regulations also include an additional clarification relating to schemes involving jurisdictions that do not impose corporate income tax on a CFC until its earnings are distributed. The Treasury Department and the IRS are aware that certain taxpayers claim that taxes are treated as paid or accrued for purposes of §1.954-1(d)(3) even in the absence of any distribution triggering foreign tax. The IRS may challenge this position under existing law. Furthermore, the proposed regulations clarify that foreign income taxes that have not accrued because they are contingent on a future distribution are not taken into account for purposes of determining the amount of foreign income taxes paid or accrued with respect to an item of income. However, if a redetermination of U.S. tax liability is required under proposed §§1.905-3(a) and 1.905-3(b)(2)(ii) when tax is imposed on the foreign corporation in connection with a distribution, the redetermined foreign tax is taken into account in applying §1.954-1(d)(3) in the adjusted year.

V. Disallowance of Foreign Tax Credits Under Section 965(g)

The Treasury Department and the IRS are aware that certain taxpayers may have engaged in certain transactions that are intended to avoid the disallowance of foreign tax credits under section 965(g) with respect to distributions of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits. For example, certain U.S. shareholders of specified foreign corporations may incur foreign income taxes on distributions recognized for foreign tax purposes that are not recognized for U.S. tax purposes (for example, consent dividends). When the section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits are distributed for U.S. tax purposes, no foreign income tax is imposed by the foreign jurisdiction. The taxpayers may argue that the foreign income taxes on the foreign distributions are not associated with a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits for U.S. tax purposes, and, accordingly, the credit need not be reduced by the section 965(g) disallowance.

Proposed §1.965-5(b)(2) clarifies that the principles of §1.904-6 apply in determining the extent to which foreign income taxes are attributable to distributions of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits for purposes of §1.965-5(b)(1). For example, under the principles of §1.904-6, foreign withholding taxes imposed on an amount that is recognized as a dividend for foreign, but not Federal income, tax purposes are attributable to an item of income to which that amount would be assigned if recognized as a distribution for Federal income tax purposes. To the extent a distribution would be a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits if it were recognized for U.S. tax purposes, under proposed §1.965-5(b)(2) the tax would be associated with section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits and disallowed in part by reason of section 965(g). For foreign corporation taxable years beginning after December 31, 2019, §1.861-20 applies in lieu of §1.904-6.

The IRS may challenge the credits claimed for foreign income taxes imposed on distributions recognized solely for foreign tax purposes in prior years to the extent that such foreign income taxes would be considered imposed on distributions of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits had such distributions been recognized for U.S. tax purposes.

VI. Updates to Consolidated Foreign Tax Credit Rules

Proposed §1.1502-4 includes amendments to regulations under section 1502 relating to the computation of the consolidated foreign tax credit. The proposed amendments update the regulations to reflect changes in the law, such as by eliminating out-of-date references to the per-country limitation. For purposes of determining the foreign tax credit limitation, the proposed regulations also provide that the amount of foreign source income in each separate category, used as the numerator in the foreign tax credit limitation fraction, is determined by applying the rules of §1.1502-11, as well as sections 904(f) and 904(g), on a group-wide basis, rather than applying those rules on a separate member basis and combining the results.

The proposed regulations also add new rules for purposes of determining the source and separate category of a consolidated NOL, as well as the portion of a consolidated net operating loss ("CNOL") that is apportioned to a separate return year of a member. The Treasury Department and the IRS have determined that, when characterizing a CNOL that is apportioned to a separate return year, it is generally appropriate to link the source and separate category of the CNOL with the member's assets that are expected to produce income with that same source and separate category so as to minimize the creation of loss accounts under sections 904(f) and 904(g) in the year in which the CNOL is used. The proposed regulations achieve this result formulaically through a two-step process that generally determines a CNOL's source and separate category by reference to the statutory and residual groupings described in §1.861-8 for purposes of applying section 904 as the operative section, which are foreign source income in each separate category, and the residual grouping, which is U.S. source income.

First, the member determines a tentative apportionment, which is a proportionate share of the amount of the CNOL in each grouping based on a comparison of the value of the member's assets in that grouping to the value of the group's total assets in the grouping. Because the total of tentative apportionments of the CNOL does not necessarily equal the member's total share of the CNOL, an adjustment is provided. If the total tentative apportionments exceed the CNOL attributable to the member, the tentative apportionment in each grouping is reduced by a pro rata share of the excess, in proportion to the amount of the tentative apportionment in that grouping over the total tentative apportionments. In contrast, if the total tentative apportionments are less than the CNOL attributable to the member, the tentative apportionment in each grouping is increased by a pro rata share of that deficiency, in proportion to the remaining CNOL in that grouping (after subtracting the tentative apportionment) over the total remaining CNOL in all groupings.

VII. Applicability Dates

The rules in proposed §§1.861-8, 1.861-9, 1.861-12, 1.861-14, 1.904-4(c)(7) and (8), 1.904(b)-3, 1.954-1, and 1.954-2, generally apply to taxable years that end on or after [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**].

The rules in proposed §§1.704-1(b)(4)(viii)(d)(1), 1.861-17, 1.861-20, 1.904-6, and 1.960-1 apply to taxable years beginning after December 31, 2019. However, taxpayers that are on the sales method for taxable years beginning after December 31, 2017, and before January 1, 2020, may rely on proposed §1.861-17 if they apply it consistently. Therefore, a taxpayer on the sales method for its taxable year beginning in 2018 may rely on proposed §1.861-17 but must also apply the sales method (relying on proposed §1.861-17) for its taxable year beginning in 2019.

Proposed §§1.904-4(e) and 1.904(g)-3 apply to taxable years ending on or after the date the final regulations are filed with the **Federal Register**.

In general, proposed §§1.905-3, 1.905-4, 1.905-5, and 301.6689-1 apply to foreign tax redeterminations (as defined in §1.905-3(a)) occurring in taxable years ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER],** and to foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a U.S. shareholder ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]**. In the case of foreign tax redeterminations of foreign corporations, proposed §1.905-3 is limited to foreign tax redeterminations that relate to taxable years of foreign corporations beginning after December 31, 2017, and proposed §1.905-5 is limited to foreign tax redeterminations that relate to taxable years of foreign corporations beginning before January 1, 2018.

Proposed §1.965-5(b)(2) applies to taxable years of foreign corporations that end on or after [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**], and with respect to a United States person, to the taxable years in which or with which such taxable years of the foreign corporations end.

Proposed §1.1502-4 applies to taxable years for which the original consolidated Federal income tax return is due (without extensions) after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Special Analyses

I. Regulatory Planning and Review

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. The Executive Order 13771 designation for any final rule resulting from these proposed regulations will be informed by comments received.

The proposed regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. The Office of Information and Regulatory Affairs (OIRA) has designated these proposed regulations as significant under section 1(b) of the MOA. Accordingly, these proposed regulations have been reviewed by OIRA.

A. Background and need for the proposed regulations

Before the Tax Cuts and Jobs Act (TCJA), the United States taxed its citizens, residents, and domestic corporations on their worldwide income. However, to the extent that a foreign jurisdiction and the United States taxed the same income, this framework could have resulted in double taxation. The U.S. foreign tax credit (FTC) regime alleviated potential double taxation by allowing a non-refundable credit for foreign income taxes paid or accrued that could be applied to reduce the U.S. tax on foreign source income. Although TCJA eliminated the U.S. tax on some foreign source income, the United States continues to tax other foreign source income, and to provide foreign tax credits against this U.S. tax. The changes made by TCJA to international taxation necessitate certain changes in this FTC regime.

The FTC calculation operates by defining different categories of foreign source income (a "separate category") based on the type of income.[3] Foreign taxes paid or accrued as well as deductions for expenses borne by U.S. parents and domestic affiliates that support foreign operations are also allocated to the separate categories under similar principles. The taxpayer can then use foreign tax credits allocated to each category against the U.S. tax owed on income in that category. This approach means that taxpayers who pay foreign taxes on income in one category cannot claim a credit against U.S. taxes owed on income in a different category, an important feature of the FTC regime. For example, suppose a domestic corporate taxpayer has $100 of active foreign source income in the "general category" and $100 of passive foreign source

[3] Prior to the TCJA, these categories were primarily the passive income and general income categories. The TCJA added new separate categories for global intangible low-taxed income (the section 951A category) and foreign branch income.

income, such as interest income, in the “passive category.” It also has $50 of foreign taxes associated with the “general category” income and $0 of foreign taxes associated with the “passive category” income. The allowable FTC is determined separately for the two categories. Therefore, none of the $50 of “general category” FTCs can be used to offset U.S. tax on the “passive category” income. This taxpayer has a pre-FTC U.S. tax liability of $42 (21 percent of $200) but can claim a FTC for only $21 (21 percent of $100) of this liability, which is the U.S. tax owed with respect to active foreign source income in the general category. The $21 represents what is known as the taxpayer’s foreign tax credit limitation. The taxpayer may carry the remaining $29 of foreign taxes ($50 minus $21) back to the prior taxable year and then forward for up to 10 years (until used), and is allowed a credit against U.S. tax on general category foreign source income in the carryover year, subject to certain restrictions.

The proposed regulations are needed to address changes introduced by the TCJA and to respond to outstanding issues raised in comments to the 2018 FTC proposed regulations. In particular, the comments highlighted the following areas of concern: (a) uncertainty concerning appropriate allocation of R&E expenditures across FTC categories, (b) the need to treat loans from partnerships to partners the same as loans from partners to partnerships with respect to aligning interest income to interest expense, and (c) uncertainty regarding the appropriate level of aggregation (affiliated group versus subgroup) at which expenses of insurance companies should be allocated to foreign source income. In addition, the proposed regulations are needed to expand the application of section 905(c) to cases where a foreign tax redetermination changes a taxpayer’s eligibility for the high-taxed exception under subpart F and GILTI.

B. Overview of the proposed regulations

These proposed regulations address the following issues: (1) the allocation and apportionment of deductions under sections 861 through 865, including new rules on the allocation and apportionment of research and experimentation (R&E) expenditures and certain deductions of life insurance companies; (2) the definition of financial services income under section 904(d)(2)(D); (3) the allocation of foreign income taxes to the foreign income to which such taxes relate; (4) the interaction of the branch loss and dual consolidated loss recapture rules with sections 904(f) and (g); (5) the effect of foreign tax redeterminations of foreign corporations on the application of the high-tax exception described in section 954(b)(4) (including for purposes of determining tested income under section 951A(c)(2)(A)(i)(III)), and required notifications under section 905(c) to the IRS of foreign tax redeterminations and related penalty provisions; (6) the definition of foreign personal holding company income under section 954; (7) the application of the foreign tax credit disallowance under section 965(g); and (8) the application of the foreign tax credit limitation to consolidated groups.

C. Economic analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of these proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these regulations.

2. Summary of economic effects

The proposed regulations provide certainty and clarity to taxpayers regarding the allocation of income, expenses, and foreign income taxes to the separate categories. In the absence of the enhanced specificity provided by these regulations, similarly situated taxpayers might interpret the foreign tax credit provisions of the tax code differently, potentially resulting in inefficient patterns of economic activity. For example, in the absence of the proposed regulations, one taxpayer might have chosen not to undertake research (that is, incur R&E expenses) in a particular location, based on that taxpayer's interpretation of the tax consequences of such expenditures, that another taxpayer, making a different interpretation of the tax treatment of R&E, might have chosen to pursue in that same location. If this difference in interpretations confers a competitive advantage on the less productive enterprise, U.S. economic performance may suffer. The guidance provided in these regulations helps to ensure that taxpayers face more uniform incentives when making economic decisions. In general, economic performance is enhanced when businesses face more uniform signals about tax treatment.

Because the TCJA is new, the Treasury Department and the IRS do not know with reasonable precision the tax interpretations that taxpayers might make in the absence of this guidance. To the extent that taxpayers would generally have interpreted the foreign tax credit rules as being less favorable to the taxpayer than the proposed regulations provide, the proposed regulations may result in additional international activity by these taxpayers relative to the no-action baseline. This additional activity may include both activities that are beneficial to the U.S. economy (perhaps because they represent enhanced international opportunities for businesses with U.S. owners) and activities that are not beneficial (perhaps because they are accompanied by reduced activity in the United States). In essence, the Treasury

Department and the IRS recognize that additional foreign economic activity by U.S. taxpayers may be a complement or substitute to activity within the United States and that to the extent these regulations change this activity (relative to the no-action baseline or alternative regulatory approaches), a mix of results may occur.

The Treasury Department and the IRS have not undertaken quantitative estimates of the economic effects of these regulations. The Treasury Department and the IRS do not have readily available data or models to estimate with reasonable precision (i) the tax stances that taxpayers would likely take in the absence of the proposed regulations or under alternative regulatory approaches; (ii) the difference in business decisions that taxpayers might make between the proposed regulations and the no-action baseline or alternative regulatory approaches; or (iii) how this difference in those business decisions will affect measures of U.S. economic performance.

In the absence of such quantitative estimates, the Treasury Department and the IRS have undertaken a qualitative analysis of the economic effects of the proposed regulations relative to the no-action baseline and relative to alternative regulatory approaches. This analysis is presented in part I.C.3 of these Special Analyses.

3. Economic effects of specific provisions

i. Rules for allocating R&E expenditures under the sales method

a. Background

Under long-standing foreign tax credit rules, taxpayers must allocate expenditures to income categories. In the case of research and experimentation (R&E)

expenditures, taxpayers can elect between a “sales method” and a “gross income method” to allocate the R&E expenses.[4]

The TCJA created some uncertainty regarding the application of the sales method because of the introduction of the section 951A category. In particular, comments raised issues regarding whether any R&E expenditures should be allocated to the section 951A category. The fact that sales by CFCs generate tested income and tested income is generally assigned to the section 951A category might imply that R&E expenditures should be allocated to the section 951A category. But the fact that royalty payments from the CFC to the U.S. taxpayer (e.g., in remuneration for IP held by the parent that is licensed to the CFC to create the products that are sold) are in the general category implies that R&E expenditures should be allocated to the general category.

The gross income method is based on a different apportionment factor (gross income) as compared to the sales method (gross receipts). However, the gross income method is subject to certain conditions that require the result to be within a certain band around the result under the sales method, because historically the Treasury Department and the IRS have considered that the gross income method could lead to anomalous results and could be more easily manipulated than the sales method.[5] The uncertainty with respect to R&E expense allocation under the sales method needed resolution, and

[4] If the taxpayer chooses the gross income method, 25 percent of the R&E expenditures are exclusively apportioned to the source where more than 50 percent of the taxpayer’s R&E activities occur (generally the United States), and the other 75 percent is apportioned ratably. If a taxpayer chooses the sales method then 50 percent of the R&E expenditures are exclusively apportioned on the same basis, and the other 50 percent is apportioned ratably.

[5] The gross income method is more susceptible to manipulation because taxpayers can manage the type and amount of their foreign gross income by, for example, not paying a dividend and because presuming a factual relationship between the R&E expenditure and the related class of income based on the relative amounts of a taxpayer’s gross income was more attenuated than a factual relationship based on sales.

because the gross income method is tied to the sales method, any changes to the sales method required consideration of the gross income method.

b. Options considered for the proposed regulations

The Treasury Department and the IRS considered three options with respect to the allocation of R&E expenditures to the section 951A category for purposes of calculating the FTC limitation. The first option was to confirm that R&E expenditures are allocated to the section 951A category under the sales method and to otherwise leave their treatment under the gross income method unchanged. The second option was to revise the sales method to provide that R&E expenditures are only allocated to the income that represents the taxpayer's return on intellectual property (thus, R&E expenditures could not be allocated to income from the taxpayer's CFC sales) and otherwise leave their treatment under the gross income method unchanged. The third option was to revise the sales method as considered in the second option and eliminate the gross income method for purposes of allocating R&E expenditures.

The proposed regulations adopt the last option. This option allows for the provision of an allocation and apportionment method for R&E expenditures that generally matches the expense reasonably with the income it generates. The matching of income and expenses generally produces a more efficient tax system contingent on the overall Code. Additionally, because this option results in no R&E expense being allocated to section 951A category income, it does not incentivize taxpayers with excess credits in the section 951A category to perform R&E through foreign subsidiaries; instead, the chosen option generally incentivizes choosing the location of R&E based on economic considerations rather than tax-related reasons, contingent on the overall

Code. Finally, because the proposed regulations adopt the principle of allocating and apportioning R&E expenditures to IP-related income of the U.S. taxpayer, the gross income method is no longer relevant, because it allocates and apportions R&E expenditures to the section 951A category, and section 951A category gross income is not IP income to the U.S. taxpayer.

c. Number of affected taxpayers

The Treasury Department and the IRS have determined that the population of affected taxpayers consists of any U.S. taxpayer with R&E expenditures and foreign operations. There are around 2,500 such taxpayers in currently available tax filings from taxable years 2015 - 2017. Based on Statistics of Income data for 2014, approximately $40 billion of R&E expenses of such taxpayers were allocated to foreign source income, out of a total of $190 billion in qualified research expenses reported by such taxpayers in that year.[6]

ii. Application of section 905(c) to changes affecting the high-tax exception

a. Background

Section 905(c) provides special rules for a foreign tax redetermination (FTR), which is when the amount of foreign tax paid in an earlier year (origin year) is changed in a later year (FTR year). This redetermination may be necessary, for example, because the taxpayer gets a refund or because a foreign audit determines that the taxpayer owes additional foreign tax. Since these additional taxes (or refunds) relate to the origin year, an FTR affects a taxpayer's origin year tax position (as well as FTC carryovers from that year).

[6] Note, however, that these taxpayers might have additional R&E expenses which are not qualified R&E expenses. The tax data do not separately identify such expenses.

Prior to TCJA, FTRs of foreign corporations generally resulted in prospective "pooling adjustments" to foreign tax credits. Under this approach, taxpayers simply added to or reduced the amount of foreign taxes in their foreign subsidiary's FTC "pool" going forward rather than amend the deemed paid taxes claimed on their origin year return. TCJA eliminated the pooling mechanism for taxes (because the adoption of a participation exemption system along with the elimination of deferral made it unnecessary) and replaced it with a system where taxes are deemed paid each year with an inclusion or distribution of previously taxed earnings and profits ("PTEP").

The 2019 FTC final regulations make clear that an FTR of a United States taxpayer must always be accounted for in the origin year, and that the taxpayer must file an amended return reflecting any resulting change in the taxpayer's U.S. tax liability. Section 905(c) provides tools to enforce this amended return requirement. It suspends the statute of limitations with respect to the assessment of any additional U.S. tax liability that results from an FTR , and imposes a civil penalty on taxpayers who fail to notify the IRS (through an amended return) of a FTR. To reflect the repeal of the pooling mechanism, the proposed regulations generally require taxpayers to account for FTRs of foreign subsidiaries on an amended return that reflects revised foreign taxes deemed paid under section 960 and any resulting change in the taxpayer's U.S. tax liability. However, the 2019 FTC final regulations require U.S. tax redeterminations only by reason of FTRs that affect the amount of foreign tax credit taxpayers claimed in the origin year. The rules do not apply to other tax effects, such as when the FTR changes the amount of earnings and profits the taxpayer's CFC had in the origin year, or affects whether or not the CFC's income qualifies for the high-tax exception under GILTI or subpart F.

The interaction of FTRs and the high-tax exception under GILTI and subpart F increases the importance of filing an origin year amended return. In particular, FTRs can give rise to inaccurate origin year U.S. liability calculations in the absence of an amended return precisely because they can change taxpayers' eligibility for the high-tax exception. Therefore, the proposed regulations provide that the section 905(c) rules cover situations in which the FTR affects not only the amount of FTCs taxpayers claimed in the origin year, but also whether or not their CFC's income qualified for the high-tax exception.

b. Options considered for the proposed regulations

The Treasury Department and the IRS considered two options for expanding section 905(c) to cover the high-tax exception. The first option was to limit section 905(c) to changes in the amount of FTCs. The second option was to provide that section 905(c) applies in connection with the high-tax exceptions under GILTI and subpart F.

The proposed regulations adopt the second option. The first option would lead to frequent occurrences of inaccurate results with respect to the GILTI and subpart F high-tax exceptions because it is common for foreign audits to change the amount of tax paid in a prior year. Furthermore, taxpayers would have an incentive to overpay their CFC's foreign tax in the origin year, claim the high-tax exception to avoid subpart F or GILTI inclusions, wait for the 3 year statute of limitations to pass, and then claim a foreign tax refund with the foreign authorities. Without section 905(c) applying, taxpayers would have no obligation or threat of penalty for not amending the origin year return. Although there are FTC regulations that deny a credit if taxpayers make a noncompulsory payment of tax (i.e., taxpayers paid more foreign tax than is necessary under foreign law), those rules are challenging to administer. While taxpayers have the burden to prove that they were legally required to pay the tax, the IRS may need to engage foreign tax law experts to establish that the taxpayer could have successfully fought paying it.

The second option provides a more accurate tax calculation than the first option, and it is instrumental in avoiding abuse. The increased number of amended returns will increase compliance costs for taxpayers, but the Treasury Department and the IRS consider that, in light of the high-tax exception, accurate origin year tax liability calculations necessitate these increased costs; however, the Treasury Department and the IRS solicit comments on this issue.

c. Number of affected taxpayers

The Treasury Department and the IRS determined that the proposed regulations potentially affect those U.S. taxpayers that pay foreign taxes and have a redetermination of that tax. Although data reporting the number of taxpayers subject to an FTR in a given year do not exist, some taxpayers currently subject to FTRs will file amended returns. The Treasury Department and the IRS estimate that there are approximately 300 to 600 U.S. companies with foreign affiliates that file amended returns per year. However, the expansion of the section 905(c) requirement to file an amended return to instances where a FTR changes eligibility for the high-tax exception under GILTI or subpart F has the potential to significantly increase the number of taxpayers filing amended returns. The Treasury Department and the IRS have determined that a high upper bound for the number of taxpayers subject to a FTR that will be required to file amended returns (i.e., taxpayers affected by this provision) can be derived by estimating the number of taxpayers with a potential GILTI or subpart F inclusion. Based on currently available tax filings for taxable years 2015 and 2016, there were about 15,000 C corporations with CFCs that filed at least one Form 5471 with their Form 1120 return. In addition, for the same period, there were about 30,000 individuals with CFCs that e-filed at least one Form 5471 with their Form 1040 return. In 2015 and 2016, there were about 3,000 S corporations with CFCs that filed at least one Form 5471 with their 1120S return. The identified S corporations had an estimated 150,000 shareholders, as an upper bound. Finally, the Treasury Department and the IRS estimate that there were approximately 7,000 U.S. partnerships with CFCs that e-filed at least one Form 5471 as Category 4 or 5 filers in 2015 and 2016. The identified partnerships had approximately 2 million partners, as indicated by the number of Schedules K-1 filed by the partnerships. This number includes both domestic and foreign partners, so it substantially overstates the number of partners that would actually be affected by the final regulations because it includes foreign partners.

iii. Extension of the partnership loan rule to loans from the partner to the partnership

a. Background

The 2019 FTC final regulations provide a rule that aligns interest income and expense when a U.S. partner makes a loan to the partnership. Under this matching rule, the partner’s gross interest income is apportioned between U.S. and foreign sources in each separate category based on the partner’s interest expense apportionment ratios. This rule minimizes the artificial increase in foreign source taxable income based solely on offsetting amounts of interest income and expense from a related party loan to a partnership. Comments in response to the 2018 FTC proposed regulations requested an equivalent rule when the partnership makes a loan to a U.S. partner.

b. Options considered for the proposed regulations:

The Treasury Department and the IRS considered two options with respect to this rule. The first option was to not provide a rule, because the abuse the Treasury Department and the IRS were concerned about was not relevant with respect to loans from the partnership to the partner. In the absence of a matching rule, the U.S. partner's U.S. source taxable income would be artificially increased but this income is not eligible to be sheltered by FTCs. The second option was to provide an identical rule for loans from the partnership to the partner as was provided in the 2019 FTC final regulations for loans from the partner to the partnership. The proposed regulations adopt the second option. This symmetry helps to ensure that similar economic transactions are treated similarly.

c. Number of affected taxpayers

The Treasury Department and the IRS consider the population of affected taxpayers to consist of any U.S. partner in a partnership which has a loan from the partnership to the partner or certain other parties related to the partner. The Treasury Department and the IRS estimate that there are approximately 450 partnerships and 5,000 partners that would be affected by this regulation.

iv. Allocation and apportionment of expenses for insurance companies

a. Background

Section 818(f) provides that for purposes of applying the expense allocation rules to life insurance companies, the deduction for policyholder dividends, reserve adjustments, death benefits, and certain other amounts are treated as items that cannot be definitely allocated to an item or class of gross income. That means, in general, that the expenses are apportioned ratably across all gross income.

Under the expense allocation rules, for most purposes, affiliated groups are treated as a single entity, although there are exceptions for certain expenses. The statute is unclear, however, about how affiliated groups are to be treated with respect to the allocation of certain expenses for insurance companies. Depending on the approach, the results could be different because the gross income categories across the affiliated group could be calculated in multiple ways. The Treasury Department and the IRS received comments and are aware that in the absence of further guidance taxpayers are likely to take opposite positions on this treatment. Some taxpayers argue that the expenses described in section 818(f) are apportioned based on the gross income of the entire affiliated group, while others argue that expenses are apportioned on a separate company or subgroup basis taking into account only the gross income of life insurance companies.

b. Options considered for the proposed regulations

The Treasury Department and the IRS are aware of at least five potential methods for allocating section 818(f) expenses in a life-nonlife consolidated group. First, the expenses might be allocated solely among items of the life insurance company that has the reserves ("separate entity method"). Second, to the extent the life insurance company has engaged in a reinsurance arrangement that constitutes an intercompany transaction (as defined in §1.1502-13(b)(1)), the expenses might be allocated in a manner that achieves single entity treatment between the ceding member and the assuming member ("limited single entity method"). Third, the expenses might be allocated among items of all life insurance members ("life subgroup method"). Fourth, the expenses might be allocated among items of all members of the consolidated group (including both life and non-life members) ("single entity method"). Fifth, the expenses might be allocated based on a facts and circumstances analysis ("facts and circumstances method").

In response to the request for comments in the 2018 FTC proposed regulations, the Treasury Department and the IRS received comments advocating for certain of the aforementioned allocation methods. The proposed regulations adopt the separate entity method because it is consistent with section 818(f) and with the separate entity treatment of reserves under §1.1502-13(e)(2). The Treasury Department and the IRS recognize, however, that this method may create opportunities for consolidated groups to use intercompany transactions to shift their section 818(f) expenses and achieve a more desirable foreign tax credit result. Accordingly, the Treasury Department and the IRS request comments on whether a life subgroup method more accurately reflects the relationship between section 818(f) expenses and the income producing activities of the life subgroup as a whole, and whether the life subgroup method is less susceptible to abuse because it might prevent a consolidated group from inflating its foreign tax credit limitation through intercompany transfers of assets, reinsurance transactions, or transfers of section 818(f) expenses. The Treasury Department and the IRS also request comments regarding the appropriate application of §1.1502-13(c) to neutralize the ancillary effects of separate-entity computation of insurance reserves, such as the computation of limitations under section 904.

c. Number of affected taxpayers

The Treasury Department and the IRS have determined that the population of affected taxpayers consists of life insurance companies that are members of an affiliated group. The Treasury Department and the IRS have established that there are approximately 60 such taxpayers.

II. Paperwork Reduction Act

For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) ("PRA"), there is a collection of information in proposed §§1.905-4 and 1.905-5(b). When a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination (FTR), the proposed regulations generally require the taxpayer to notify the IRS of the FTR and provide certain information necessary to redetermine the U.S. tax due for the year or years affected by the FTR. If there is no change in the U.S. tax liability as a result of the FTR or if the FTR is caused by certain de minimis fluctuations in foreign currency rates, the taxpayer may simply attach the notification to their next filed tax return and make any appropriate adjustments in that year. However, taxpayers are generally required to file an amended return (or an administrative adjustment request in the case of certain partnerships) for the year or years affected by the FTR along with an updated Form 1116 Foreign Tax Credit (Individual, Estate, or Trust) (covered under OMB Control Number 1545-0074 individual, or 1545-0121 estate and trust) or Form 1118 Foreign Tax Credit-Corporations (OMB Control Number 1545-0123), and a written statement providing specific information relating to the FTR. Since the burden for filing amended income tax returns and the Forms 1116 and 1118 are covered under the OMB Control Numbers listed in the prior sentence, the burden estimates for OMB Control Number 1545-1056 only cover the burden for the written statements.

For purposes of the PRA, the reporting burden associated with proposed §§1.905-4 and 1.905-5(b) will be reflected in the PRA submission associated with OMB control number 1545-1056, which is set to expire on December 31, 2020. The number of respondents to this collection was estimated at 13,000 and the total estimated burden time was estimated to be 54,000 hours and total estimated monetized costs of $2,430,540 ($2016).

For taxpayers who are required to file an amended return (along with related Form 1116 or Form 1118) in order to report an FTR, and for purposes of the PRA, the reporting burden for filing the amended return will be reflected in OMB control numbers 1545-0123 (relating to business filers, which represents a total estimated burden time, including all related forms and schedules, of 3.157 billion hours and total estimated monetized costs of $58.148 billion ($2017)), 1545-0074 (relating to individual filers, which represents a total estimated burden time, including all related forms and schedules, of 1.784 billion hours and total estimated monetized costs of $31.764 billion ($2017)), and 1545-0121 (relating to estate and trust filers, which represents a total estimated burden time, including all related forms and schedules, of 25,066,693 hours). These overall burden estimates for OMB control numbers 1545-0123, 1545-0074, and 1545-0121 include, but do not isolate, the estimated burden of the foreign tax credit-related forms as a result of the information collection in the proposed regulations.

These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by the proposed regulations. These burdens have also been reported for other regulations related to the taxation of cross-border income and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burden that international tax provisions imposed prior to the TCJA.

As a result of the changes made in the TCJA to the foreign tax credit rules generally, and to section 905(c) specifically, the Treasury Department and the IRS anticipate that the number of respondents may increase modestly among taxpayers who file Form 1120 series returns. The possible increase in the number of respondents is due to the elimination of adjustments to pools of post-1986 earnings and profits and post-1986 foreign income taxes as an alternative to filing an amended return following the changes made in the TCJA. These changes to the burden estimate will be reflected in the PRA submission for the renewal of OMB control number 1545-1056 as well as in the OMB control numbers1545-0074 (for individuals) and 1545-0123 (for business taxpayers).

The estimates for the number of impacted filers with respect to the collections of information described in this Part II of the Special Analyses are based on filers of income tax returns that file a Form 1065, Form 1040, or Form 1120 series because only filers of these forms are generally subject to the collection of information requirement. The IRS estimates the number of impacted filers to be the following:

Tax Forms Impacted		
Collection of Information	Number of respondents (estimated)	Forms to which the information may be

		attached
§1.905-4	8,900 - 11,700	Form 1065 series, Form 1040 series, and Form 1120 series
§1.905-5(b)	8,900 11,700	Form 1065 series, Form 1040 series, and Form 1120 series

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to these proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described in this Part II of the Special Analyses and ways for the IRS to minimize the paperwork burden. No burden estimates specific to the proposed regulations are currently available. The Treasury Department has not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. Those estimates would capture both changes made by the TCJA and those that arise out of discretionary authority exercised in the proposed regulations. The Treasury Department and the IRS welcome comments on all aspects of information collection burdens related to the foreign tax credit. In addition, when available, drafts of IRS forms are posted for comment at https://apps.irs.gov/app/picklist/list/draftTaxForms.htm.

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the proposed regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act.

The proposed regulations provide guidance needed to comply with statutory changes and affect individuals and corporations claiming foreign tax credits. The domestic small business entities that are subject to the foreign tax credit rules in the Code and in the proposed regulations are generally those domestic small business entities that are at least 10 percent corporate shareholders of foreign corporations, and so are eligible to claim dividends-received deductions or compute foreign taxes deemed paid under section 960 with respect to inclusions under subpart F and section 951A from CFCs. Other aspects of these proposed regulations also affect domestic small business entities that operate in foreign jurisdictions or that have income from sources outside of the United States. Based on 2017 Statistics of Income data, the Treasury Department and the IRS computed the fraction of taxpayers owning a CFC by gross receipts size class. The smaller size classes have a relatively small fraction of taxpayers that own CFCs, which suggests that many domestic small business entities would be unaffected by these regulations.

Many of the important aspects of the proposed regulations, including all of the rules in proposed §§1.861-8(d)(2)(ii)(B), 1.904-4(c)(7), 1.904-6(f), 1.905-3(b)(2), 1.905-5, 1.954-1, 1.954-2, and 1.965-5(b)(2) apply only to U.S. persons that operate a foreign business in corporate form, and, in most cases, only if the foreign corporation is a CFC. Because it takes significant resources and investment for a business to operate outside of the United States in corporate form, and in particular to own a CFC, the owners of such businesses will infrequently be domestic small business entities, as indicated by the Table. Other provisions in the proposed regulations, including the rules in proposed §§1.861-8(d)(2)(v), 1.861-8(e)(16), 1.861-14, 1.904-4(e), 1.1502-4, and 1.1502-21, generally apply only to members of a consolidated group and insurance companies or other members of the financial services industry earning income from sources outside of the United States. It is infrequent for domestic small entities to operate as part of an affiliated group, to be taxed as an insurance company, or to constitute a financial services entity, and also earn income from sources outside of the United States. Consequently, the Treasury Department and the IRS project that the proposed regulations are unlikely to affect a substantial number of domestic small business entities, however adequate data are not available at this time to certify that a substantial number of small entities would be unaffected.

Fraction of U.S. Corporate Taxpayers reporting CFC Ownership, by Gross Receipts Size Class

Gross Receipts Size Class	Percentage with a CFC
<1 mil	0.40%
1-5 mil	0.80%
5-10 mil	2.70%
10-20 mil	4.50%
20-30 mil	9.30%
30-50 mil	12.00%
50-100 mil	19.70%
100-150 mil	26.80%
150-200 mil	32.50%
200-250 mil	37.40%
250-500 mil	43.70%
>=500 mil	63.50%

*Data based on 2017 Statistics of Income sample for all 1120 returns except 1120-S and return type=2 (1120-L, 1120-RIC, 1120-F, 1120-REIT, 1120-PC,1120, 1120-L Consolidated 1504c return (controlling industries 524142 and 524143),1120-PC Consolidated 1504C return (controlling industries 524156, 524159), and 1120 Section 594/1504c consolidated return (controlling industries not 524142, 524143, 524156, 524159), 1120 Non-consolidated return).

The Treasury Department and the IRS have determined that the proposed regulations will not have a significant economic impact on domestic small business entities. Based on published information from 2013, foreign tax credits as a percentage of three different tax-related measures of annual receipts (see Table for variables) by corporations are substantially less than the 3 to 5 percent threshold for significant economic impact. The amount of foreign tax credits in 2013 is an upper bound on the change in foreign tax credits resulting from the proposed regulations.

Size (by Business Receipts)	under $500,000	$500,000 under $1,000,000	$1,000,000 under $5,000,000	$5,000,000 under $10,000,000	$10,000,000 under $50,000,000	$50,000,000 under $100,000,000	$100,000,000 under $250,000,000	$250,000,000 or more
FTC/Total Receipts	0.03%	0.00%	0.00%	0.01%	0.01%	0.03%	0.09%	0.56%
FTC/(Total Receipts-Total Deductions)	0.48%	0.03%	0.04%	0.26%	0.22%	0.51%	1.20%	9.00%
FTC/Business Receipts	0.05%	0.00%	0.00%	0.01%	0.01%	0.04%	0.10%	0.64%

Source: Statistics of Income (2013) Form 1120 available at https://www.irs.gov/statistics

Although proposed §1.905-4 contains a collection of information requirement, the small businesses that are subject to the requirements of proposed §1.905-4 are domestic small entities with significant foreign operations. The data to assess precise counts of small entities affected by proposed §1.905-4 are not readily available, but, as the data above suggest, a significant number of small entities are not likely to have significant foreign operations. Further, as demonstrated in the second table in this Part III, foreign tax credits do not have a significant economic impact for small business entities. Therefore, the Treasury Department and the IRS have determined that a substantial number of domestic small business entities will not be subject to proposed §1.905-4. Moreover, as discussed in this Part III, the proposed regulations do not have a significant economic impact on small entities. Accordingly, it is hereby certified that the requirements of proposed §1.905-4 will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. The Treasury Department and the IRS also request comments from the public on the certifications in this Part III.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2019, that threshold is approximately $154 million. This proposed rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Request for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “Addresses” heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. Additionally, the Treasury Department and the IRS have specifically requested comments in the following parts of the Explanation of Provisions: I.A.1 (various aspects of stewardship expense including definition and exceptions), I.A.5 (future implementation of section 864(f) and potential capitalization of certain expenses solely for purposes of §1.861-9), I.D (life subgroup method), I.E.1 (different classification methods for R&E expenditures), I.E.3 (contract research arrangements), II.A (additional guidance under sections 954(h) and 952(c)(1)(B)(vi) with respect to financial services entities), II.B (the treatment of foreign tax on base differences and on income that is recognized by a different person for U.S. tax purposes, the interaction of proposed §1.904-6(f) with sections 245A(g) and 909, and the allocation and apportionment of certain state and foreign income taxes), III.B (foreign tax redeterminations and predecessor or successor entities), III.C.1 (alternative notification requirements under section 905(c)), III.C.2 (coordination between sections 905(c) and 6227), and III.D (alternative adjustments for post-2017 foreign tax redeterminations with respect to pre-2018 taxable years of foreign corporations).

All comments will be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of the proposed regulations are Karen J. Cate, Jeffrey P. Cowan, Jeffrey L. Parry, Larry R. Pounders, and Suzanne M. Walsh of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entries for §1.861-14 and adding entries for §§1.905-4 and 1.905-4(b)(2)(ii) to read in part as follows:

Authority: 26 U.S.C. 7805.

* * * * *

Section 1.861-14 also issued under 26 U.S.C. 864(e)(7).

* * * * *

Section 1.905-4 also issued under 26 U.S.C. 989(c)(4) and 26 U.S.C. 6689(a).

Section 1.905-4(b)(2)(ii) also issued under 26 U.S.C. 6227(d) and 26 U.S.C. 6241(11).

* * * * *

Par 2. Section 1.704-1 is amended by

1. Revising the fourth sentence and adding a new fifth sentence in paragraph (b)(1)(ii)(b)(1).

2. Revising paragraph (b)(4)(viii)(d)(1).

The revisions read as follows:

§1.704-1 Partner's distributive share

* * * * *

(b) * * *

(1) * * *

(ii) * * *

(b) * * *

(1) * * * Except as provided in the next sentence, the provisions of paragraphs (b)(4)(viii)(a)(1), (b)(4)(viii)(c)(1), (b)(4)(viii)(c)(2)(ii) and (iii), (b)(4)(viii)(c)(3) and (4), (b)(4)(viii)(d)(1) (as in effect on July 24, 2019), and Examples 1, 2, and 3 in paragraphs (b)(6)(i), (ii), and (iii) of this section apply for partnership taxable years that both begin on or after January 1, 2016, and end after February 4, 2016. For partnership taxable years beginning after December 31, 2019, paragraph (b)(4)(viii)(d)(1) of this section applies. * * *

* * * * *

(4) * * *

(viii) * * *

(d) * * * (1) In general. CFTEs are allocated and apportioned to CFTE categories in accordance with §1.861-20 by treating each CFTE category as a statutory grouping (with no residual grouping). See Examples 2 and 3 in paragraphs (b)(6)(ii) and (iii) of this section, which illustrate the application of this paragraph in the case of serial disregarded payments subject to withholding tax. In addition, if as described in §1.861-20(e), foreign law does not provide for the direct allocation or apportionment of expenses, losses or other deductions allowed under foreign law to a CFTE category of income, then such expenses, losses or other deductions must be allocated and apportioned to gross income as determined under foreign law in a manner that is consistent with the allocation and apportionment of such items for purposes of determining the net income in the CFTE categories for Federal income tax purposes pursuant to paragraph (b)(4)(viii)(c)(3) of this section.

* * * * *

Par. 3. Section 1.861-8 is amended by:

1. Adding a sentence to the end of paragraph (a)(1).

2. Revising paragraph (d)(2)(ii)(B).

3. Adding paragraph (d)(2)(v).

4. Revising paragraph (e)(4)(ii).

5. Revising the heading of paragraph (e)(5) and adding five sentences to the end of paragraph (e)(5).

6. Revising the first sentence of paragraph (e)(6)(i).

7. Revising paragraphs (e)(7) and (8).

8. Adding paragraph (e)(16).

9. Revising paragraphs (g)(1) through (g)(18) and (h).

The additions and revisions read as follows:

§1.861-8 Computation of taxable income from sources within the United States and from other sources and activities.

(a) * * * (1) * * * The term "section 861 regulations" means this section, §§1.861-8T, 1.861-9, 1.861-9T, 1.861-10, 1.861-10T, 1.861-11, 1.861-11T, 1.861-12, 1.861-12T, 1.861-13, 1.861-14, 1.861-14T, 1.861-17, and §1.861-20.

* * * * *

(d) * * *

(2) * * *

(ii) * * *

(B) Certain stock and dividends. The term "exempt income" includes the portion of the dividends that are deductible under section 243(a)(1) or (2) (relating to the dividends received deduction) or section 245(a) (relating to the dividends received deduction for dividends from certain foreign corporations). Thus, for purposes of apportioning deductions using a gross income method, gross income does not include a dividend to the extent that it gives rise to a dividend received deduction under either section 243(a)(1), section 243(a)(2), or section 245(a). In addition, for purposes of apportioning deductions using an asset method, assets do not include that portion of the value of the stock (determined in accordance with §1.861-9(g), and, as relevant, §§1.861-12 and 1.861-13) equal to the portion of dividends paid thereon that would be deductible under either section 243(a)(1), section 243(a)(2), or section 245(a). For example, in the case of stock for which all dividends would be allowed a deduction of 50 percent under section 243(a)(1), 50 percent of the value of the stock is treated as an exempt asset. In the case of stock which generates, has generated, or can reasonably be expected to generate qualifying dividends deductible under section 243(a)(3), such stock does not constitute an exempt asset. However, such stock and the qualifying dividends thereon are eliminated from consideration in the apportionment of interest expense under the consolidation rule set forth in §1.861-11T(c), and in the apportionment of other expenses under the consolidation rules set forth in §1.861-14T.

* * * * *

(v) Dividends received deduction and tax-exempt interest of insurance companies--(A) In general. For purposes of characterizing gross income or assets as exempt or not exempt under this section, the following rules apply on a company wide basis pursuant to the rules in paragraph (d)(2)(v)(A)(1) and (2) of this section.

(1) In the case of an insurance company taxable under section 801, the term "exempt income" includes the portion of dividends received that satisfy the requirements of deductibility under sections 243(a)(1) and (2) and 245(a) but without regard to any disallowance under section 805(a)(4)(A)(ii) of the policyholder's share of the dividends or any similar disallowance under section 805(a)(4)(D), and also includes tax-exempt interest but without reduction for the policyholder's share of tax-exempt interest that reduces the closing balance of items described in section 807(c), as provided under section 807(a)(2)(B) and 807(b)(1)(B). The term "exempt assets" includes the corresponding portion of assets that give rise to exempt income described in the preceding sentence. See §1.861-8(e)(16) for a special rule concerning the allocation of reserve expenses to dividends received by a life insurance company.

(2) In the case of an insurance company taxable under section 831, the term "exempt income" includes the portion of interest and dividends deductible under sections 832(c)(7) and (12) or sections 834(c)(1) and (7). Exempt income also includes the amounts reducing the losses incurred under section 832(b)(5) to the extent such amounts are not already taken into account in the preceding sentence. The term "exempt assets" includes the corresponding portion of assets that give rise to exempt income described in the preceding two sentences.

(B) Examples. The following examples illustrate the application of paragraph (d)(2)(v)(A) of this section.

(1) Example 1--(i) Facts. USC is a domestic life insurance company that has $300x of gross income, consisting of $100x of foreign source general category income and $200x of U.S. source passive category interest income, $100x of which is tax-exempt interest income from municipal bonds under section 103. USC's opening balance of its section 807(c) reserves is $50,000x and USP's closing balance of its section 807(c) reserves is $50,130x. Under section 807(b)(1)(B), USP's closing balance of its section 807(c) reserves, $50,130x, is reduced by the amount of the policyholder's share of tax-exempt interest. The policyholder's share of tax-exempt interest under section 812(b) is equal to 30 percent of the $100x of tax-exempt interest ($30x). Therefore, under sections 803(a)(2) and 807(b), USP's reserve deduction is $100x ($50,130x of reserve deduction minus $30x (30 percent of $100x of tax-exempt interest), minus $50,000x). USC has no other income or deductions.

(ii) Analysis -- allocation. Under section 818(f)(1), USC's reserve deduction is treated as an item that cannot be definitely allocated to an item or class of gross income. Accordingly, under paragraph (b)(5) of this section, USC's reserve deduction is allocable to all of USC's gross income as a class.

(iii) Analysis -- apportionment. Under paragraph (c)(3) of this section, the reserve deduction is ratably apportioned between the statutory grouping (foreign source general category income) and the residual grouping (U.S. source income) on the basis of the relative amounts of gross income in each grouping. For purposes of apportioning deductions under §1.861-8T(d)(2)(i)(B), exempt income is not taken into account. Under paragraph (d)(2)(v)(A)(1) of this section, in the case of an insurance company taxable under section 801, exempt income includes tax-exempt interest without regard to any reduction for the policyholder's share. USC has U.S. source income of $200x of which $100x is tax-exempt without regard to the reduction for the policyholder's share of tax-exempt interest that reduces the closing balance of items described in section 807(c). Thus, the gross income taken into account in apportioning USC's reserve deduction is $100x of foreign source general category gross income and $100x of U.S. source gross income. Of USC's $100x reserve deduction, $50x ($100x x $100x/$200x) is apportioned to foreign source general category gross income and $50x ($100x x $100x/$200x) is apportioned to U.S. source gross income.

(2) Example 2--(i) Facts. USC is a domestic life insurance company that has $300x of gross income consisting of $100x of foreign source general category income and $200x of U.S. source general category dividend income eligible for the 50% dividends received deduction (DRD) under section 243(a)(1). Under section 805(a)(4)(A)(ii), USC is allowed a 50% DRD on the company's share of the dividend received. Under section 812(a), the company's share is equal to 70% of the dividend income eligible for the DRD under section 243(a)(1), which results in a DRD of $70x (70% x 50% x $200x), and under section 812(b), the policyholder's share is equal to 30% of the dividend income eligible for the DRD under section 243(a)(1), or $30x. USC is entitled to a $130x deduction for an increase in its life insurance reserves under sections 803(a)(2) and 807(b). Unlike for tax-exempt interest income, there is no adjustment under section 807(b)(1)(B) to the reserve deduction for the policyholder's share of dividends eligible for the DRD under section 243(a)(1). USC has no other income or deductions.

(ii) Analysis -- allocation. Under section 818(f)(1), USC's reserve is treated as an item that cannot be definitely allocated to an item or class of gross income except that, under §1.861-8(e)(16), an amount of reserve expenses of a life insurance company equal to the DRD that is disallowed because it is attributable to the policyholder's share of dividends is treated as definitely related to such dividends. Thus, USC has a life insurance reserve deduction of $130x, of which $30x (equal to the policyholder's share of the DRD that would have been allowed under section 243(a)(1)) is directly allocated and apportioned to U.S. source dividend income. Under paragraph (b)(5) of this section, the remaining portion of USC's reserve deduction ($100x) is allocable to all of USC's gross income as a class.

(iii) Analysis -- apportionment. Under paragraph (c)(3) of this section, the deduction is ratably apportioned between the statutory grouping (foreign source general category income) and the residual grouping (U.S. source income) on the basis of the relative amounts of gross income in each grouping. For purposes of apportioning deductions under §1.861-8T(d)(2)(i)(B), exempt income is not taken into account. Under paragraph (d)(2)(v)(A)(1) of this section, in the case of an insurance company taxable under section 801, exempt income includes dividends deductible under section 805(a)(4) without regard to any reduction to the DRD for the policyholder's share in section 804(a)(4)(A)(ii). Thus, the gross income taken into account in apportioning $100x of USC's remaining reserve deduction is $100x of foreign source general category gross income and $100x of U.S. source gross income. Of USC's $100x remaining reserve deduction, $50x ($100x x $100x/$200x) is apportioned to foreign source general category gross income and $50x ($100x x $100x/$200x) is apportioned to U.S. source gross income.

* * * * *

(e) * * *

(4) * * *

(ii) Stewardship expenses--(A) In general. Stewardship expenses result from "overseeing" functions undertaken for a corporation's own benefit as an investor in a related corporation. For purposes of this section, stewardship expenses of a corporation are those expenses resulting from "duplicative activities" (as defined in §1.482-9(l)(3)(iii)) or "shareholder activities" (as defined in §1.482-9(l)(3)(iv)) of the corporation with respect to the related corporation. Thus, for example, stewardship expenses include expenses of an activity the sole effect of which is either to protect the corporation's capital investment in the related corporation or to facilitate compliance by the corporation with reporting, legal, or regulatory requirements applicable specifically to the corporation, or both. If a corporation has a foreign or international department which exercises overseeing functions with respect to related foreign corporations and, in addition, the department performs other functions that generate other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations and foreign-source royalties), some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also generate U.S. source income (such as fees for services performed in the United States).

(B) Allocation. Stewardship expenses are considered definitely related and allocable to dividends and inclusions received or accrued, or to be received or accrued, under sections 78, 951 and 951A, as well as amounts included under sections 1291, 1293, and 1296, from the related corporation.

(C) Apportionment. Stewardship expenses must be apportioned between the statutory grouping (or groupings) and residual grouping based on the relative values of the stock in each grouping held by a taxpayer, as determined and characterized under §1.861-9T(g) (and, as relevant, §§1.861-12 and 1.861-13) for purposes of allocating and apportioning the taxpayer's interest expense.

(D) Partnerships. The principles of paragraph (e)(4)(ii)(A) of this section apply to determine if expenses incurred with respect to a partnership are stewardship expenses. Stewardship expenses incurred with respect to a partnership are considered definitely related and allocable to a partner's distributive share of partnership income. The principles of paragraph (e)(4)(ii)(C) of this section apply to apportion expenses incurred with respect to a partnership.

(5) Legal and accounting fees and expenses; damages awards, prejudgment interest, and settlement payments. * * * Awards for litigation or arbitral damages, prejudgment interest, and payments in settlement of or in anticipation of claims for damages, including punitive damages, arising from product liability and similar or related claims are definitely related and allocable to the class of gross income produced by the specific sales of the products or services that gave rise to the claims for damage or injury. If the claims arise from an event incident to the production of products or provision of services rather than from damage or injury caused by the product or service, the payments are definitely related and allocable to the class of gross income ordinarily produced by the assets used to produce the products or services that are involved in the event. If necessary, the deductions arising from the event are apportioned among the statutory and residual groupings on the basis of the relative

values (as determined under §1.861-9T(g) and, as relevant, §§1.861-12 and 1.861-13, for purposes of allocating and apportioning the taxpayer’s interest expense) of the assets in each grouping. If the claims are made by investors in a corporation, arise from negligence, fraud, or other malfeasance of the corporation (or its representatives), and are not described in the preceding two sentences, then the damages, prejudgment interest, and settlement payments paid by the corporation are definitely related and allocable to all income of the corporation and are apportioned among the statutory and residual groupings based on the relative value of the corporation’s assets in each grouping (as determined under §1.861-9T(g) and, as relevant, §§1.861-12 and 1.861-13, for purposes of allocating and apportioning the taxpayer’s interest expense). The grouping (or groupings) of income to which damages, prejudgment interest, and settlement payments is allocated and apportioned is determined based on the groupings to which the related income would be assigned if the income were recognized in the taxable year in which the deduction is allowed.

(6) * * * (i) * * * The deduction for foreign income, war profits and excess profits taxes allowed by section 164 is allocated and apportioned among the applicable statutory and residual groupings under §1.861-20. * * *

* * * * *

(7) <u>Losses on the sale, exchange, or other disposition of property</u>. See §§1.865-1 and 1.865-2 for rules regarding the allocation of certain losses.

(8) <u>Net operating loss deduction</u>--(i) <u>Components of net operating loss</u>. A net operating loss is assigned to statutory or residual grouping components by reference to the losses in each such statutory or residual grouping that are not allocated to reduce

income in other groupings in the taxable year of the loss. For example, for purposes of section 904, the source and separate category components of a net operating loss are determined by reference to the amounts of separate limitation loss and U.S. source loss (determined without regard to adjustments required under section 904(b)) that are not allocated to reduce U.S. source income or income in other separate categories under the rules of sections 904(f) and 904(g) for the taxable year in which the net operating loss arose. See §1.904(g)-3(d)(2). See §1.1502-4 for rules applicable in computing the foreign tax credit limitation and determining the source and separate category of a net operating loss of a consolidated group.

(ii) Components of section 172 deduction. A net operating loss deduction allowed under section 172 is allocated and apportioned to statutory and residual groupings by reference to the statutory and residual grouping components of the net operating loss that is deducted in the taxable year. Except as provided under the rules for an operative section, a partial net operating loss deduction is treated as ratably comprising the components of a net operating loss. See, for example, §1.904(g)-3, which is an exception to the general rule described in the previous sentence and provides rules for determining the source and separate category of a partial net operating loss deduction for purposes of section 904 as the operative section.

* * * * *

(16) Special rule for the allocation of reserve expenses of a life insurance company. An amount of reserve expenses of a life insurance company equal to the dividends received deduction that is disallowed because it is attributable to the

policyholders' share of dividends received is treated as definitely related to such dividends. See paragraph (d)(2)(v)(B)(<u>2</u>) of this section (<u>Example 2</u>).

* * * * *

(g) * * *

(g)(1) through (14) [Reserved]

(15) <u>Example 15: Payment in settlement of claim for damages allocated to specific class of gross income</u>--(i) <u>Facts</u>--(A) USP, a domestic corporation, designs, manufactures, and sells Product A in the United States. USP also operates a foreign branch, within the meaning of §1.904-4(f)(3)(vii), in Country X through FDE, a disregarded entity organized in Country X, which manufactures and sells Product A in Country X. USP earns $300x of U.S. source income from sales of Product A to customers in the United States. The sales of Product A to customers in Country X result in aggregate gross income of $100x, of which $80x is U.S. source income attributable to USP's manufacturing activities and $20x is U.S. source income attributable to FDE's distribution activities. The $100x of income from sales of Product A to customers in Country X constitutes foreign branch category income. FDE is sued under Country X law for damages after Product A harms a customer in Country X. FDE makes a deductible payment to the Country X customer in settlement of the legal claims for damages.

(ii) <u>Analysis</u>. Because Product A caused the customer's injury, the claim for damages arose from the specific sales of Product A to the customer in Country X. Claims that might arise from damages caused by Product A to customers in the United States are irrelevant in allocating the deduction for the settlement payments made to the customer in Country X. Therefore, FDE's damages payment deduction is allocable to the class of gross income of sales of Product A in Country X. For purposes of section 904(d), because that class of gross income consists solely of U.S. source income, none of that income is included in the statutory grouping of foreign source foreign branch category income, and accordingly the damages payment deduction reduces USP's residual grouping of U.S. source income.

(16) <u>Example 16: Legal damages payment arising from event prior to sale</u>--(i) <u>Facts</u>--(A) The facts are the same as in paragraph (g)(15) of this section (the facts in <u>Example 15</u>) except that there is a disaster at FDE's warehouse in Country X arising from the negligence of an employee. The inventory of Product A in the warehouse is destroyed and FDE employees as well as residents in the vicinity of the warehouse are injured. USP's reputation in the United States suffers such that USP expects to subsequently lose market share in the United States. FDE makes damages payments totaling $80x to both its injured employees and the nearby residents.

(ii) Analysis. FDE's warehouse in Country X is used in connection with sales of Product A to customers in Country X. Thus, the $80x damages payment is allocable to the class of gross income ordinarily produced by the assets used to produce Product A. No apportionment of the $80x is necessary for purposes of applying section 904(d) because the class of gross income to which the deduction is allocated consists solely of U.S. source income

(17) Example 17: Payment following a change in law--(i) Facts. The facts are the same as in paragraph (g)(15) (the facts in Example 15) except that FDE manufactures and sells Product A in Country X in 2015 (before the enactment of the section 904(d)(1)(B) separate category for foreign branch income) and is sued in 2016 under Country X law for damages after Product A harms a customer in Country X. FDE makes a deductible damages payment to the Country X customer pursuant to a court judgment in 2019.

(ii) Analysis. The specific sales of Product A in Country X in 2015 led to the customer's injury in Country X. The payment in 2019 of the deductible damages payment is definitely related and allocable to the class of gross income consisting of Product A sales in Country X. Although the income earned from the Product A sales in Country X in 2015 was foreign source general category income, in 2019 the assets used to produce such income is U.S. source foreign branch category income. Accordingly, the deductible damages payment is allocated to foreign branch category income. No apportionment of the payment is necessary because the class of gross income to which the deduction is allocated consists solely of U.S. source income.

(18) Example 18: Stewardship and supportive expenses--(i) Facts--(A) USP, a domestic corporation, manufactures and sells Product A in the United States. USP owns 100% of the stock of USSub, a domestic corporation, and CFC1, CFC2, and CFC3, which are all controlled foreign corporations. USP and USSub file separate returns for U.S. Federal income tax purposes but are members of the same affiliated group under section 243(b)(2). USSub, CFC1, CFC2, and CFC3 perform similar functions in the United States and in the foreign countries T, U, and V, respectively. The tax book value of USP's stock in each of its four subsidiaries is $10,000x.

(B) USP's supervision department (the Department) incurs expenses of $1,500x. The Department is responsible for the supervision of its four subsidiaries and for rendering certain services to the subsidiaries, and the Department provides all the supportive functions necessary for USP's foreign activities. The Department performs three principal types of activities. First, the Department performs services outside the United States for the direct benefit of CFC2 for which a fee is paid by CFC2 to USP. The cost to the Department of the services for CFC2 is $900x, which results in a total charge (after a $100x markup) to CFC2 of $1,000x, all of which is foreign source income to USP. Second, the Department provides services related to license agreements that USP maintains with subsidiaries CFC1 and CFC2 and which give rise to foreign source income to USP. The cost of the services is $60x. Third, it performs activities described in §1.482–9(l)(3)(iii) that are in the nature of shareholder oversight, that duplicate functions performed by the subsidiaries' own employees, and that do not provide an additional benefit to the subsidiaries. For example, a team of auditors from USP's accounting department periodically audits the subsidiaries' books and prepares internal reports for use by USP's management. Similarly, USP's treasurer periodically reviews for the board of directors of USP the subsidiaries' financial policies. These activities do not provide an additional benefit to the related corporations. The cost of the duplicative services and related supportive expenses is $540x.

(C) USP also earns the following items of income. First, under section 951(a), USP includes $2,000x of subpart F income that is passive category income. Second, under section 951A and the section 951A regulations (as defined in §1.951A-1(a)(1)), USP has a GILTI inclusion amount of $2,000x. USP's deduction under section 250 is $1,000x ("section 250 deduction"), all of which is by reason of section 250(a)(1)(B)(i). No portion of USP's section 250 deduction is reduced by reason of section 250(a)(2)(B). Finally, USP also earns $1,000x of fees from CFC2 and receives royalties of $1,000x from CFC1 and CFC2.

(D) Under §1.861-9T(g)(3), USSub owns assets that generate income described in the residual grouping of gross income from U.S. sources. USP uses the asset method described in §1.861-12T(c)(3)(ii) to characterize the stock in its CFCs. After application of §1.861-13(a), USP determines that $5,000x of the stock of each of the three CFCs is assigned to the section 951A category ("section 951A category stock") in the non-section 245A subgroup; $2,000x of the stock of each of the three CFCs is assigned to the general category in the section 245A subgroup; and $3,000x of the stock of each of the three CFCs is assigned to the passive category in the non-section 245A subgroup. Additionally, under §1.861-8(d)(2)(ii)(C)(2), $2,500x of the stock of each of the three CFCs that is section 951A category stock is an exempt asset. Accordingly, with respect to the stock of its controlled foreign corporations in the aggregate, USP has $7,500x of section 951A category stock in a non-section 245A subgroup, $6,000x of general category stock in a section 245A subgroup, $9,000x of passive category stock in a non-section 245A subgroup, and $7,500x of stock that is an exempt asset.

(ii) Analysis--(A) Character of USP Department services. The first and second activities (the services rendered for the benefit of CFC2, and the provision of services related to license agreements with CFC1 and CFC2) are not properly characterized as stewardship expenses because they are not incurred solely to protect the corporation's capital investment in the related corporation or to facilitate compliance by the corporation with reporting, legal, or regulatory requirements applicable specifically to the corporation. The third activity described is in the nature of shareholder oversight and is characterized as stewardship as described in paragraph (e)(4)(ii)(A) of this section because the expense is related to duplicative activities.

(B) Allocation. First, the deduction of $900x for expenses related to services rendered for the benefit of CFC2 is definitely related (and therefore allocable) to the $1,000x in fees for services that USP receives from CFC2. Second, the $60x of deductions attributable to USP's license agreements with CFC1 and CFC2 are definitely related (and therefore allocable) solely to royalties received from CFC1 and CFC2. Third, the stewardship deduction of $540x is definitely related (and therefore allocable) to dividends and inclusions received from all the subsidiaries.

(C) Apportionment--(1) No apportionment of USP's deduction of $900x for expenses related to the services is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, foreign source general category income.

(2) No apportionment of USP's deduction of $60x attributable to the ancillary services is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, foreign source general category income.

(3) For purposes of apportioning USP's $540x stewardship expenses in determining the foreign tax credit limitation, the statutory groupings are foreign source general category income, foreign source passive category income, and foreign source section 951A category income. The residual grouping is U.S. source income.

(4) USP's deduction of $540x for the Department's stewardship expenses which are allocable to dividends and inclusions received from the subsidiaries are apportioned using the same value of USP's stock in USSub, CFC1, CFC2, and CFC3 that is used for purposes of allocating and apportioning USP's interest expense. However, the $10,000x value of USP's stock of USSub is eliminated because USSub generates qualifying dividends deductible under section 243(a)(3). See §1.861-8(d)(2)(ii)(B).

(5) Although USP may be allowed a section 245A deduction with respect to dividends from the CFCs, the value of the stock of the CFCs is not eliminated because the section 245A deduction does not create exempt income or result in the stock being treated as an exempt asset. See section 864(e)(3) and §1.861-8T(d)(2)(iii)(C). Therefore, the only asset value upon which stewardship expenses are apportioned is the stock in USP's CFCs.

(6) Taking into account the characterization of USP's stock in CFC1, CFC2, and CFC3, and excluding the exempt portion, the $540x of Department expenses is apportioned as follows: $180x ($540x x $7,500x/$22,500x) to section 951A category income, $144x ($540x x $6,000x/$22,500x) to general category income, and $216x ($540x x $9,000x/$22,500x) to passive category income. Section 904(b)(4)(B)(i) applies to $144x of the stewardship expense apportioned to the CFCs' stock that is characterized as being in the section 245A subgroup in the general category.

* * * * *

(h) Applicability date--(1) Except as provided in paragraph (h)(2) of this section, this section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

(2) Paragraphs (d)(2)(ii)(B), (d)(2)(v), (e)(4), (e)(5), (e)(6)(i), (e)(8), (e)(16), and (g)(15) through (g)(18) of this section apply to taxable years that end on or after [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**]. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also end before [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**], see §1.861-8(d)(2)(ii)(B), (e)(4), (e)(5), (e)(6)(i), and (e)(8) as in effect on [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

Par. 4. Section 1.861-8T is amended by revising paragraph (d)(2)(ii)(B) to read as follows:

§1.861-8T Computation of taxable income from sources within the United States and from other sources and activities (temporary).

* * * * *

(d)(2)(ii)(B). For further guidance, see §1.861-8(d)(2)(ii)(B).

* * * * *

Par. 5. Section 1.861-9 is amended by:

1. Revising the section heading.

2. Revising paragraphs (a) through (b).

3. Adding paragraph (b)(8).

4. Revising paragraphs (c)(1) through (4).

5. Adding paragraph (e)(9).

6. Revising paragraph (k).

The revisions and additions read as follows:

§1.861-9 Allocation and apportionment of interest expense and rules for asset-based apportionment.

(a) For further guidance, see §1.861-9T(a).

(b) Interest equivalent--(1) Certain expenses and losses--(i) General rule. Any expense or loss (to the extent deductible) incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time is subject to allocation and apportionment under the rules of this section and §1.861-9T(b) if such expense or loss is substantially incurred in consideration of the time value of money. However, the allocation and apportionment of a loss under this paragraph (b) and §1.861-9T(b) does not affect the characterization of such loss as capital or ordinary for any purpose other than for purposes of the section 861 regulations (as defined in §1.861-8(a)(1)).

(b)(1)(ii) For further guidance, see §1.861-9T(b)(1)(ii)

(b)(2) through (7) For further guidance, see §1.861-9T(b)(2) through (7).

(8) Guaranteed payments. Any deductions for guaranteed payments for the use of capital under section 707(c) are allocated and apportioned in the same manner as interest expense.

(c)(1) through (c)(4). For further guidance, see §1.861-9T(c)(1) through (c)(4).

* * * * *

(e) * * *

(9) Special rule for upstream partnership loans--(i) In general. For purposes of apportioning interest expense that is not directly allocable under paragraph (e)(4) of this section or §1.861-10T, a UPL debtor's pro rata share of the value of the upstream

partnership loan (as determined under paragraph (h)(4)(i) of this section) is not considered an asset of the UPL debtor taken into account as described in paragraphs (e)(2) and (3) of this section.

(ii) Treatment of interest expense and interest income attributable to an upstream partnership loan. If a UPL debtor (or any other person in the same affiliated group as the UPL debtor) takes into account a distributive share of UPL interest income, the UPL debtor assigns an amount of its distributive share of the UPL interest income equal to the matching expense amount for the taxable year that is attributable to the same loan to the same statutory and residual groupings using the same ratios as the statutory and residual groupings of gross income from which the UPL interest expense is deducted by the UPL debtor (or any other person in the same affiliated group as the UPL debtor). Therefore, the amount of the distributive share of UPL interest income that is assigned to each statutory and residual grouping is the amount that bears the same proportion to the matching expense amount as the UPL interest expense in that statutory or residual grouping bears to the total UPL interest expense of the UPL debtor (or any other person in the same affiliated group as the UPL debtor).

(iii) Anti-avoidance rule for third party back-to-back loans. If, with a principal purpose of avoiding the rules in this paragraph (e)(9), a partnership makes a loan to a person that is not related (within the meaning of section 267(b) or 707) to the lender, the unrelated person makes a loan to a direct or indirect partner in the partnership (or any person in the same affiliated group as a direct or indirect partner), and the first loan would constitute an upstream partnership loan if made directly to the direct or indirect partner (or person in the same affiliated group as a direct or indirect partner), then the rules of this paragraph (e)(9) apply as if the first loan was made directly by the partnership to the partner (or affiliate of the partner), and the interest expense paid by the partner is treated as made with respect to the first loan. Such a series of loans will be subject to this recharacterization rule without regard to whether there was a principal purpose of avoiding the rules in this paragraph (e)(9) if the loan to the unrelated person would not have been made or maintained on substantially the same terms but for the loan of funds by the unrelated person to the direct or indirect partner (or affiliate of the partner). The principles of this paragraph (e)(9)(iii) also apply to similar transactions that involve more than two loans and regardless of the order in which the loans are made.

(iv) Interest equivalents. The principles of this paragraph (e)(9) apply in the case of a partner, or any person in the same affiliated group as the partner, that takes into account a distributive share of income and has a matching expense amount (treating any interest equivalent described in §§1.861-9(b) and 1.861-9T(b) as interest income or expense for purposes of paragraph (e)(9)(v)(B) of this section) that is allocated and apportioned in the same manner as interest expense under §§1.861-9(b) and 1.861-9T(b).

(v) Definitions. For purposes of this paragraph (e)(9), the following definitions apply.

(A) Affiliated group. The term affiliated group has the meaning provided in §1.861-11(d)(1).

(B) Matching expense amount. The term matching expense amount means the lesser of the total amount of the UPL interest expense taken into account directly or indirectly by the UPL debtor for the taxable year with respect to an upstream partnership loan or the total amount of the distributive shares of the UPL interest income of the UPL debtor (or any other person in the same affiliated group as the UPL debtor) with respect to the loan.

(C) UPL debtor. The term UPL debtor means the person that holds the payable with respect to a upstream partnership loan. If a partnership holds the payable, then any partner in the partnership (other than a partner described in paragraph (e)(4)(i) of this section) is also considered a UPL debtor.

(D) UPL interest expense. The term UPL interest expense means an item of interest expense paid or accrued with respect to a upstream partnership loan, without regard to whether the expense was currently deductible (for example, by reason of section 163(j)).

(E) UPL interest income. The term UPL interest income means an item of gross interest income received or accrued with respect to an upstream partnership loan.

(F) Upstream partnership loan. The term upstream partnership loan means a loan by a partnership to a person that owns an interest, directly or indirectly through one or more other partnerships or other pass-through entities, in the partnership, or to any person in the same affiliated group as that person.

(vi) Examples. The following examples illustrate the application of this paragraph (e)(9).

(A) Example 1--(1) Facts. US1, a domestic corporation, directly owns 60% of PRS, a foreign partnership that is not engaged in a U.S. trade or business. The remaining 40% of PRS is directly owned by US2, a domestic corporation that is unrelated to US1. US1, US2, and PRS all use the calendar year as their taxable year. In Year 1, PRS loans $1,000x to US1. For Year 1, US1 has $100x of interest expense with respect to the loan and PRS has $100x of interest income with respect to the loan.

US1's distributive share of the interest income is $60x. Under paragraph (e)(2) of this section, $75x of US1's interest expense with respect to the loan is allocated to U.S. source income and $25x is allocated to foreign source foreign branch category income. Under paragraph (h)(4)(i) of this section, US1's share of the total value of the loan between US1 and PRS is $600x.

(2) Analysis. The loan by PRS to US1 is an upstream partnership loan and US1 is an UPL debtor. Under paragraph (e)(9)(iv)(B) of this section, the matching expense amount is $60x, the lesser of the UPL interest expense taken into account by US1 with respect to the loan for the taxable year ($100x) and US1's distributive share of the UPL interest income ($60x). Under paragraph (e)(9)(ii) of this section, US1 assigns $45x of the UPL interest income to U.S. source income ($60x x $75x/$100x) and $15x of the UPL interest income to foreign source foreign branch category income ($60x x $25x/$100x). Under paragraph (e)(9)(i) of this section, the disregarded portion of the upstream partnership loan is $600x.

(B) Example 2--(1) Facts. The facts are the same as in paragraph (e)(9)(vi)(A)(1) of this section (the facts in Example 1), except that US1 and US2 are part of the same affiliated group, US2's distributive share of the interest income is $40x, and under paragraph (h)(4)(i) of this section US2's share of the total value of the loan between US1 and PRS is $400x.

(2) Analysis. The loan by PRS to US1 is an upstream partnership loan and US1 is an UPL debtor. Under paragraph (e)(9)(iv)(B) of this section, the matching expense amount is $100x, the lesser of the UPL interest expense taken into account by US1 with respect to the loan for the taxable year ($100x) and the total amount of US1 and US2's distributive shares of the UPL interest income ($100x). Under paragraph (e)(9)(ii) of this section, US1 assigns $75x of the UPL interest income to U.S. source income ($100x x $75x/$100x) and $25x of the UPL interest income to foreign source foreign branch category income ($100x x $25x/$100x). Under paragraph (e)(9)(i) of this section, the disregarded portion of the upstream partnership loan is $1,000x, the total amount of US1 and US2's share of the loan between US1 and PRS.

* * * * *

(k) Applicability date--(1) Except as provided in paragraph (k)(2) of this section, this section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

(2) Paragraphs (b)(1)(i), (b)(8), and (e)(9) of this section apply to taxable years that end on or after [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**]. For taxable years that both begin after December 31, 2017, and end on or after December

4, 2018, and also end before [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**], see §1.861-9T(b)(1)(i) as in effect on [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

§1.861-9T [AMENDED]

Par. 6. Section 1.861-9T is amended by revising paragraph (b)(1)(i) to read "For further guidance, see §1.861-9(b)(1)(i)." and adding paragraph (b)(8) to read "For further guidance, see §1.861-9(b)(8).".

Par. 7. Section 1.861-12 is amended by revising paragraphs (d) through (j) and adding paragraph (k) to read as follows:

§1.861-12 Characterization rules and adjustments for certain assets.

* * * * *

(d) through (e) For further guidance, see §1.861-12T(d) through (e).

(f) Assets connected with capitalized, deferred, or disallowed interest --(1) In general. In the case of any asset in connection with which interest expense accruing during a taxable year is capitalized, deferred, or disallowed under any provision of the Code, the value of the asset for allocation and apportionment purposes is reduced by the principal amount of indebtedness the interest on which is so capitalized, deferred, or disallowed. Assets are connected with debt (the interest on which is capitalized, deferred, or disallowed) only if using the debt proceeds to acquire or produce the asset causes the interest to be capitalized, deferred, or disallowed.

(2) Examples. The following examples illustrate the application of paragraph (f)(1) of this section.

(i) Example 1: Capitalized interest under section 263A--(A) Facts. X is a domestic corporation that uses the tax book value method of apportionment. X has $1,000x of indebtedness and incurs $100x of interest expense. Using $800x of the

$1,000x debt proceeds to produce tangible property, X capitalizes $80x of interest expense under the rules of section 263A. X deducts the remaining $20x of interest expense.

(B) Analysis. Because interest on $800x of debt is capitalized under section 263A by reason of the use of debt proceeds to produce the tangible property, $800x of the principal amount of X's debt is connected to the tangible property under paragraph (f)(1) of this section. Therefore, for purposes of apportioning the remaining $20x of X’s interest expense, the adjusted basis of the tangible property is reduced by $800x.

(ii) Example 2: Disallowed interest under section 163(l)--(A) Facts. X, a domestic corporation, owns 100% of the stock of Y, a domestic corporation. X and Y file a consolidated return and use the tax book value method of apportionment. In Year 1, X makes a loan of $1,000x to Y (Loan A) and Y then uses the Loan A proceeds to acquire in a cash purchase all the stock of a foreign corporation, Z. Interest on Loan A is payable in U.S. dollars or, at the option of Y, in stock of Z.

(B) Analysis. Under section 163(l), Loan A is a disqualified debt instrument because interest on Loan A is payable at the option of Y in stock of a related party to Y. Because Loan A is a disqualified debt instrument, section 163(l)(1) disallows Y’s interest deduction for interest payable on Loan A. In addition, the value of the Z stock is not reduced under paragraph (f)(1) of this section because the use of the Loan A proceeds to acquire the stock of Z is not the cause of Y’s interest deduction being disallowed. Rather, the Loan A terms allowing interest to be paid in stock of Z is the cause of Y’s interest deduction being disallowed under section 163(l). Therefore, no adjustment is made to Y’s adjusted basis in the stock of Z for purposes of allocating the interest expense of X and Y.

(g) through (j) For further guidance, see §1.861-12T(g) through (j).

(k) Applicability date--(1) Except as provided in paragraph (k)(2) of this section, this section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

(2) Paragraph (f) this section applies to taxable years that end on or after [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**]. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also end before [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**], see §1.861-

12T(f) as in effect on [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

§1.861-12T [Amended]

Par. 8. Section 1.861-12T is amended by revising paragraph (f) to read "For further guidance, see §1.861-12(f)."

Par. 9. Section 1.861-14 is amended by:

1. Removing the last sentence in paragraph (d)(1).

2. Revising paragraphs (d)(3) through (e)(5).

3. Redesignating paragraph (e)(6)(i) as paragraph (e)(6) and removing paragraph (e)(6)(ii).

4. Revising paragraphs (f) through (j).

5. Adding paragraph (k).

The revisions and additions read as follows:

§1.861-14 Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations.

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(d)(3) through (d)(4) For further guidance, see § 1.861-14T(d)(3) through (d)(4).

(e) Expenses to be allocated and apportioned under this section--(1) Expenses not directly allocable to specific income producing activities or property--(i) The expenses that are required to be allocated and apportioned under the rules of this section are expenses that are not directly allocable to specific income producing activities or property solely of the member of the affiliated group that incurred the expense, including (but not limited to) certain expenses related to supportive functions, research and experimental expenses, stewardship expenses, legal and accounting expenses, and litigation damages awards, prejudgment interest, and settlement payments. Interest expense of members of an affiliated group of corporations is allocated and apportioned under §1.861-11T and not under the rules of this section. Expenses that are included in inventory costs or that are capitalized are not subject to allocation and apportionment under the rules of this section.

(ii) For further guidance, see §1.861-14T(e)(1)(ii).

(2) <u>Research and experimental expenditures</u>. R&E expenditures (as defined in §1.861-17(a)) in the case of an affiliated group are allocated and apportioned under the rules of §1.861-17 as if all members of the affiliated group were a single taxpayer. Thus, R&E expenditures are allocated to all gross intangible income of all members of the affiliated group reasonably connected with the relevant broad SIC code category. If fewer than all members of the affiliated group derive gross intangible income reasonably connected with that relevant broad SIC code category, then such expenditures are apportioned under the rules of this paragraph (e)(2) only among those members, as if those members were a single taxpayer.

(3) <u>Expenses related to supportive functions</u>. For further guidance, see §1.861-14T(e)(3).

(4) <u>Stewardship expenses</u>. Stewardship expenses are allocated and apportioned in accordance with the rules of §1.861-8(e)(4). In general, stewardship expenses are considered definitely related and allocable to dividends and inclusions received or accrued, or to be received or accrued, from a related corporation. If members of the affiliated group, other than the member that incurred the stewardship expense, receive or may receive dividends or accrue or may accrue inclusions from the related

corporation, such expense must be allocated and apportioned in accordance with the rules of paragraph (c) of this section as if all such members of the affiliated group that receive or may receive dividends were a single corporation. Such expenses must be apportioned between statutory and residual groupings of income within the appropriate class of gross income by reference to the apportionment factors contributed by the members of the affiliated group treated as a single corporation.

(5) Legal and accounting fees and expenses; damages awards, prejudgment interest, and settlement payments. Legal and accounting fees and expenses, as well as litigation or arbitral damages awards, prejudgment interest, and settlement payments, are allocated and apportioned under the rules of §1.861-8(e)(5). To the extent that under §1.861-14T(c)(2) and (e)(1)(ii) of this section such expenses are not directly allocable to specific income-producing activities or property of one or more members of the affiliated group, such expenses must be allocated and apportioned as if all members of the affiliated group were a single corporation. Specifically, such expenses must be allocated to a class of gross income that takes into account the gross income which is generated, has been generated, or is reasonably expected to be generated by the other members of the affiliated group. If the expenses relate to the gross income of fewer than all members of the affiliated group as determined under §1.861-14T(c)(2), then those expenses must be apportioned under the rules of §1.861-14T(c)(2), as if those fewer members were a single corporation. Such expenses must be apportioned taking into account the apportionment factors contributed by the members of the group that are treated as a single corporation.

(f) through (g) For further guidance, see §1.861-14T(f) through (g).

(h) Allocation of section 818(f) expenses. Life insurance company expenses specified in section 818(f)(1) are allocated and apportioned on a separate entity basis, including with regard to members of a consolidated group. Those expenses are not allocated and apportioned on a life-nonlife group or a life subgroup basis. See also §1.861-8(e)(16) for rules on the allocation of reserve expenses with respect to dividends received by a life insurance company.

(i) through (j) [Reserved].

(k) Applicability date. This section applies to taxable years ending on or after [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**].

Par. 10. Section 1.861-14T is amended by revising paragraphs (e)(1)(i), (e)(2)(i) and (ii), (e)(4) and (5), and (h) to read as follows:

§1.861-14T Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations. (Temporary)

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(e)(1)(i) For further guidance, see §1.861-14(e)(1)(i).

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(e)(2)(i) through (e)(2)(ii) For further guidance, see §1.861-14(e)(2)(i) through §1.861-14(e)(2)(ii).

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(e)(4) through (e)(5) For further guidance, see §1.861-14(e)(4) through §1.861-14(e)(5).

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(h) For further guidance, see §1.861-14(h).

* * * * *

Par. 11. Section 1.861-17 is revised to read as follows:

§1.861-17 Allocation and apportionment of research and experimental expenditures.

(a) Scope. This section provides rules for the allocation and apportionment of research and experimental expenditures that a taxpayer deducts, or amortizes and deducts, in a taxable year under section 174 or section 59(e) (applicable to expenditures that are allowable as a deduction under section 174(a)) (R&E expenditures). R&E expenditures do not include any expenditures that are not deductible by reason of the second sentence under §1.482-7(j)(3)(i) (relating to CST Payments (as defined in §1.482-7(b)(1)) owed to a controlled participant in a cost sharing arrangement), because nondeductible amounts are not allocated and apportioned under §§1.861-8 through 1.861-17.

(b) Allocation--(1) In general. The method of allocation and apportionment of R&E expenditures set forth in this section recognizes that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation. In addition, the method set forth in this section recognizes that successful R&E expenditures ultimately result in the creation of intangible property that will be used to generate income. Therefore, R&E expenditures ordinarily are considered deductions that are definitely related to gross intangible income (as defined in paragraph (b)(2) of this section) reasonably connected with the relevant SIC code category (or categories) of the taxpayer and therefore allocable to gross intangible income as a class related to the SIC code category (or categories) and apportioned under the rules in this section. For purposes of this allocation, a taxpayer's SIC code category (or categories) are determined in accordance with the provisions of paragraph (b)(3) of this section. For purposes of this section, the term intangible property means intangible property, as defined in section 367(d)(4), that is derived from R&E expenditures.

(2) Definition of gross intangible income. The term gross intangible income means all gross income earned by a taxpayer that is attributable (in whole or in part) to intangible property and includes gross income from sales or leases of products or services derived (in whole or in part) from intangible property, income from sales of intangible property, income from platform contribution transactions described in §1.482-7(b)(1)(ii), royalty income from the licensing of intangible property, and amounts taken into account under section 367(d) by reason of a transfer of intangible property. Gross intangible income also includes a distributive share of any amounts described in the previous sentence, but does not include dividends or any amounts included in income under sections 951, 951A, or 1293.

(3) SIC code categories--(i) Allocation based on SIC code categories. Ordinarily, a taxpayer's R&E expenditures are incurred to produce gross intangible income that is reasonably connected with one or more relevant SIC code categories. Where research and experimentation is conducted with respect to more than one SIC code category, the taxpayer may aggregate the categories for purposes of allocation and apportionment. However, the taxpayer may not subdivide any categories. Where research and experimentation is not clearly related to any SIC code category (or categories), it will be considered conducted with respect to all of the taxpayer's SIC code categories.

(ii) Use of three digit standard industrial classification codes. A taxpayer determines the relevant SIC code categories by reference to the three digit classification of the Standard Industrial Classification Manual (SIC code). The SIC Manual is available at https://www.osha.gov/pls/imis/sic_manual.html.

(iii) Consistency. Once a taxpayer selects a SIC code category for the first taxable year for which this section applies to the taxpayer, it must continue to use that category in following years unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in the category is appropriate.

(iv) Wholesale trade and retail trade categories. A taxpayer must use a SIC code category within the divisions of “wholesale trade” or “retail trade” if it is engaged solely in sales-related activities with respect to a particular category of products. In the case of a taxpayer that conducts material non-sales-related activities with respect to a particular category of products, all R&E expenditures related to sales of the products must be allocated and apportioned as if the expenditures were reasonably connected to the most closely related three digit SIC code category other than those within the wholesale and retail trade divisions. For example, if a taxpayer engages in both the manufacturing and assembling of cars and trucks (SIC Code 371) and in a wholesaling activity related to motor vehicles and motor vehicle parts and supplies (SIC Code 501), the taxpayer must allocate and apportion all R&E expenditures related to both activities as if they relate solely to the manufacturing SIC Code 371. By contrast, if the taxpayer engages only in the wholesaling activity related to motor vehicles and motor vehicle parts and supplies, the taxpayer must allocate and apportion all R&E expenditures to the wholesaling SIC Code 501.

(c) Exclusive apportionment. Solely for purposes of applying this section to section 904 as the operative section, an amount equal to fifty percent of a taxpayer's R&E expenditures in a SIC code category (or categories) is apportioned exclusively to the residual grouping of U.S. source gross intangible income if research and experimentation that accounts for at least fifty percent of such R&E expenditures was performed in the United States. Similarly, an amount equal to fifty percent of a taxpayer's R&E expenditures in a SIC code category (or categories) is apportioned exclusively to the statutory grouping (or groupings) of foreign source gross intangible income in that SIC code category if research and experimentation that accounts for more than fifty percent of such R&E expenditures was performed outside the United States. If there are multiple separate categories with foreign source gross intangible income in the SIC code category, the fifty percent of R&E expenditures apportioned under the previous sentence is apportioned ratably to foreign source gross intangible income based on the relative amounts of gross receipts from gross intangible income in the SIC code category in each separate category, as determined under paragraph (d) of this section.

(d) Apportionment based on gross receipts from sales of products or services--(1) In general. A taxpayer's R&E expenditures not apportioned under paragraph (c) of this section are apportioned between the statutory grouping (or among the statutory groupings) within the class of gross intangible income and the residual grouping within such class according to the rules in paragraph (d)(1)(i) through (iv) of this section. See paragraph (b) of this section for defining the class of gross intangible income in relation to SIC code categories.

(i) A taxpayer's R&E expenditures not apportioned under paragraph (c) of this section are apportioned in the same proportions that:

(A) The amounts of the taxpayer's gross receipts from sales and leases of products (as measured by gross receipts without regard to cost of goods sold) or services that are related to gross intangible income within the statutory grouping (or statutory groupings) and in the residual grouping bear, respectively, to

(B) The total amount of such gross receipts in the class.

(ii) For purposes of this paragraph (d), the amount of the gross receipts used to apportion R&E expenditures also includes gross receipts from sales and leases of products or services of any controlled or uncontrolled party to the extent described in paragraph (d)(3) and (4) of this section.

(iii) The statutory grouping (or groupings) or residual grouping to which the gross receipts are assigned is the grouping to which the gross intangible income related to the sale, lease, or service is assigned. In cases where the gross intangible income of the taxpayer is income not described in paragraph (d)(3) or (4) of this section, the grouping to which the taxpayer's gross receipts and the gross intangible income are assigned is the same. In cases where the taxpayer's gross intangible income is related to sales, leases, or services described in paragraphs (d)(3) or (4) of this section, the gross receipts that will be used for purposes of this paragraph (d) are the gross receipts of the controlled or uncontrolled parties that are exploiting the taxpayer's intangible property. The grouping to which the controlled or uncontrolled parties' gross receipts are assigned is determined based on the grouping of the taxpayer's gross intangible income attributable to the license, sale, or other transfer of intangible property to such controlled or uncontrolled party as described in paragraph (d)(3)(i) or (d)(4)(i) of this section, and not the grouping to which the gross receipts would be assigned if the assignment were based on the income earned by the controlled or uncontrolled party. See paragraph (g)(1) of this section (Example 1).

(iv) For purposes of applying this section to section 904 as the operative section, because a United States person's gross intangible income cannot include income assigned to the section 951A category, no R&E expenditures of a United States person are apportioned to foreign source income in the section 951A category.

(2) Apportionment in excess of gross income. Amounts apportioned under this section may exceed the amount of gross income related to the SIC code category within the statutory or residual grouping. In such case, the excess is applied against other gross income within the statutory or residual grouping. See §1.861-8(d)(1) for applicable rules where the apportionment results in an excess of deductions over gross income within the statutory or residual grouping.

(3) Sales or services of uncontrolled parties--(i) In general. For purposes of the apportionment within a class under paragraph (d)(1) of this section, the gross receipts of each uncontrolled party from particular products or services incorporating intangible property that was licensed, sold, or transferred by the taxpayer to such uncontrolled party (directly or indirectly) are taken into account for determining the taxpayer's apportionment if the taxpayer can reasonably be expected to license, sell, or transfer to that uncontrolled party, directly or indirectly, intangible property that would arise from the taxpayer's current R&E expenditures. If the taxpayer has previously licensed, sold, or transferred intangible property related to a SIC code category to an uncontrolled

party, the taxpayer is presumed to expect to license, sell, or transfer to that uncontrolled party all future intangible property related to the same SIC code category.

(ii) Definition of uncontrolled party. For purposes of this paragraph (d)(3), the term uncontrolled party means a party that is not a person with a relationship to the taxpayer specified in section 267(b), or is not a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3)).

(iii) Sales of components. In the case of a sale or lease of a product by an uncontrolled party that is derived from the taxpayer's intangible property but is incorporated as a component of a larger product (for example, where the product incorporating the intangible property is a component of a large machine), only the portion of the gross receipts from the larger product that are attributable to the component derived from the intangible property is included. For purposes of the preceding sentence, a reasonable estimate based on the principles of section 482 must be made. See paragraph (g)(4)(ii)(B)(3) of this section (Example 4).

(iv) Reasonable estimates of gross receipts. If the amount of gross receipts of an uncontrolled party is unknown, a reasonable estimate of gross receipts must be made annually. Appropriate economic analyses, based on the principles of section 482, must be used to estimate gross receipts. See paragraph (g)(5)(B)(3)(ii) of this section (Example 5).

(4) Sales or services of controlled corporations--(i) In general. For purposes of the apportionment within a class under paragraph (d)(1) of this section, the gross receipts from sales, leases, or services of a controlled corporation are taken into account if the taxpayer can reasonably be expected to license, sell, or transfer to that

controlled corporation, directly or indirectly, intangible property that would arise from the taxpayer's current R&E expenditures. Except to the extent provided in paragraph (d)(4)(iv) of this section, if the taxpayer has previously licensed, sold, or transferred intangible property related to a SIC code category to a controlled corporation, the taxpayer is presumed to expect to license, sell, or transfer to that controlled corporation all future intangible property related to the same SIC code category.

(ii) Definition of a corporation controlled by the taxpayer. For purposes of this paragraph (d)(4), the term controlled corporation means any corporation that has a relationship to the taxpayer specified in section 267(b) or is a member of a controlled group of corporations to which the taxpayer belongs (within the meaning of section 993(a)(3)). Because an affiliated group is treated as a single taxpayer, a member of an affiliated group is not a controlled corporation. See paragraph (e) of this section.

(iii) Gross receipts not to be taken into account more than once. Sales, leases, or services between controlled corporations or between a controlled corporation and the taxpayer are not taken into account more than once; in such a situation, the amount of gross receipts of the selling corporation must be subtracted from the gross receipts of the buying corporation.

(iv) Effect of cost sharing arrangements. If the controlled corporation has entered into a cost sharing arrangement, in accordance with the provisions of §1.482-7, with the taxpayer for the purpose of developing intangible property, then the taxpayer is not reasonably expected to license, sell, or transfer to that controlled corporation, directly or indirectly, intangible property that would arise from the taxpayer's share of the R&E expenditures with respect to the cost shared intangibles as defined in §1.482-7(j)(1)(i).

Therefore, solely for purposes of apportioning a taxpayer's R&E expenditures (which does not include the amount of CST Payments received by the taxpayer; see paragraph (a) of this section) that are intangible development costs (as defined in §1.482-7(d)) with respect to a cost sharing arrangement, the controlled corporation's gross receipts are not taken into account for purposes of paragraphs (d)(1) and (d)(4)(i) of this section.

(5) Application of section 864(e)(3). Section 864(e)(3) and §1.861-8(d)(2)(ii) do not apply for purposes of this section.

(e) Affiliated groups. See §1.861-14(e)(2) for rules on allocating and apportioning R&E expenditures of an affiliated group (as defined in §1.861-14(d)).

(f) Special rules for partnerships--(1) R&E expenditures. For purposes of applying this section, if R&E expenditures are incurred by a partnership in which the taxpayer is a partner, the taxpayer's R&E expenditures include the taxpayer's distributive share of the partnership's R&E expenditures.

(2) Purpose and location of expenditures. In applying exclusive apportionment under paragraph (c) of this section, a partner's distributive share of R&E expenditures incurred by a partnership is treated as incurred by the partner for the same purpose and in the same location as incurred by the partnership.

(3) Apportionment based on gross receipts. In applying the remaining apportionment under paragraph (d) of this section, a taxpayer's gross receipts from a SIC code category include the full amount of any gross receipts from the SIC code category of any partnership not described in paragraph (d)(3)(ii) of this section in which the taxpayer is a direct or indirect partner if the gross receipts would have been included had the partnership been a corporation.

(g) Examples. The following examples illustrate the application of the rules in this section.

(1) Example 1--(i) Facts. X, a domestic corporation, is a manufacturer and distributor of small gasoline engines for lawnmowers. Gasoline engines are a product within the category, Engines and Turbines (SIC Industry Group 351). Y, a wholly owned foreign subsidiary of X, also manufactures and sells these engines abroad. X owns no other foreign subsidiaries. During Year 1, X incurred R&E expenditures of $60,000x, which it deducts under section 174 as a current expense, to invent and patent a new and improved gasoline engine. All of the research and experimentation was performed in the United States. Also in Year 1, the domestic gross receipts of X of gasoline engines total $500,000x and foreign gross receipts of Y total $300,000x. X provides technology for the manufacture of engines to Y through a license that requires the payment of an arm's length royalty. In Year 1, X's gross income is $200,000x, of which $140,000x is U.S. source income from domestic sales of gasoline engines, $40,000x is income included under section 951A all of which relates to Y's foreign source income from sales of gasoline engines, $10,000x is foreign source royalties from Y, and $10,000x is U.S. source interest income. None of the foreign source royalties are allocable to passive category income of Y, and therefore, under §§1.904-4(d) and 1.904-5(c)(3), the foreign source royalties are general category income to X.

(ii) Analysis--(A) Allocation. The R&E expenditures were incurred in connection with developing intangible property related to small gasoline engines and they are definitely related to the items of gross intangible income related to the SIC code category 351, namely gross income from the sale of small gasoline engines in the United States and royalties received from subsidiary Y, a foreign manufacturer of gasoline engines. Accordingly, under paragraph (b) of this section, the R&E expenditures are allocable to the class of gross intangible income related to SIC code category 351, all of which is general category income of X. X's U.S. source interest income and income included under section 951A are not within this class of gross intangible income and, therefore, no portion of the R&E expenditures are allocated to the U.S. source interest income or foreign source income in the section 951A category.

(B) Apportionment--(1) In general. For purposes of applying this section to section 904 as the operative section, the statutory grouping of gross intangible income is foreign source general category income and the residual grouping of gross intangible income is U.S. source income.

(2) Exclusive apportionment. Under paragraph (c) of this section, because at least 50% of X's research and experimental activity was performed in the United States, 50% of the R&E expenditures, or $30,000x ($60,000x x 50%), is apportioned exclusively to the residual grouping of U.S. source gross intangible income. The remaining 50% of the R&E expenditures is then apportioned between the statutory and residual groupings on the basis of the relative amounts of gross receipts from sales of small gasoline engines by X and Y that are related to the U.S. source sales income and foreign source royalty income, respectively.

(3) Apportionment based on gross receipts. After taking into account exclusive apportionment, X has $30,000x ($60,000x – $30,000x) of R&E expenditures that must be apportioned between the residual and statutory groupings. Because Y is a controlled corporation of X, its gross receipts within the SIC code are taken into account in apportioning X's R&E expenditures if X is reasonably expected to license, sell, or transfer intangible property that would arise from the R&E expenditures that result in the $60,000x deduction. Because Y has licensed the intangible property developed by X related to the SIC code, it is presumed it is reasonably expected to license the intangible property that would be developed from the current research and experimentation. Therefore, under paragraphs (d)(1) and (5) of this section, $11,250x ($30,000x x $300,000x/($500,000x + $300,000x)) is apportioned to the statutory grouping of X's gross intangible income attributable to its license of intangible property to Y, or foreign source general category income. No portion of the gross receipts by X or Y are disregarded under section 864(e)(3), regardless of whether the income related to those sales is eligible for a deduction under section 250(a)(1)(A). The remaining $18,750x ($30,000x x $500,000x/($500,000x + $300,000x)) is apportioned to the residual grouping of gross intangible income, or U.S. source income.

(4) Summary. Accordingly, for purposes of the foreign tax credit limitation, $11,250x of X's R&E expenditures are apportioned to foreign source general category income, and $48,750x ($30,000x + $18,750x) of X's R&E expenditures are apportioned to U.S. source income.

(2) Example 2--(i) Facts. The facts are the same as in paragraph (g)(1)(i) of this section (the facts in Example 1) except that X also spends $30,000x in Year 1 for research on steam turbines, all of which is performed in the United States, and X has steam turbine gross receipts in the United States of $400,000x. X's foreign subsidiary Y neither manufactures nor sells steam turbines. The steam turbine research is in addition to the $60,000x in R&E expenditures incurred by X on gasoline engines for lawnmowers. X thus has $90,000x of R&E expenditures. X's gross income is $250,000x, of which $140,000x is U.S. source income from domestic sales of gasoline engines, $50,000x is U.S. source income from domestic sales of steam turbines, $40,000x is income included under section 951A all of which relates to foreign source income derived from Y's sales of gasoline engines, $10,000x is foreign source royalties from Y, and $10,000x is U.S. source interest income.

(ii) Analysis--(A) Allocation. X's R&E expenditures generate gross intangible income from sales of small gasoline engines and steam turbines. Both of these products are in the same three digit SIC code category, Engines and Turbines (SIC Industry Group 351). Therefore, under paragraph (a) of this section, X's R&E expenditures are definitely related to all items of gross intangible income attributable to SIC code category 351. These items of X's gross intangible income are gross income from the sale of small gasoline engines and steam turbines in the United States and royalties from foreign subsidiary Y, a foreign manufacturer and seller of small gasoline engines. X's U.S. source interest income and income included under section 951A is not within this class of gross intangible income and, therefore, no portion of X's R&E expenditures are allocated to the U.S. source interest income or income in the section 951A category.

(B) Apportionment--(1) In general. For purposes of applying this section to section 904 as the operative section, the statutory grouping of gross intangible income is foreign source general category income and the residual grouping of gross intangible income is U.S. source income.

(2) Exclusive apportionment. Under paragraph (c) of this section, because at least 50% of X's research and experimental activity was performed in the United States, 50% of the R&E expenditures, or $45,000x ($90,000x x 50%), are apportioned exclusively to the residual grouping of U.S. source gross intangible income. The remaining 50% of the R&E expenditures is then apportioned between the residual and statutory groupings on the basis of the relative amounts of gross receipts of small gasoline engines and steam turbines by X and Y with respect to which gross intangible income is foreign source general category income and U.S. source income.

(3) Apportionment based on gross receipts. After taking into account exclusive apportionment, X has $45,000x ($90,000x – $45,000x) of R&E expenditures that must be apportioned between the residual and statutory groupings. Even though a portion of the R&E expenditures that must be apportioned are attributable to research performed with respect to steam turbines, and Y does not sell steam turbines, because Y previously licensed intangible property related to SIC code category 351, it is presumed that X expects to license all intangible property related to SIC code category 351, including intangible property related to steam turbines. Therefore, under paragraph (d)(1) of this section, $11,250x ($45,000x x $300,000x/($500,000x + $400,000x + $300,000x)) is apportioned to the statutory grouping of gross intangible income of the royalty income to which the gross receipts by Y were related, or foreign source general category income. The remaining $33,750x ($45,000x x ($500,000x + $400,000x)/($500,000x + $400,000x + $300,000x)) is apportioned to the residual grouping of gross intangible income, or U.S. source gross income.

(4) Summary. Accordingly, for purposes of the foreign tax credit limitation, \$11,250x of X's R&E expenditures are apportioned to foreign source general category income and \$78,750x (\$45,000x + \$33,750x) of X's R&E expenditures are apportioned to U.S. source gross income.

(3) Example 3--(i) Facts--(A) Acquisitions and transfers by X. The facts are the same as in paragraph (g)(1)(i) of this section (the facts in Example 1) except that, in Year 2, X and Y terminate the license for the manufacture of engines that was in place in Year 1 and enter into an arm's length cost-sharing arrangement, in accordance with the provisions of §1.482-7, to share the funding of all of X's research activity. In Year 2, Y makes a PCT Payment (as defined in §1.482-7(b)(1)) of \$50,000x that is sourced as a royalty and a CST Payment of \$25,000x under the cost sharing arrangement.

(B) Gross receipts and R&E expenditures. In Year 2, X and Y continue to sell gasoline engines, with gross receipts of \$600,000x in the United States and \$400,000x abroad by Y. X incurs research costs of \$85,000x in Year 2 for research activities conducted in the United States, but cannot deduct \$25,000x of that amount by reason of the second sentence under §1.482-7(j)(3)(i) (relating to CST Payments).

(C) Gross income of X. In Year 2, X's gross income is \$350,000x, of which \$200,000x is U.S. source income from domestic sales of gasoline engines, \$50,000x is foreign source income attributable to the PCT Payment, and \$100,000x is income included under section 951A all of which relates to foreign source income derived from engine sales by Y.

(ii) Analysis--(A) Allocation. The \$60,000x of R&E expenditures were incurred in connection with small gasoline engines and they are definitely related to the items of gross intangible income related to the SIC code category, namely gross income from the sale of small gasoline engines in the United States and PCT Payments from Y. Accordingly, under paragraph (a) of this section, the R&E expenditures are allocable to this class of gross intangible income. X's income included under section 951A is not within this class of gross intangible income and, therefore, no portion of X's R&E expenditures is allocated to X's section 951A category income.

(B) Apportionment--(1) In general. For purposes of applying this section to section 904 as the operative section, the statutory grouping of gross intangible income is foreign source general category income, and the residual grouping of gross intangible income is U.S. source income.

(2) Exclusive apportionment. Under paragraph (c) of this section, because at least 50% of X's research and experimentation was performed in the United States, 50% of the R&E expenditures, or \$30,000x (\$60,000x x 50%), is apportioned exclusively to the residual grouping of gross intangible income, U.S. source gross income.

(3) Apportionment based on gross receipts. Under paragraph (d)(5)(v) of this section, none of Y's gross receipts are taken into account because they are attributable to the cost shared intangible under the valid cost sharing arrangement. Because all of the gross receipts from sales that are taken into account under paragraph (d)(1) of this section relate to gross intangible income that is included in the residual grouping, $30,000x is apportioned to the residual grouping of gross intangible income, or U.S. source gross income.

(4) Summary. Accordingly, for purposes of the foreign tax credit limitation, $60,000x of X's R&E expenditures are apportioned to U.S. source income.

(4) Example 4--(i) Facts--(A) X's R&E expenditures. X, a domestic corporation, is engaged in continuous research and experimentation to improve the quality of the products that it manufactures and sells, which are floodlights, flashlights, fuse boxes, and solderless connectors. X incurs $100,000x of R&E expenditures in Year 1 that was performed exclusively in the United States. As a result of this research activity, X acquires patents that it uses in its own manufacturing activity.

(B) License to Y and Z. In Year 1, X licenses its floodlight patent to Y and Z, uncontrolled foreign corporations, for use in their own territories, Countries Y and Z, respectively. Corporation Y pays X a royalty of $3,000x plus $0.20x for each floodlight sold. Gross receipts from sales of floodlights by Y for the taxable year are $135,000x (at $4.50x per unit) or 30,000x units, and the royalty is $9,000x ($3,000x + $0.20x × 30,000x). Y has sales of other products of $500,000x. Z pays X a royalty of $3,000x plus $0.30x for each unit sold. Z manufactures 30,000x floodlights in the taxable year, and the royalty is $12,000x ($3,000x + $0.30x × 30,000x). The dollar value of Z's gross receipts from floodlight sales is not known because, in this case, the floodlights are not sold separately by Z but are instead used as a component in Z's manufacture of lighting equipment for theaters. However, a reasonable estimate of Z's gross receipts attributable to the floodlights, based on the principles of section 482, is $120,000x. The gross receipts from sales of all Z's products, including the lighting equipment for theaters, are $1,000,000x.

(C) X's gross receipts and gross income. X's gross receipts from sales of floodlights for the taxable year are $500,000x and its sales of its other products (flashlights, fuse boxes, and solderless connectors) are $400,000x. X has gross income of $500,000x, consisting of U.S. source gross income from domestic sales of floodlights, flashlights, fuse boxes, and solderless connectors of $479,000x, and foreign source royalty income of $9,000x and $12,000x from foreign corporations Y and Z respectively. The royalty income is general category income to X under section 904(d)(2)(A)(ii) and §1.904-4(b)(2)(ii).

(ii) Analysis--(A) Allocation. X's R&E expenditures are definitely related to all of the gross intangible income from the products that it produces, which are floodlights, flashlights, fuse boxes, and solderless connectors. All of these products are in the same three digit SIC code category, Electric Lighting and Wiring Equipment (SIC

Industry Group 364). Therefore, under paragraph (b) of this section, X's R&E expenditures are definitely related to the class of gross intangible income related to SIC code category 354 and to all items of gross intangible income attributable to the class. These items of X's gross intangible income are gross income from the sale of floodlights, flashlights, fuse boxes, and solderless connectors in the United States and royalties from Corporations Y and Z.

(B) Apportionment--(1) In general. For purposes of applying this section to section 904 as the operative section, the statutory grouping of gross intangible income is foreign source general category income, and the residual grouping of gross intangible income is U.S. source income.

(2) Exclusive apportionment. Under paragraph (c) of this section, because at least 50% of X's research and experimentation was performed in the United States, 50% of the R&E expenditures, or $50,000x ($100,000x x 50%), is apportioned exclusively to the residual grouping of U.S. source gross intangible income.

(3) Apportionment based on gross receipts. After taking into account exclusive apportionment, X has $50,000x ($100,000x – $50,000x) of R&E expenditures that must be apportioned between the residual and statutory groupings. Gross receipts from sales of Y and Z are taken into account in apportioning the R&E expenditures if X is reasonably expected to license, sell, or transfer the intangible property that would arise from the research and experimentation that results in the $100,000x deduction. Because X licensed intangible property related to the SIC code in Year 1, it is presumed that it would continue to license the intangible property that would be developed from the current research and experimentation. Under paragraph (d)(3)(i) of this section, because Y and Z are uncontrolled parties with respect to X, only gross receipts from their sales of the licensed product, floodlights, are included for purposes of apportionment. In addition, under paragraph (d)(3)(iii) of this section, only the portion of Z's gross receipts that are attributable to the floodlights that incorporate the intangible property licensed from X, rather than Z's total gross receipts, are used for purposes of apportionment. All of X's gross receipts from sales in the entire SIC code category are included for purposes of apportionment on the basis of gross intangible income attributable to those sales. Under paragraph (d)(1) of this section, $11,039x ($50,000x × ($135,000x + $120,000x)/($900,000x + $135,000x + $120,000x)) is apportioned to the statutory grouping of gross intangible income, or foreign source general category income. The remaining $38,961x ($50,000x × $900,000x/($900,000x + $135,000x + $120,000x)) is apportioned to the residual grouping of gross intangible income, or U.S. source gross income.

(4) Summary. Accordingly, for purposes of the foreign tax credit limitation, $11,039x of X's R&E expenditures are apportioned to foreign source general category income and $88,961x ($50,000x + $38.961x) of X's R&E expenditures are apportioned to U.S. source gross income.

(5) Example 5--(i) Facts. X, a domestic corporation, is a cloud storage service provider. Cloud storage services are a service within the category, Computer Programming, Data Processing, and other Computer Related Services (SIC Industry Group 737). During Year 1, X incurred R&E expenditures of $50,000x to invent and copyright new storage monitoring and management software. All of the research and experimentation was performed in the United States. X uses this software in its own business to provide services to customers. X also licenses a version of the software that can be used by other businesses that provide cloud storage services. X licenses the software to uncontrolled party U, which sub-licenses the software to other businesses that provide cloud storage services to customers. U does not use the software except to sublicense it. As a part of the licensing agreement with U, U and its sub-licensees are only permitted to use the software in certain countries outside of the United States. Under the contract with U, U pays X a royalty of 50% on the amount it receives from its sub-licensees that use the software to provide services to customers. In Year 1, X earns $300,000x of gross receipts from providing cloud storage services within the U.S. Further, in Year 1 U receives $10,000x of royalty income from its sub-licensees and pays a royalty of $5,000x to X. Thus, X also earns $5,000x of foreign source royalty income from licensing its software to U for use outside of the United States.

(ii) Analysis--(A) Allocation. The R&E expenditures were incurred in connection with the development of cloud computing software and they are definitely related to the items of gross intangible income related to the SIC Code category, namely gross income from the storage monitoring and management software in the United States and royalties received from U. Accordingly, under paragraph (b) of this section, the R&E expenditures are allocable to this class of gross intangible income, all of which is general category income of X.

(B) Apportionment--(1) In general. For purposes of applying this section to section 904 as the operative section, the statutory grouping of gross intangible income is foreign source general category income, and the residual grouping of gross intangible income is U.S. source income.

(2) Exclusive apportionment. Under paragraph (c) of this section, because at least 50% of X's research and experimental activity was performed in the United States, 50% of the R&E expenditures, or $25,000x ($50,000x x 50%), is apportioned exclusively to the residual grouping of U.S. source gross intangible income.

(3) Apportionment based on gross receipts--(i) In general. After taking into account exclusive apportionment, X has $25,000x ($50,000x – $25,000x) of R&E expenditures that must be apportioned between the statutory and residual groupings. Because U’s sub-licensees’ gross receipts incorporate intangible property licensed by X, U’s sub-licensees’ gross receipts from services incorporating the licensed intangible property are taken into account in apportioning X’s R&E expenditures if X is reasonably expected to license, sell, or transfer intangible property that would arise from the R&E expenditures incurred in Year 1. Because U has licensed and the sub-licensees have sublicensed the intangible property developed by X related to the SIC code, it is presumed that U would continue to license the intangible property that would be developed from the current research and experimentation.

(ii) Determination of U’s sub-licensee’s gross receipts. Under paragraph (d)(3)(iv) of this section, X can make a reasonable estimate of the gross receipts of U’s sub-licensees from services incorporating the intangible property licensed by X by estimating, after an appropriate economic analysis, that U would charge a 5% royalty on the sub-licensee’s sales. U received a royalty of $10,000x from the sub-licensees. X then determines U’s sub-licensees’ foreign sales by dividing the total royalty payments received by U by the royalty estimated rate ($10,000x/.05x = $200,000x).

(iii) Results of apportionment based on gross receipts. Therefore, under paragraphs (d)(1) and (3) of this section, $10,000x ($25,000x x $200,000x/($300,000x + $200,000x)) is apportioned to the statutory grouping of gross intangible income, or foreign source general category income. The remaining $15,000x ($25,000x x $300,000x/($300,000x + $200,000x)) is apportioned to the residual grouping of gross intangible income, or U.S. source income.

(4) Summary. Accordingly, for purposes of the foreign tax credit limitation, $10,000x of X’s R&E expenditures are apportioned to foreign source general category income and $40,000x ($25,000x + $15,000x) of X’s R&E expenditures are apportioned to U.S. source income.

(h) Applicability date. This section applies to taxable years beginning after December 31, 2019.

Par 12. Section 1.861-20 is added to read as follows:

§1.861-20 Allocation and apportionment of foreign income taxes.

(a) Scope. This section provides rules for the allocation and apportionment of foreign income taxes, including allocating and apportioning foreign income taxes to separate categories for purposes of the foreign tax credit. The rules of this section apply except as modified under the rules for an operative section. See, for example, §§1.704-1(b)(4)(viii)(d)(1), 1.904-6, 1.960-1(d)(3)(ii), and 1.965-5(b)(2). Paragraph (b) of this section provides definitions for the purposes of this section. Paragraph (c) of this section provides the general rule for allocation and apportionment of foreign income taxes. Paragraph (d) of this section provides rules for assigning foreign gross income to statutory and residual groupings. Paragraph (e) of this section provides rules for allocating and apportioning foreign law deductions to foreign gross income in the statutory and residual groupings. Paragraph (f) of this section provides rules for apportioning foreign income taxes among statutory and residual groupings. Paragraph (g) of this section provides examples that illustrate the application of this section. Paragraph (h) of this section provides the applicability dates for this section.

(b) Definitions. The following definitions apply for purposes of this section.

(1) Corporation. The term corporation has the same meaning as set forth in §301.7701-2(b), except that it does not include a reverse hybrid.

(2) Corresponding U.S. item. The term corresponding U.S. item means the item of U.S. gross income or U.S. loss, if any, that arises from the same transaction or other realization event from which an item of foreign gross income also arises. An item of U.S. gross income or U.S. loss is a corresponding U.S. item even if the item of foreign gross income that arises from the same transaction or realization event differs in amount from the item of U.S. gross income or U.S. loss. A corresponding U.S. item

does not include an item of gross income that is exempt, excluded or eliminated from U.S. gross income, nor does it include an item of U.S. gross income or U.S. loss that is not realized, recognized or taken into account by the taxpayer in the U.S. taxable year in which the taxpayer paid or accrued the foreign income tax.

(3) Foreign capital gain amount. The term foreign capital gain amount means the portion of a distribution that under foreign law gives rise to gross income of a type described in section 301(c)(3)(A).

(4) Foreign dividend amount. The term foreign dividend amount means the portion of a distribution that is taxable as a dividend under foreign law.

(5) Foreign gross income. The term foreign gross income means the items of gross income included in the base upon which a foreign income tax is imposed. This includes all items of foreign gross income included in the foreign tax base, even if the foreign taxable year begins in the U.S. taxable year that precedes the U.S. taxable year in which the taxpayer pays or accrues the foreign income tax.

(6) Foreign income tax. The term foreign income tax means an income, war profits, or excess profits tax within the meaning of §1.901-2(a) that is a separate levy within the meaning of §1.901-2(d).

(7) Foreign law CFC. The term foreign law CFC means a foreign corporation certain of the earnings of which are taxable to its shareholder under a foreign law subpart F regime.

(8) Foreign law distribution. The term foreign law distribution has the meaning provided in paragraph (d)(3)(i)(C) of this section.

(9) Foreign law subpart F income. The term foreign law subpart F income means the items of a foreign law CFC, computed under foreign law, that give rise to an inclusion in a taxpayer's foreign gross income by reason of a foreign law subpart F regime.

(10) Foreign law subpart F regime. A foreign law subpart F regime is a foreign law tax regime similar to the subpart F regime described in sections 951 through 959 that imposes a tax on a shareholder of a corporation based on an inclusion in the shareholder's taxable income of certain of the corporation's current earnings that are of a type that is similar to subpart F income, whether or not the foreign law deems the corporation's earnings to be distributed.

(11) Foreign taxable income. The term foreign taxable income means foreign gross income reduced by the deductions that are allowed under foreign law.

(12) Foreign taxable year. The term foreign taxable year has the meaning set forth in section 7701(a)(23), applied by substituting "under foreign law" for the phrase "under subtitle A."

(13) Reverse hybrid. The term reverse hybrid means an entity that is described in §301.7701-2(b) and that is a fiscally transparent entity (under the principles of §1.894-1(d)(3)) or a branch under the laws of a foreign country imposing tax on the income of the entity.

(14) Taxpayer. The term taxpayer has the meaning described in §1.901-2(f)(1).

(15) U.S. capital gain amount. The term U.S. capital gain amount means the portion of a distribution to which section 301(c)(3)(A) applies.

(16) U.S. dividend amount. The term U.S. dividend amount means the portion of a distribution that is made out of earnings and profits under Federal income tax law or out of previously taxed earnings and profits described in section 959(a) or (b). It also includes amounts included in gross income as a dividend by reason of section 1248 or section 964(e).

(17) U.S. gross income. The term U.S. gross income means the items of gross income that a taxpayer recognizes and includes in taxable income under Federal income tax law for its U.S. taxable year.

(18) U.S. loss. The term U.S. loss means the item of loss that a taxpayer recognizes and includes in taxable income under Federal income tax law for its U.S. taxable year.

(19) U.S. return of capital amount. The term U.S. return of capital amount means the portion of a distribution to which section 301(c)(2) applies.

(20) U.S. taxable year. The term U.S. taxable year has the same meaning as that of the term taxable year set forth in section 7701(a)(23).

(c) General rule. A foreign income tax is allocated or apportioned to the statutory and residual groupings that include the items of foreign gross income included in the base on which the tax is imposed. Each foreign income tax (that is, each separate levy) is allocated and apportioned separately under the rules in this section. A foreign income tax is allocated and apportioned to or among the statutory and residual groupings under the following steps:

(1) First, by assigning the items of foreign gross income to the groupings under the rules of paragraph (d) of this section;

(2) Second, by allocating and apportioning the deductions that are allowed under foreign law to the foreign gross income in the groupings under the rules of paragraph (e) of this section; and

(3) Third, by allocating and apportioning the foreign income tax by reference to the foreign taxable income in the groupings under the rules of paragraph (f) of this section.

(d) Assigning items of foreign gross income to the statutory and residual groupings--(1) In general. Each item of foreign gross income is assigned to a statutory or residual grouping. The amount of the item is determined under foreign law. However, Federal income tax law applies to characterize the item and the transaction or other realization event from which the item arose, and to assign it to a grouping. Except as provided in paragraph (d)(3) of this section, if a taxpayer pays or accrues a foreign income tax that is imposed on foreign taxable income that includes an item of foreign gross income in a U.S. taxable year in which the taxpayer also realizes, recognizes, or takes into account a corresponding U.S. item, then the item of foreign gross income is assigned to the grouping to which the corresponding U.S. item is assigned. If the corresponding U.S. item is a U.S. loss (or zero), the foreign gross income is assigned to the grouping to which a gain would be assigned had the transaction or other realization event given rise to a gain, rather than a U.S. loss (or zero), for Federal income tax purposes, and not (if different) to the grouping to which the U.S. loss is allocated and apportioned in computing U.S. taxable income. Paragraph (d)(3) of this section provides special rules regarding the assignment of the item of foreign gross income in particular circumstances.

(2) Items of foreign gross income with no corresponding U.S. item. Except as provided in paragraph (d)(3) of this section, the rules in paragraphs (d)(2)(i) and (ii) of this section apply for purposes of characterizing an item of foreign gross income and assigning it to a grouping if the taxpayer does not realize, recognize, or take into account a corresponding U.S. item in the same U.S. taxable year in which the taxpayer pays or accrues foreign income tax that is imposed on foreign taxable income that includes the item of foreign gross income.

(i) Foreign gross income from U.S. nonrecognition event, or U.S. recognition event that falls in a different U.S. taxable year. If a taxpayer recognizes an item of foreign gross income arising from a transaction or other foreign realization event that does not result in the recognition of gross income or loss under Federal income tax law in the same U.S. taxable year in which the foreign income tax is paid or accrued, then the item of foreign gross income is characterized and assigned to the grouping to which the corresponding U.S. item would be assigned if the event giving rise to the foreign gross income resulted in the recognition of gross income or loss under Federal income tax law in that U.S. taxable year. For example, if a foreign gross income item of gain arises from a distribution of property that is treated as a taxable disposition of the property under foreign law, and the realization event under foreign law does not cause the recognition of gain or loss under Federal income tax law, the foreign gross income item of gain is assigned to the grouping to which a corresponding U.S. item of gain or loss on a taxable disposition of the property would be assigned. However, foreign gross income arising from the receipt of the distribution is assigned under the rules of paragraphs (d)(3)(i) and (ii) of this section. As another example, if a taxpayer pays or accrues a foreign income tax that is imposed on foreign taxable income that includes an item of foreign gross income by reason of a transaction or other realization event that also gave rise to an item of U.S. gross income or U.S. loss, but the U.S. and foreign taxable years end on different dates and the event occurred in the last U.S. taxable year that ends before the end of the foreign taxable year, then the item of foreign gross income is characterized and assigned to the grouping to which the corresponding U.S. item would be assigned if the item of U.S. gross income or U.S. loss were taken into account under Federal income tax law in the U.S. taxable year in which the foreign income tax is paid or accrued.

(ii) Foreign gross income of a type that is recognized but excluded from U.S. gross income--(A) In general. If a taxpayer recognizes an item of foreign gross income that is a type of recognized gross income that Federal income tax law excludes from U.S. gross income, then the item of foreign gross income is assigned to the grouping to which the item of gross income would be assigned if it were included in U.S. gross income. Notwithstanding the previous sentence, foreign gross income that is attributable to a base difference is assigned under paragraph (d)(2)(ii)(B) of this section.

(B) Base differences. If a taxpayer recognizes an item of foreign gross income that is attributable to a base difference, then the item of foreign gross income is assigned to the residual grouping. But see §1.904-6(b)(1) (assigning foreign gross income attributable to a base difference to foreign source income in the separate category described in section 904(d)(2)(H)(i)) for purposes of applying section 904 as the operative section). An item of foreign gross income is attributable to a base difference under this paragraph (d)(2)(ii)(B) only if it is one of the following items:

(<u>1</u>) Death benefits described in section 101;

(<u>2</u>) Gifts and inheritances described in section 102;

(<u>3</u>) Contributions to capital described in section 118;

(<u>4</u>) The receipt of money or other property in exchange for stock described in section 1032 (including by reason of a transfer described in section 351(a));

(<u>5</u>) The receipt of money or other property in exchange for a partnership interest described in section 721;

(<u>6</u>) The portion of a distribution of property by a corporation to its shareholder with respect to its stock that is described in section 301(c)(2); and

(<u>7</u>) A distribution to a partner described in section 733.

(3) <u>Special rules for assigning certain items of foreign gross income to a statutory or residual grouping</u>--(i) <u>Items of foreign gross income included by a taxpayer in its capacity as a shareholder</u>--(A) <u>Scope</u>. The rules of this paragraph (d)(3)(i) apply to assign to a statutory or residual grouping an item of foreign gross income that a taxpayer includes in foreign taxable income in its capacity as a shareholder of a corporation as a result of a distribution, a foreign law distribution, an inclusion, or gain with respect to the stock of the corporation (as determined under foreign law).

(B) <u>Characterizing and assigning foreign gross income items that arise from a distribution</u>--(<u>1</u>) <u>In general</u>. If there is a distribution by a corporation that is recognized for both foreign law and Federal income tax purposes, a taxpayer first applies the rules of paragraph (d)(3)(i)(B)(<u>2</u>) of this section, and then (if necessary) applies the rules of paragraph (d)(3)(i)(B)(<u>3</u>) of this section to determine the amount and the character of the items of foreign gross income that arise from the distribution. Foreign gross income arising from any portion of a distribution that is not recognized as a distribution for Federal income tax purposes is characterized under the rules for foreign law distributions in paragraph (d)(3)(i)(C) of this section. See §1.960-1(d)(3)(ii) for rules for assigning foreign gross income arising from a distribution described in this paragraph to income groups or PTEP groups for purposes of section 960 as the operative section.

(2) Characterizing and assigning the foreign dividend amount. The foreign dividend amount is, to the extent of the U.S. dividend amount, assigned to the same statutory and residual groupings from which a distribution of the U.S. dividend amount is made under Federal income tax law. If the foreign dividend amount exceeds the U.S. dividend amount, the excess foreign dividend amount is an item of foreign gross income that is, to the extent of the U.S. return of capital amount, treated as attributable to a base difference described in paragraph (d)(2)(ii)(B)(6) of this section. Any additional excess of the foreign dividend amount over the sum of the U.S. dividend amount and the U.S. return of capital amount is an item of foreign gross income that is assigned to the statutory or residual grouping (or ratably to the groupings) to which the U.S. capital gain amount is assigned.

(3) Characterizing and assigning the foreign capital gain amount. The foreign capital gain amount is, to the extent of the U.S. capital gain amount, assigned to the statutory and residual groupings to which the U.S. capital gain amount is assigned under Federal income tax law. If the foreign capital gain amount exceeds the U.S. capital gain amount, the excess is, to the extent of the U.S. return of capital amount, treated as attributable to a base difference described in paragraph (d)(2)(ii)(B)(6) of this section. Any additional excess of the foreign capital gain amount over the sum of the

U.S. capital gain amount and the U.S. return of capital amount is assigned ratably to the statutory and residual groupings to which the U.S. dividend amount is assigned.

(C) Foreign gross income items arising from a foreign law distribution. An item of foreign gross income that arises from an event that foreign law treats as a taxable distribution (other than by reason of a foreign law subpart F regime) but that Federal income tax law does not treat as a distribution of property (for example, a stock dividend described in section 305 or a foreign law consent dividend) (a foreign law distribution) is assigned under the rules of paragraph (d)(3)(i)(B) of this section to the same statutory or residual groupings to which the foreign gross income would be assigned if a distribution of property in the amount of the foreign law distribution were made for Federal income tax purposes in the U.S. taxable year in which the taxpayer paid or accrued the foreign income tax.

(D) Foreign gross income from an inclusion under a foreign law subpart F regime. An item of foreign gross income that a taxpayer includes under foreign law in its capacity as a shareholder of a foreign law CFC under a foreign law subpart F regime is assigned to the same statutory and residual groupings as the item of foreign law subpart F income of the foreign law CFC that gives rise to the item of foreign gross income of the taxpayer. The assignment is made by treating the items of foreign gross income of the taxpayer attributable to the foreign law subpart F regime inclusion as the items of foreign gross income of the foreign law CFC and applying the rules in this paragraph (d) by treating the foreign law CFC as the taxpayer in its U.S. taxable year with or within which its foreign taxable year (under the law of the foreign jurisdiction imposing the shareholder-level tax) ends. See §1.904-6(f) for special rules with respect to items of foreign gross income relating to items of the foreign law CFC that give rise to inclusions under section 951A for purposes of applying section 904 as the operative section.

(ii) Tax imposed on disregarded payments--(A) Disregarded payments made by a foreign branch. Except as provided in paragraph (d)(3)(ii)(C) of this section, an item of foreign gross income that a taxpayer includes by reason of the receipt of a disregarded payment made by a disregarded entity or other foreign branch is assigned to the statutory or residual grouping to which the income out of which the payment is made is assigned. For purposes of this paragraph (d)(3)(ii), a disregarded payment is considered to be made ratably out of all of the accumulated after-tax income of the foreign branch, as computed for Federal income tax purposes. The accumulated after-tax income of the foreign branch is deemed to have arisen in the statutory and residual groupings in the same ratio as the tax book value of the assets of the branch in the groupings, determined in accordance with §1.987-6(b)(2), unless the payment was made with a principal purpose of avoiding the purposes of an operative section, or results in a material distortion in the association of foreign income tax with U.S. gross income in the same statutory or residual grouping as the foreign gross income from the payment. For purposes of applying §1.987-6(b)(2) under this paragraph (d)(3)(ii), assets of the foreign branch include stock held by the foreign branch. But see §1.904-6(b)(2)(i) (assigning certain items based on the separate category to which the U.S. gross income to which the disregarded payment is allocable is assigned under §1.904-4(f)(2)(vi)(A) for purposes of applying section 904 as the operative section).

(B) Disregarded payments made by an owner. Except as provided in paragraph (d)(3)(ii)(C) of this section, an item of foreign gross income that a taxpayer includes by reason of the receipt of a disregarded payment made to a foreign branch by a foreign branch owner is assigned to the residual grouping. But see §1.904-6(b)(2)(ii) (assigning certain items to the foreign branch category for purposes of applying section 904 as the operative section).

(C) Disregarded payments in connection with disregarded sales or exchanges of property. An item of foreign gross income attributable to gain recognized under foreign law by reason of a disregarded payment received in exchange for property is characterized and assigned under the rules of paragraph (d)(2)(i) of this section.

(D) Definitions. For purposes of this paragraph (d)(3)(ii) and paragraph (g) of this section, the terms disregarded entity, disregarded payment, foreign branch, and foreign branch owner have the same meaning given to those terms in §1.904-4(f)(3). A foreign branch owner can include a foreign corporation. See §1.904-4(f)(3)(viii).

(iii) Reverse hybrids. An item of foreign gross income that a taxpayer includes in foreign taxable income in its capacity as the owner of a reverse hybrid is assigned to a statutory or residual grouping by treating the taxpayer's items of foreign gross income included from the reverse hybrid as the foreign gross income of the reverse hybrid, and applying the rules in this paragraph (d) by treating the reverse hybrid as the taxpayer in the reverse hybrid's U.S. taxable year with or within which its foreign taxable year (under the law of the foreign jurisdiction imposing the owner-level tax) ends. See §1.904-6(f) for special rules that apply for purposes of section 904 with respect to items of foreign gross income that under this paragraph (d)(3)(iii) would be assigned to a separate category that includes income that gives rise to inclusions under section 951A.

(iv) Gain on sale of disregarded entity. An item of foreign gross income arising from gain recognized on the disposition of a disregarded entity that is characterized as a disposition of assets for Federal income tax purposes is assigned to statutory and residual groupings in the same proportion as the gain that would be treated as foreign gross income in each grouping if the transaction were treated as a disposition of assets for foreign tax law purposes.

(e) Allocating and apportioning deductions (allowed under foreign law) to foreign gross income in a grouping--(1) Application of foreign law expense allocation rules. In order to determine foreign taxable income in each statutory grouping, or the residual grouping, foreign gross income in each grouping is reduced by deducting any expenses, losses, or other amounts that are deductible under foreign law that are specifically allocable to the items of foreign gross income in the grouping under the laws of that foreign country. If expenses are not specifically allocated under foreign law, then the expenses are allocated and apportioned among the groupings under the principles of foreign law. Thus, for example, if foreign law provides that expenses will be apportioned on a gross income basis, the foreign law deductions are apportioned on the basis of the relative amounts of foreign gross income assigned to each grouping.

(2) Application of U.S. expense allocation rules in the absence of foreign law rules. If foreign law does not provide rules for the allocation or apportionment of expenses, losses or other deductions to particular items of foreign gross income, then the principles of the section 861 regulations (as defined in §1.861-8(a)(1)) apply in

allocating and apportioning such expenses, losses, or other deductions to foreign gross income. For example, in the absence of foreign law expense allocation rules, the principles of the section 861 regulations apply to allocate definitely related expenses to particular categories of foreign gross income and provide the methods for apportioning foreign law expenses that are definitely related to more than one statutory grouping or that are not definitely related to any statutory grouping. For this purpose, the apportionment of expenses required to be made under the principles of the section 861 regulations need not be made on other than a separate company basis. If the taxpayer applies the principles of the section 861 regulations for purposes of allocating foreign law deductions under this paragraph (e), the taxpayer must apply the principles in the same manner as the taxpayer applies such principles in determining the income or earnings and profits for Federal income tax purposes of the taxpayer (or of the foreign branch, controlled foreign corporation, or other entity that paid or accrued the foreign taxes, as the case may be). For example, a taxpayer must use the modified gross income method under §1.861-9T when applying the principles of that section for purposes of this paragraph (e) to determine the amount of foreign taxable income in each grouping if the taxpayer applies the modified gross income method in determining the income and earnings and profits of a controlled foreign corporation for Federal income tax purposes.

(f) Apportionment of foreign income tax among groupings. If foreign taxable income is assigned to more than one grouping, then the foreign income tax is apportioned among the statutory and residual groupings by multiplying the foreign income tax by a fraction, the numerator of which is the foreign taxable income in a grouping and the denominator of which is all foreign taxable income on which the foreign income tax is imposed. If foreign law, including by reason of an income tax convention, exempts certain types of income from tax, or if foreign taxable income is reduced to or below zero by foreign law deductions, then no foreign income tax is allocated and apportioned to that income. A withholding tax (as defined in section 901(k)(1)(B)) is allocated and apportioned to the foreign gross income from which it is withheld. If foreign law, including by reason of an income tax convention, provides for a specific rate of tax with respect to certain types of income (for example, capital gains), or allows credits only against tax on particular items or types of income (for example, credit for foreign withholding taxes), then such provisions are taken into account in determining the amount of foreign tax imposed on such foreign taxable income.

(g) Examples. The following examples illustrate the application of this section and §1.904-6.

(1) Presumed facts. Except as otherwise provided, the following facts are assumed for purposes of the examples:

(i) USP and US2 are domestic corporations, which are unrelated;

(ii) USP elects to claim a foreign tax credit under section 901;

(iii) CFC, CFC1, and CFC2 are controlled foreign corporations organized in Country A, and are not reverse hybrids;

(iv) All parties have a U.S. dollar functional currency and a U.S. taxable year and foreign taxable year that corresponds to the calendar year;

(v) No party has expenses for Country A tax purposes or expenses for U.S. tax purposes (other than foreign income tax expense); and

(vi) Section 904 is the operative section, and terms have the meaning provided in this section or §§1.904-4 and 1.904-5.

(2) Example 1: Corresponding U.S. item--(i) Facts. USP conducts business in Country A that gives rise to a foreign branch. In Year 1, for Country A tax purposes, USP earns $600x of gross income from the sale of Asset X and incurs foreign income tax of $80x. Also in Year 1, for Federal income tax purposes, USP earns $800x of foreign branch category income from the sale of Asset X.

(ii) Analysis. For purposes of allocating and apportioning the $80x of Country A foreign income tax, the $600x of Country A gross income from the sale of Asset X is first assigned to separate categories. The $800x of foreign branch category income from the sale of Asset X is the corresponding U.S. item to the Country A item of gross income. Under paragraph (d)(1) of this section, because USP recognizes a corresponding U.S. item with respect to the Country A item of gross income in the same U.S. taxable year, the $600x of Country A gross income is assigned to the same separate category as the corresponding U.S. item. This is the case even though the amount of gross income recognized for Federal income tax purposes differs from the amount recognized for Country A tax purposes. Accordingly, the $600x of Country A gross income is assigned to the foreign branch category. Additionally, because all of the Country A taxable income is assigned to a single separate category, the $80x of Country A tax is also allocated to the foreign branch category. No apportionment of the $80x is necessary because the class of gross income to which the tax is allocated consists entirely of a single statutory grouping, foreign branch category income.

(3) Example 2: Characterization of transactions--(i) Facts. USP owns all of the outstanding stock of CFC, which conducts business in Country A. In Year 1, USP sells all of the stock of CFC to US2. For Country A tax purposes, USP recognizes $800x of gain on which Country A imposes $80x of foreign income tax based on its rules for taxing capital gains of nonresidents. For Federal income tax purposes, USP recognizes $800x of gain on the sale of the stock of CFC, all of which is included in the gross income of USP as a dividend under section 1248(a). Under §§1.904-4(d) and 1.904-5(c)(4), the $800x is general category income to USP.

(ii) Analysis. For purposes of allocating and apportioning the $80x of Country A foreign income tax, the $800x of Country A gross income from the sale of the stock of CFC is first assigned to separate categories. The $800x of general category income from the sale of the stock of CFC is the corresponding U.S. item to the Country A item of gross income. Under paragraph (d)(1) of this section, because USP recognizes a corresponding U.S. item with respect to the Country A gross income in the same U.S. taxable year, the $800x of Country A gross income is assigned to the same separate category as the corresponding U.S. item. Accordingly, the $800x of Country A gross income is assigned to the general category. This is the case even though for Country A tax purposes the $800x of Country A gross income is characterized as gain from the sale of stock, which would be passive category income under section 904(d)(2)(B)(i), because the income is assigned to a separate category based on the characterization of the gain as a dividend under Federal income tax law. Additionally, because all of the Country A taxable income is assigned to a single separate category, the $80x of Country A tax is also allocated to the general category. No apportionment of the $80x is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, general category income.

(4) Example 3: No corresponding U.S. item because of a timing difference--(i) Facts. USP owns all of the outstanding stock of CFC, which conducts business in Country A. CFC sells Asset X. For Country A tax purposes, the sale of Asset X occurs in Year 1, CFC recognizes $400x of foreign gross income and incurs $80x of foreign income tax. For Federal income tax purposes, the sale of Asset X occurs in Year 2 and CFC recognizes $500x of general category income.

(ii) Analysis. For purposes of allocating and apportioning the $80x of Country A foreign income tax in Year 1, the $400x of Country A gross income from the sale of Asset X is first assigned to separate categories. There is no corresponding U.S. item because the U.S. gross income related to the sale is recognized in a different U.S. taxable year than the item of foreign gross income. Under paragraph (d)(2)(i) of this section, because there would be a corresponding U.S. item if the realization event occurred in the same U.S. taxable year for U.S. and foreign tax purposes, the item of foreign gross income (the $400x from the sale of Asset X) is characterized and assigned to the groupings to which the corresponding U.S. item would be assigned if it were recognized for Federal income tax purposes in the same U.S. taxable year in which the item of foreign gross income is recognized. This is the case even though the amount of gross income recognized for Federal income tax purposes differs from the amount recognized for Country A tax purposes. Accordingly, the $400x of Country A gross income is assigned to the general category. Additionally, because all of the Country A taxable income is assigned to a single separate category, the $80x of Country A tax is also allocated to the general category. No apportionment of the $80x is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, general category income.

(5) Example 4: No corresponding U.S. item because excluded from gross income--(i) Facts. USP conducts business in Country A. In Year 1, USP earns $200x of interest income on a State or local bond. For Country A tax purposes, the $200x of income is included in gross income and incurs $10x of foreign income tax. For Federal income tax purposes, the $200x is excluded from gross income under section 103.

(ii) Analysis. For purposes of allocating and apportioning the $10x of Country A foreign income tax, the $200x of Country A gross income is first assigned to separate categories. There is no corresponding U.S. item because the interest income is excluded from U.S. gross income. Thus, the rules of paragraph (d)(2) of this section apply to characterize and assign the foreign gross income to the groupings to which a corresponding U.S. item would be assigned if it were recognized under Federal income tax law in that U.S. taxable year. The interest income is excluded from U.S. gross income, but is otherwise described or identified by section 103. Accordingly, under paragraph (d)(2)(ii)(A) of this section, the $200x of Country A gross income is assigned to the separate category to which the interest income would be assigned under Federal income tax law if the income were included in gross income. Under section 904(d)(2)(B)(i), the interest income would be passive category income. Accordingly, the $200x of Country A gross income is assigned to the passive category. Additionally, because all of the Country A taxable income is assigned to a single separate category, the $10x of Country A tax is also allocated to the passive category (subject to the rules in §1.904-4(c)). No apportionment of the $10x is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, passive category income.

(6) Example 5: Actual distribution--(1) Facts. USP owns all of the outstanding stock of CFC1, which in turn owns all of the outstanding stock of CFC2. CFC1 and CFC2 conduct business in Country A. In Year 1, CFC2 distributes $300x to CFC1. For Country A tax purposes, $100x of the distribution is the foreign dividend amount, $160x is treated as a nontaxable return of capital, and the remaining $40x is the foreign capital gain amount. CFC1 incurs $20x of foreign income tax with respect to the foreign dividend amount and $4x of foreign income tax with respect to the foreign capital gain amount. The $20x and $4x of foreign income tax are each a separate levy. For Federal income tax purposes, $150x of the distribution is the U.S. dividend amount, $100x is the U.S. return of capital amount, and the remaining $50x is the U.S. capital gain amount. Under section 904(d)(3)(D) and §§1.904-4(d) and 1.904-5(c)(4), the $150x of U.S. dividend amount consists solely of general category income in the hands of CFC1. Under section 904(d)(2)(B)(i) and §1.904-4(b)(2)(i)(A), the $50x of U.S. capital gain amount is passive category income to CFC1.

(ii) Analysis--(A) In general. Because the $20x of Country A foreign income tax and the $4x of Country A foreign income tax are separate levies, the taxes are allocated and apportioned separately. For purposes of allocating and apportioning each foreign income tax, the relevant item of Country A gross income (the foreign dividend amount or foreign capital gain amount) is first assigned to separate categories. The U.S. dividend amount and U.S. capital gain amount are corresponding U.S. items. However, paragraph (d)(3)(i)(B) of this section (and not paragraph (d)(1) of this section) applies to assign the items of foreign gross income arising from the distribution.

(B) Foreign dividend amount. Under paragraph (d)(3)(i)(B)(2) of this section, the foreign dividend amount ($100x) is, to the extent of the U.S. dividend amount ($150x), assigned to the same separate category from which the distribution of the U.S. dividend amount is made under Federal income tax law. Thus, $100x of foreign gross income that is the foreign dividend amount is assigned to the general category. Additionally, because all of the Country A taxable income included in the base on which the $20x of foreign income tax is imposed is assigned to a single separate category, the $20x of Country A tax on the foreign dividend amount is also allocated to the general category. No apportionment of the $20x is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, general category income.

(C) Foreign capital gain amount. Under paragraph (d)(3)(i)(B)(3) of this section, the foreign capital gain amount ($40x) is, to the extent of the U.S. capital gain amount ($50x), assigned to the same separate category to which the U.S. capital gain is assigned under Federal income tax law. Thus, the $40x of foreign gross income that is the foreign capital gain amount is assigned to the passive category. Additionally, because all of the Country A taxable income in the base on which the $4x of foreign income tax is imposed is assigned to a single separate category, the $4x of Country A tax on the foreign dividend amount is also allocated to the passive category. No apportionment of the $4x is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, passive category income.

(7) Example 6: Foreign law distribution--(i) Facts. USP owns all of the outstanding stock of CFC. In Year 1, for Country A tax purposes, CFC distributes $1,000x of its stock that is treated as a dividend to USP, and Country A imposes a withholding tax on USP of $150x with respect to the $1,000x of foreign gross income. For Federal income tax purposes, the distribution is treated as a stock dividend described in section 305(a) and USP recognizes no U.S. gross income. At the time of the distribution, CFC has $800x of section 965(a) PTEP (as defined in §1.960-3(c)(2)(vi)) in a single annual PTEP account (as defined in §1.960-3(c)(1)), and $500x of earnings and profits described in section 959(c)(3). Section 965(g) is the operative section for purposes of applying this section. See §1.965-5(b)(2).

(ii) Analysis. For purposes of allocating and apportioning the $150x of Country A foreign income tax, the $1,000x of Country A gross income is first assigned to the relevant statutory and residual groupings for purposes of applying section 965(g) as the operative section. Under §1.965-5(b)(2), the statutory grouping is the portion of the distribution that is attributable to section 965(a) previously taxed earnings and profits and the residual grouping is the portion of the distribution attributable to other earnings and profits. There is no corresponding U.S. item because under section 305 USP recognizes no U.S. gross income with respect to the distribution. Under paragraph (d)(3)(i)(C) of this section, the item of foreign gross income (the $1,000x distribution) is assigned under the rules of paragraph (d)(3)(i)(B) of this section to the same statutory or residual groupings to which the foreign gross income would be assigned if a distribution of the same amount were made for Federal income tax purposes in Year 1. Under paragraph (d)(3)(i)(B)(2) of this section, the foreign dividend amount ($1,000x) is, to the extent of the U.S. dividend amount ($1,000x), assigned to the same statutory or residual groupings from which a distribution of the U.S. dividend amount would be made under Federal income tax law. Thus, $800x of foreign gross income related to the foreign dividend amount is assigned to the statutory grouping for the portion of the distribution attributable to section 965(a) previously taxed earnings and profits and $200x of foreign gross income is assigned to the residual grouping. Under paragraph (f) of this section, $120x ($150x x $800x/$1000x) of the Country A foreign income tax is apportioned to the statutory grouping and $30x ($150x x $200x/$1000x) of the Country A foreign income tax is apportioned to the residual grouping. See section 965(g) and §1.965-5(b) for application of the applicable percentage (as defined in §1.965-5(d)) to the foreign income tax allocated and apportioned to the statutory grouping.

(8) Example 7: Foreign law subpart F regime, CFC shareholder--(i) Facts. USP owns all of the outstanding stock of CFC1, which in turn owns all of the outstanding stock of CFC2. CFC2 is organized and conducts business in Country B. Country A has a foreign law subpart F regime that imposes a tax on CFC1 for certain earnings of CFC2, a foreign law CFC. In Year 1, CFC2 earns $400x of interest income and $200x of royalty income. CFC2 incurs no foreign income tax. For Country A tax purposes, the $400x of interest income and $200x of royalty income are each an item of foreign law subpart F income of CFC2 that are included in the gross income of CFC1. CFC1 incurs $150x of Country A foreign income tax with respect to the foreign law subpart F income. For Federal income tax purposes, with respect to CFC2, the $400x of interest income is passive category income under section 904(d)(2)(B)(i) and the $200x of royalty income is general category income under §1.904-4(b)(2)(iii).

(ii) Analysis. For purposes of allocating and apportioning CFC1's $150x of Country A foreign income tax, the $600x of Country A gross income is first assigned to separate categories. The $600x of foreign gross income is not included in the U.S. gross income of CFC1, and thus, there is no corresponding U.S. item. Under paragraph (d)(3)(i)(D) of this section, each item of foreign law subpart F income that is included in CFC1's foreign gross income is assigned to the same separate category as the item of foreign law subpart F income of CFC2. With respect to CFC2, the $400x of interest income and the $200x of royalty income would be corresponding U.S. items if CFC2 were the taxpayer. Accordingly, $400x of CFC1's foreign gross income is assigned to the passive category and $200x of CFC1's foreign gross income is assigned to the general category. Under paragraph (f) of this section, $100x ($150x x $400x/$600x) of the Country A foreign income tax is apportioned to the passive category and $50x ($150x x $200x/$600x) of the Country A foreign income tax is apportioned to the general category.

(9) Example 8: Foreign law subpart F regime, U.S. shareholder--(i) Facts. The facts are the same as in paragraph (g)(8)(i) of this section (the facts in Example 7), except that both CFC1 and CFC2 are organized and conduct business in Country B, all of the outstanding stock of CFC1 is owned by Individual X, a U.S. citizen resident in Country A, and Country A imposes tax of $150x on foreign gross income of $600x under its foreign law subpart F regime on Individual X, rather than on CFC1. For Federal income tax purposes, in the hands of CFC2, the $400x of interest income is passive category subpart F income and the $200x of royalty income is general category tested income (as defined in §1.951A-2(b)(1)). CFC2's $400x of interest income gives rise to a passive category subpart F inclusion under section 951(a)(1)(A), and its $200x of tested income gives rise to a GILTI inclusion amount (as defined in §1.951A-1(c)(1)) of $200x, with respect to Individual X.

(ii) Analysis. The analysis is the same as in paragraph (g)(8)(ii) of this section (the analysis in Example 7) except that under §1.904-6(f), because $50x of the Country A foreign income tax is allocated and apportioned under paragraph (d)(3)(i)(D) of this section to CFC2's general category tested income group to which Individual X's inclusion under section 951A is attributable, the $50x of Country A foreign income tax is allocated and apportioned in the hands of Individual X to the section 951A category.

(10) Example 9: Disregarded payment--(i) Facts. USP owns all of the outstanding stock of CFC1. CFC1 owns all of the interests in FDE, a disregarded entity organized in Country A. FDE owns all of the outstanding stock of CFC2. In Year 1, FDE pays $400x of interest to CFC1. For Country A tax purposes, CFC1 includes the $400x of interest income in gross income and incurs foreign income tax of $80x. For Federal income tax purposes, the $400x payment is a disregarded payment and results in no income to CFC1. The tax book value of the assets of FDE, including the stock of CFC2, in each separate category (determined in accordance with §1.987-6(b)(2)) is as follows: $750x of general category assets and $250x of passive category assets. The payment of the $400x of interest is not made with the principal purpose of avoiding the purposes of section 904, and does not result in a material distortion of the association of foreign income tax with U.S. gross income in a separate category.

(ii) Analysis. For purposes of allocating and apportioning CFC1's $80x of foreign income tax, the $400x of Country A gross income is first assigned to separate categories. The $400x of foreign gross income is not included in the U.S. gross income of CFC1, and thus, there is no corresponding U.S. item. Under paragraph (d)(3)(ii)(A) of this section, the $400x payment is considered to be made ratably out of all of the accumulated after-tax income of FDE, which is deemed to have arisen in the separate categories in the same ratio of the tax book value of the assets in the separate categories (as determined under §1.987-6(b)(2)). Accordingly, $300x ($400x x $750x/$1,000x) of the Country A gross income is assigned to the general category and $100x ($400x x $250x/$1,000x) of the Country A gross income is assigned to the passive category. Under paragraph (f) of this section, $60x ($80x x $300x/$400x) of the Country A foreign income tax is apportioned to the general category and $20x ($80x x $100x/$400x) of the Country A foreign income tax is apportioned to the passive category.

(11) Example 10: Disregarded transfer of built-in gain property--(i) Facts. USP owns FDE, a foreign branch operating in Country A. FDE transfers Asset F, equipment used in FDE's trade or business in Country A, for no consideration to USP in a transaction that is disregarded for Federal income tax purposes but treated as a distribution of Asset F from a foreign corporation to its U.S. shareholder for Country A tax purposes. Asset F has a fair market value of $250x at the time of transfer and an adjusted basis of $100x for both Federal income tax and Country A tax purposes. Country A imposes $30x of tax on FDE with respect to the $150x of built-in gain on a deemed sale of Asset F, which is recognized for Country A tax purposes by reason of the transfer to USP. If FDE had sold Asset F for $250x in a transaction that was regarded for Federal income tax purposes, FDE would also have recognized gain

of $150x for Federal income tax purposes, and that gain would have been characterized as foreign branch category income as defined in §1.904-4(f). Country A also imposes $25x of withholding tax on USP by reason of the distribution of Asset F, valued at $250x, to USP.

(ii) Analysis--(A) Net basis tax on built-in gain. For purposes of allocating and apportioning the $30x of Country A foreign income tax imposed on FDE by reason of the deemed sale of Asset F, the $150x of Country A gross income from the deemed sale of Asset F is first assigned to a separate category. Because the transaction is disregarded for Federal income tax purposes, there is no corresponding U.S. item. However, FDE would have recognized gain of $150x, which would have been a corresponding U.S. item, if the deemed sale had been recognized for Federal income tax purposes. Therefore, under paragraph (d)(2)(i) of this section the item of foreign gross income is characterized and assigned to the grouping to which such corresponding U.S. item would have been assigned if the deemed sale were recognized under Federal income tax law. Because the sale of Asset F in a regarded transaction would have resulted in foreign branch category income, the foreign gross income is characterized as foreign branch category income. Because all of the Country A foreign taxable income is assigned to a single separate category, the $30x of Country A tax is also allocated to the foreign branch category. No apportionment of the $30x is necessary because the class of gross income to which the tax is allocated consists entirely of a single statutory grouping, foreign branch category income.

(B) Withholding tax on distribution. For purposes of allocating and apportioning the $25x of Country A withholding tax imposed on USP by reason of the transfer of Asset F, the $250x of Country A gross income from the distribution of Asset F is first assigned to a separate category. The transfer is a remittance from FDE to USP that is disregarded for Federal income tax purposes (as described in §1.904-4(f)(2)(vi)(C)(2) and §1.904-4(f)(3)(ix)) and thus there is no corresponding U.S. item. Under paragraph (d)(3)(ii)(A) of this section the item of foreign gross income is assigned to the groupings to which the income out of which the payment is made is assigned, and the payment is considered to be made ratably out of all of the accumulated after-tax income of FDE, as computed for Federal income tax purposes. The accumulated after-tax income of FDE is deemed to have arisen in the statutory and residual groupings in the same ratio as the tax book value of the FDE's assets in the groupings, determined in accordance with §1.987-6(b)(2). Because all of FDE's assets produce foreign branch category income, the foreign gross income is characterized as foreign branch category income. Because all of the Country A foreign taxable income from which the tax is withheld is assigned to a single separate category, under paragraph (f) of this section the $25x of Country A withholding tax is also allocated to the foreign branch category. No apportionment of the $25x is necessary because the class of gross income to which the tax is allocated consists entirely of a single statutory grouping, foreign branch category income.

(12) Example 11: Sale of disregarded entity--(i) Facts. USP sells FDE, a disregarded entity that is organized and operates in Country A, for $500x. FDE owns Asset X and Asset Y, each having a fair market value of $250x. For Country A tax

purposes, FDE has a basis in Asset X of $100x and a basis in Asset Y of $200x; USP's basis in FDE is $100x; and the sale is treated as a sale of stock. Country A imposes foreign income tax of $40x on USP on the Country A gross income of $400x resulting from the sale of FDE, based on its rules for taxing capital gains of nonresidents. For Federal income tax purposes, USP has a basis of $150x in Asset X, which produces passive category income, and a basis of $150x in Asset Y, which produces general category income that would not be foreign personal holding company income if earned by a CFC. For Federal income tax purposes USP recognizes $100x of passive category income and $100x of general category income from the sale of FDE.

(ii) Analysis. For purposes of allocating and apportioning USP's $40x of Country A foreign income tax, the $400x of Country A gross income resulting from the sale of FDE is first assigned to separate categories. Under paragraph (d)(3)(iv) of this section, USP's $400x of Country A gross income is assigned among the statutory groupings in the same percentages as the foreign gross income in each category that would have resulted if the sale of FDE were treated as an asset sale for Country A tax purposes. Because for Country A tax purposes Asset X had a built-in gain of $150x and Asset Y had a built-in gain of $50x, $300x ($400x x $150x/$200x) of the Country A gross income is assigned to the passive category and $100x ($400x x $50x/$200x) is assigned to the general category. Under paragraph (f) of this section, $30x ($40x x $300x/$400x) of the Country A foreign income tax is apportioned to the passive category, and $10x ($40x x $100x/$400x) of the Country A foreign income tax is apportioned to the general category.

(h) Applicability date. This section applies to taxable years beginning after December 31, 2019.

Par. 13. Section 1.904-4 is amended by:

1. Revising paragraph (c)(7)(i).

2. Revising the third and fourth sentences of paragraph (c)(7)(ii).

3. Revising paragraph (c)(7)(iii).

4. Adding paragraphs (c)(8)(v) through (viii).

5. Revising paragraph (e)(1)(ii) and (e)(2).

6. Removing paragraphs (e)(3) and (4).

7. Removing the language "§1.904-6(b)" in paragraph (o) and adding the language "1.904-6(e)" in its place.

8. Revising paragraph (q).

The revisions and additions read as follows:

§1.904-4 Separate application of section 904 with respect to certain categories of income.

* * * * *

(c) * * *

(7) * * * (i) In general. If the effective rate of tax imposed by a foreign country on income of a foreign corporation that is included in a taxpayer's gross income is reduced under foreign law on distribution of such income, the rules of this paragraph (c) apply at the time that the income is included in the taxpayer's gross income, without regard to the possibility of a subsequent reduction of foreign tax on the distribution. If the inclusion is considered to be high-taxed income, then the taxpayer must initially treat the inclusion as general category income, section 951A category income or income in a specified separate category as provided in paragraph (c)(1) of this section. When the foreign corporation distributes the earnings and profits to which the inclusion was attributable and the foreign tax on the inclusion is reduced, then if a redetermination of U.S. tax liability is required under §1.905-3(b)(2), the taxpayer must redetermine whether the revised inclusion (if any) should be considered to be high-taxed income. See §1.905-3(b)(2)(ii) (requiring a redetermination of the amount of the inclusion, the application of the high-tax exception under section 954(b)(4), and the amount of foreign taxes deemed paid). If, taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income, then the taxpayer, in redetermining its U.S. tax liability for the year or years affected, must treat the inclusion and the associated taxes (as reduced on the distribution) as passive category income and

taxes. For this purpose, the foreign tax on an inclusion under section 951(a)(1) or 951A(a) is considered reduced on distribution of the earnings and profits associated with the inclusion if the total taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is less than the total taxes deemed paid in the year of inclusion. Therefore, any foreign currency gain associated with the earnings and profits that are distributed with respect to the inclusion is not taken into account in determining whether there is a reduction of tax requiring a redetermination of whether the inclusion is high-taxed income.

(ii) * * * If, however, foreign law does not attribute a reduction in taxes to a particular year or years, then the reduction in taxes shall be attributable, on an annual last in-first out (LIFO) basis, to foreign taxes potentially subject to reduction that are associated with previously taxed income, then on a LIFO basis to foreign taxes associated with income that under paragraph (c)(7)(iii) of this section remains as passive income but that was excluded from subpart F income or tested income under section 954(b)(4) or section 951A(c)(2)(A)(i)(III), and finally on a LIFO basis to foreign taxes associated with other earnings and profits. Furthermore, in applying the ordering rules of section 959(c), distributions shall be considered made on a LIFO basis first out of earnings described in section 959(c)(1) and (2), then on a LIFO basis out of earnings and profits associated with income that remains passive income under paragraph (c)(7)(iii) of this section but that was excluded from subpart F income or tested income under section 954(b)(4) or section 951A(c)(2)(A)(i)(III), and finally on a LIFO basis out of other earnings and profits. * * *

(iii) Treatment of income excluded under section 954(b)(4) or section 951A(c)(2)(A)(i)(III). If the effective rate of tax imposed by a foreign country on income of a foreign corporation is reduced under foreign law on distribution of that income, the rules of section 954(b)(4) (including for purposes of determining tested income under section 951A(c)(2)(A)(i)(III)) are applied in the year of inclusion without regard to the possibility of a subsequent reduction of foreign tax. See §1.954-1(d)(3)(iii) and §1.951A-2(c)(6)(iv). If a taxpayer excludes passive income from a controlled foreign corporation's foreign personal holding company income or tested income under section 954(b)(4) or section 951A(c)(2)(A)(i)(III), then, notwithstanding the general rule of §1.904-5(d)(2), the income is considered to be passive category income until distribution of that income. At that time, if after the redetermination of U.S. tax liability required under §1.905-3(b)(2) the taxpayer still elects to exclude the passive income under section 954(b)(4) or section 951A(c)(2)(A)(i)(III), the rules of this paragraph (c)(7)(iii) apply to determine whether the income is high-taxed income upon distribution and, therefore, income in another separate category. For purposes of determining whether a reduction in tax is attributable to taxes on income excluded under section 954(b)(4) or section 951A(c)(2)(A)(i)(III), the rules of paragraph (c)(7)(ii) of this section apply. The rules of paragraph (c)(7)(ii) of this section also apply for purposes of ordering distributions to determine whether such distributions are out of earnings and profits associated with such excluded income. For an example illustrating the operation of this paragraph (c)(7)(iii), see paragraph (c)(8)(vi) of this section (Example 6).

(8) * * *

(v) Example 5-- CFC, a controlled foreign corporation, is a wholly-owned subsidiary of USP, a domestic corporation. USP and CFC are calendar year taxpayers.

In Year 1, CFC's only earnings consist of $200x of pre-tax passive income that is foreign personal holding company income that is earned in foreign Country X. Under Country X's tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed. In Year 1, CFC pays $100x of foreign tax with respect to its passive income. USP does not elect to exclude this income from subpart F under section 954(b)(4) and includes $200x in gross income ($100x of net foreign personal holding company income and $100x of the amount under section 78 (the "section 78 dividend")). At the time of the inclusion, the income is considered to be high-taxed income under paragraphs (c)(1) and (c)(6)(i) of this section and is general category income to USP ($100x > $42x (21% x $200x)). CFC does not distribute any of its earnings in Year 1. In Year 2, CFC has no additional earnings. On December 31, Year 2, CFC distributes the $100x of earnings from Year 1. At that time, CFC receives a $60x refund from Country X attributable to the reduction of the Country X corporate tax imposed on the Year 1 earnings. The refund is a foreign tax redetermination under §1.905-3(a) that under §1.905-3(b)(2) and §1.954-1(d)(3)(iii) requires a redetermination of CFC's Year 1 subpart F income and the application of section 954(b)(4), as well as a redetermination of USP's Year 1 inclusion under section 951(a)(1), its deemed paid taxes under section 960(a), and its Year 1 U.S. tax liability. As recomputed taking into account the $60x refund, CFC's Year 1 passive category net foreign personal holding company income is increased by $60x to $160x, CFC's foreign income taxes attributable to that income are reduced from $100x to $40x, and the income still qualifies to be excluded from CFC's subpart F income under section 954(b)(4) ($40x > $37.80x (90% x 21% x $200x)). Assuming USP does not change its Year 1 election, USP's Year 1 inclusion under section 951(a)(1) is increased by $60x to $160x, and the associated deemed paid tax and section 78 dividend are reduced by $60x to $40x. Under paragraph (c)(7)(i) of this section, in connection with the adjustments required under section 905(c), USP must redetermine whether the adjusted Year 1 inclusion is high-taxed income of USP. Taking into account the $60x refund, the inclusion is not considered high-taxed income of USP ($40x < $42x (21% x $200x)). Therefore, USP must treat the $200x of income ($160x inclusion plus $40x section 78 amount) and the $40x of taxes associated with the inclusion in Year 1 as passive category income and taxes. USP must also follow the appropriate procedures under §1.905-4.

(vi) Example 6. The facts are the same as in paragraph (c)(8)(v) of this section (the facts in Example 5), except that in Year 1, USP elects to apply section 954(b)(4) to exclude CFC's passive income from its subpart F income, both before and after the recomputation of CFC's Year 1 subpart F income and USP's Year 1 U.S. tax liability that is required by reason of the Year 2 $60x foreign tax redetermination. Although the income is not considered to be subpart F income, under paragraph (c)(7)(iii) of this section it remains passive category income until distribution. In Year 2, the $100x distribution is a dividend to USP, because CFC has $160x of accumulated earnings and profits described in section 959(c)(3) (the $100x of earnings in Year 1 increased by the $60x refund received in Year 2 that under §1.905-3(b)(2) is taken into account in Year 1). Under paragraph (c)(7)(iii) of this section, USP must determine whether the dividend income is high-taxed income to USP in Year 2. The treatment of the dividend as passive category income may be relevant in determining deductions allocable or apportioned to such dividend income or related stock that are excluded in the computation of USP's foreign tax credit limitation under section 904(a) in Year 2. See section 904(b)(4). Under paragraph (c)(1) of this section, the dividend income is passive category income to USP because the foreign taxes paid and deemed paid by USP ($0x) with respect to the dividend income do not exceed the highest U.S. tax rate on that income.

(vii) Example 7. The facts are the same as in paragraph (c)(8)(v) of this section (the facts in Example 5), except that the distribution in Year 2 is subject to a withholding tax of $25x. Under paragraph (c)(7)(i) of this section, USP must redetermine whether its Year 1 inclusion should be considered high-taxed income of USP because there is a net $35x reduction ($60x refund of foreign corporate tax – $25x withholding tax) of foreign tax. By taking into account both the reduction in foreign corporate tax and the additional withholding tax, the inclusion continues to be considered high-taxed income of USP in Year 1 ($65x > $42x (21% x $200). USP must follow the appropriate section 905(c) procedures. USP must redetermine its U.S. tax liability for Year 1, but the Year 1 inclusion and the $65x taxes ($40x of deemed paid tax in Year 1 and $25x withholding tax in Year 2) will continue to be treated as general category income and taxes.

(viii) Example 8--(A) CFC, a controlled foreign corporation operating in Country G, is a wholly-owned subsidiary of USP, a domestic corporation. USP and CFC are calendar year taxpayers. Country G imposes a tax of 50% on CFC's earnings. Under Country G's system, the foreign corporate tax on particular earnings is reduced on distribution of those earnings to 30% and no withholding tax is imposed. Under Country G's law, distributions are treated as made out of a pool of undistributed earnings subject to the 50% tax rate. For Year 1, CFC's only earnings consist of passive income that is foreign personal holding company income that is earned in foreign Country G. CFC has taxable income of $110x for Federal income tax purposes and $100x for Country G purposes. Country G, therefore, imposes a tax of $50x on the Year 1 earnings of CFC. USP does not elect to exclude this income from subpart F under section 954(b)(4) and includes $110x in gross income ($60x of net foreign personal holding company income under section 951(a) and $50x of the section 78 dividend). The highest rate of tax under section 11 in Year 1 is 34%. Therefore, at the time of the section 951(a) inclusion, the income is considered to be high-taxed income under paragraph (c) of this section and is general category income to USP. CFC does not distribute any of its earnings in Year 1.

(B) In Year 2, CFC earns general category income that is not subpart F income or tested income. CFC again has $110x in taxable income for Federal income tax purposes and $100x in taxable income for Country G purposes, and CFC pays $50x of tax to foreign Country G. In Year 3, CFC has no taxable income or earnings. On December 31, Year 3, CFC distributes $60x of its total $120x of earnings and receives a refund of foreign tax of $24x. The $24x refund is a foreign tax redetermination under §1.905-3(a) that under §1.905-3(b)(2) requires a redetermination of CFC's Year 1 subpart F income and USP's deemed paid taxes and Year 1 U.S. tax liability. Country G treats the distribution of earnings as out of the 50% tax rate pool of $200x of earnings accumulated in Year 1 and Year 2, as calculated for Country G tax purposes. However, under paragraph (c)(7)(ii) of this section, the distribution, and, therefore, the reduction of tax is treated as first attributable to the $60x of passive category earnings attributable to income previously taxed in Year 1, and none of the distribution is treated as made out of the $60x of earnings accumulated in Year 2 (which is not previously taxed). Because 40 percent (the reduction in tax rates from 50 percent to 30 percent is a 40 percent reduction in the tax) of the $50x of foreign taxes attributable to the $60x of Year 1 passive income as calculated for Federal income tax purposes is refunded, $20x of the $24x foreign tax refund reduces foreign taxes on CFC's Year 1 passive income from $50x to $30x. The other $4x of the tax refund reduces the taxes imposed in Year 2 on CFC's general category income from $50x to $46x.

(C) Under paragraph (c)(7) of this section, in connection with the section 905(c) adjustment USP must redetermine whether its Year 1 subpart F inclusion should be considered high-taxed income. By taking into account the reduction in foreign tax, the inclusion is increased by $20x to $80x, the deemed paid taxes are reduced by $20x to $30x, and the inclusion is not considered high-taxed income ($30x < 34% x $110x). Therefore, USP must treat the revised section 951(a) inclusion and the taxes associated with the section 951(a) inclusion as passive category income and taxes in Year 1. USP must follow the appropriate procedures under §1.905-4.

* * * * *

(e) * * * (1) * * *

(ii) Definition of financial services income. The term financial services income means income derived by a financial services entity, as defined in paragraph (e)(2) of this section, that is:

(A) Income derived in the active conduct of a banking, financing, or similar business under section 954(h)(3)(A)(i);

(B) Income that is of a kind that would be insurance income as defined in section 953(a)(1) (including related person insurance income as defined in section 953(c)(2) and without regard to the exception in section 953(a)(2) for income that is exempt insurance income under section 953(e));

(C) Income from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary to the proper conduct of the insurance business; or

(D) Passive income as defined in section 904(d)(2)(B) and paragraph (b) of this section as determined before the application of the exception for high-taxed income but after the application of the exception for export financing interest.

* * * * *

(2) Financial services entities--(i) Definition of financial services entity--(A) In general. The term financial services entity means an individual or corporation that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business (active financing business) within the meaning of paragraphs (e)(2)(i)(A)(1) through (4) of this section for any taxable year. Except as provided in paragraph (e)(2)(ii) of this section, a determination of whether an individual or corporation is a financial services entity is done on an individual or entity-by-entity basis. An individual or corporation is predominantly engaged in the active financing business for any year if for that year:

(1) It is predominantly engaged in the active conduct of a banking, financing, or similar business under section 954(h)(2)(B) (substituting the reference to “controlled foreign corporation” with “individual or corporation”);

(2) It is an insurance company meeting the requirements of section 953(e)(3)(A) and (C) provided that the company’s foreign personal holding company income does not exceed the amount that would be treated as derived in the active conduct of an insurance business under section 954(i) if all of the insurance and annuity contracts issued or reinsured by the company had qualified as exempt contracts under section 953(e)(2);

(3) It is a qualifying insurance corporation as defined in section 1297(f) that is engaged in the active conduct of an insurance business under section 1297(b)(2)(B) (but without regard to whether the corporation is a foreign corporation); or

(4) It is a domestic corporation, or a corporation that has elected to be treated as a domestic corporation under section 953(d), that is subject to Federal income tax under subchapter L on its net income and is subject to regulation as an insurance (or reinsurance) company in its jurisdiction of organization.

(B) Certain gross income included and excluded. For purposes of applying the rules in paragraph (e)(2)(i)(A) of this section (including by reason of paragraph (e)(2)(ii) of this section), gross income includes interest on State and local bonds described in section 103(a), but does not include income from a distribution of previously taxed earnings and profits described in section 959(a) or (b).

(C) Treatment of partnerships and other pass-through entities. For purposes of applying the rules in paragraph (e)(2)(i)(A) of this section (including by reason of paragraph (e)(2)(ii) of this section) with respect to an individual or corporation that is a direct or indirect partner in a partnership, the partner's distributive share of partnership income is characterized as if each partnership item of gross income were realized directly by the partner. For example, in applying section 954(h)(2)(B) under paragraph (e)(2)(i)(A) of this section, a customer with respect to a partnership is treated as a related person with respect to an individual or corporation that is a partner in the partnership if the customer is related to the individual or corporation under section 954(d)(3). Similar principles apply for an individual or corporation's share of income from any other pass-through entities.

(ii) Financial services group. A corporation that is a member of a financial services group is deemed to be a financial services entity regardless of whether it is a financial services entity under paragraph (e)(2)(i) of this section. For purposes of this paragraph (e)(2)(ii), a financial services group means an affiliated group as defined in section 1504(a) (but determined without regard to paragraphs (2) or (3) of section 1504(b)) if the affiliated group as a whole meets the requirements of section 954(h)(2)(B)(i) (except that the reference to "controlled foreign corporation" is substituted with "affiliated group" in section 954(h)(2)(B)(i)). For purposes of determining whether an affiliated group is a financial services group under the previous sentence, only the income of group members that are domestic corporations or foreign corporations that are controlled foreign corporations in which U.S. members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock is included. In addition, indirect ownership is determined under section 318 and the regulations under that section, and the income of the group does not include any income from transactions with other members of the group.

(iii) Examples. The following examples illustrate the application of paragraph (e)(2) of this section.

(A) Example 1--(1) Facts. USP is a domestic corporation that is the parent of a consolidated group which includes B (a domestic corporation that is primarily engaged in a manufacturing business), C (a domestic corporation whose primary function is to manage the treasury operations of the consolidated group), and D (a domestic corporation that is engaged in the active and regular conduct of financing purchases by unrelated customers of B's products). USP also owns a 20% partnership interest in PS, a domestic partnership that is engaged in the active and regular conduct of making loans to customers that are not related persons with respect to it or USP. The other 80% of PS is owned by USX, a domestic corporation unrelated to USP (or any other member of the USP consolidated group). B has gross income of \$170x consisting of income from its manufacturing operations. C has gross income of \$20x consisting of interest income from loans to B. D has gross income of \$100x consisting of interest income from making loans to unrelated customers that purchase B's products. PS has gross income of \$50x consisting of interest on loans that it makes to customers in the ordinary course of its business, \$10x of which is attributable to loans to C, \$30x of which is attributable to loans to Z (a wholly owned subsidiary of USX), and \$10 of which is attributable to loans to customers unrelated to either the USP or USX affiliated groups. USP, B, C, and D have no other items of gross income and no other intercompany transactions.

(2) Analysis--(i) Entity test. Under paragraph (e)(2)(i)(A) of this section, B and C are not financial services entities because neither meets the requirements of being predominantly engaged in the active conduct of a banking, finance, insurance, or similar business. B does not meet the requirements because all of its income is derived from manufacturing. C does not meet the requirements because it lends solely to related persons. Under paragraph (e)(2)(i)(A)(1) of this section, D is a financial services entity because all of its gross income is derived from making loans to unrelated customers in the ordinary course of its lending business in a manner that meets the requirements of section 954(h)(2)(B)(i). Under paragraph (e)(2)(i)(C) of this section, USP's distributive share of partnership income from PS is characterized as if each item of PS's gross income were realized directly by USP. Thus, USP includes a \$10x distributive share of income from PS, \$2x of which is from related party loans to C and \$8x of which is from loans to persons that are not related persons with respect to USP. Under paragraph (e)(2)(i)(A)(1) of this section, USP is a financial services entity because more than 70% of its gross income is derived from making loans to unrelated customers in the ordinary course of a lending business (\$8x/\$10x > 70% x \$10x) and meets the requirements of section 954(h)(2)(B)(i).

(ii) Affiliated group test. Under paragraph (e)(2)(ii) of this section, a corporation that is a member of a financial services group is deemed to be a financial services entity regardless of whether it is a financial services entity under paragraph (e)(2)(i) of this section. This would apply if the USP, B, C, and D affiliated group as a whole meets the requirements of section 954(h)(2)(B)(i). The USP affiliated group derives $108x ($100x by D and $8x by USP) from loans to unrelated customers and derives $278x of total gross income after making the adjustments provided in paragraph (e)(2)(ii) of this section ($300x total gross income minus $20x interest on intercompany loan from C to B and $2x interest on loan from PS to C). Because the gross income USP's affiliated group derives directly from the active and regular conduct of a lending or finance business from transactions with customers which are not related persons is 39% ($108x divided by $278x), the USP affiliated group does not satisfy the more than 70% of gross income test of section 954(h)(2)(B)(i), and the USP affiliated group is not a financial services group. USP and D are financial services entities under paragraph (e)(2)(i)(A) of this section. B and C are not financial services entities under either of paragraphs (e)(2)(i) or (ii) of this section.

(B) Example 2--(1) Facts. The facts are the same as in paragraph (e)(2)(iii)(A)(1) of this section (the facts in Example 1) except that USX is the parent of a consolidated group, which includes Y (a domestic corporation that is a U.S. licensed bank), and Z (a domestic corporation that is a non-bank lender that is engaged in the active and regular conduct of making loans to customers unrelated to USX or its affiliates). Y has gross income of $200x, consisting of $190x from making loans to unrelated customers in the ordinary course of its banking business and $10x of other income not described in section 954(h)(4). Z has gross income of $160x, consisting of interest income from making loans to unrelated customers. USX, Y, and Z have no other items of gross income and no other intercompany transactions.

(2) Analysis--(i) Entity test. Under paragraph (e)(2)(i)(A) of this section, Y and Z are financial services entities. Y is a financial services entity because it satisfies the requirements of section 954(h)(2)(B)(ii). Z is a financial services entity because all of its gross income is derived from making loans to unrelated customers in the ordinary course of its lending business in a manner that meets the requirements of section 954(h)(2)(B)(i). Under paragraph (e)(2)(i)(C) of this section, USX's distributive share of partnership income from PS is characterized as if each item of PS's gross income were realized directly by USX. Thus, USX includes a $40x distributive share of income from PS, $24x of which is from related party loans to Z and $16x of which is from loans to unrelated parties. Under paragraph (e)(2)(i)(A)(1) of this section, USX is not a financial services entity because only 60% ($24x divided by $40x) of its gross income is derived from making loans to unrelated customers in the ordinary course of a lending business and, therefore, USX does not meet the more than 70% of gross income test of section 954(h)(2)(B)(i).

(ii) Affiliated group test. Under paragraph (e)(2)(ii) of this section, a corporation that is a member of a financial services group is deemed to be a financial services entity regardless of whether it is a financial services entity under paragraph (e)(2)(i) of this section. This would apply if the USX, Y, and Z affiliated group as a whole meets the requirements of section 954(h)(2)(B)(i). The USX affiliated group derives $366x ($190x by Y, $160x by Z, and $16x by USP) from loans to unrelated customers and derives $376x of total gross income after making the adjustments provided in paragraph (e)(2)(ii) of this section ($400x total gross income minus $24x interest on loans from PS to Z). Because the gross income USX's affiliated group derives directly from the active and regular conduct of a lending or finance business from transactions with customers which are not related persons is 97% ($366x divided by $376x), the USX affiliated group satisfies the more than 70% of gross income test of section 954(h)(2)(B)(i), and the USX affiliated group is a financial services group. Y and Z are financial services entities under paragraph (e)(2)(i)(A). USX is a financial services entity under paragraph (e)(2)(ii) of this section.

* * * * *

(q) Applicability date--(1) Except as provided in paragraph (q)(2) and (3) of this section, this section applies for taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

(2) Paragraphs (c)(7)(i), (c)(7)(iii), (c)(8)(v) through (viii) apply to taxable years ending on or after [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**]. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also end before [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**], see §1.904-4(c)(7)(i) and (c)(7)(iii) as in effect on [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

(3) Paragraphs (e)(1)(ii) and (e)(2) of this section apply to taxable years ending on or after the date the final regulations are filed with the **Federal Register**. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also end before the date the final regulations are filed with the **Federal Register**, see §1.904-4(e)(1)(i) and (e)(2) as in effect on [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

Par. 14. §1.904-6 is amended by:

1. Revising the section heading.

2. Revising paragraph (a).

3. Redesignating paragraph (b) as paragraph (e) and adding a new paragraph (b).

4. Adding paragraph (c) and revising paragraph (d).

5. Removing the language “paragraph (b)(4)(ii)” in newly-redesignated paragraph (e)(4)(i) and adding the language “paragraph (e)(4)(ii)” in its place.

6. Removing the language “paragraph (b)(4)(ii)(B)” in newly-redesignated paragraph (e)(4)(ii)(C) and adding the language “paragraph (e)(4)(ii)(B)” in its place.

7. Adding paragraphs (f) through (h).

The revisions and additions read as follows:

§1.904-6 Allocation and apportionment of foreign income taxes.

(a) In general. The amount of foreign income taxes paid or accrued with respect to a separate category (as defined in §1.904-5(a)(4)(v)) of income (including U.S. source income assigned to the separate category) includes only those foreign income taxes that are allocated and apportioned to the separate category under the rules of §1.861-20 (as modified by this section). In applying the foreign tax credit limitation under sections 904(a) and (d) to general category income described in section 904(d)(2)(A)(ii) and §1.904-4(d), the general category is a statutory grouping. However, the general category income is the residual grouping of income for purposes of assigning foreign income taxes to separate categories. In addition, in determining the numerator of the foreign tax credit limitation under sections 904(a) and (d), where U.S. source income is the residual grouping, the amount of foreign income taxes paid or accrued for which a deduction is allowed, for example, under section 901(k)(7), with respect to foreign source income in a separate category includes only those foreign income taxes that are allocated and apportioned to foreign source income in the separate category under the rules of §1.861-20 (as modified by this section). For purposes of this section, unless otherwise stated, terms have the same meaning as provided in §1.861-20(b).

(b) Assigning an item of foreign gross income to a separate category. For purposes of assigning an item of foreign gross income to a separate category or categories (or foreign source income in a separate category) under §1.861-20, the rules of this paragraph (b) apply.

(1) Base differences. Any item of foreign gross income that is attributable to a base difference described in §1.861-20(d)(2)(ii)(B) is assigned to the separate category described in section 904(d)(2)(H)(i), and to foreign source income in that category.

(2) Certain disregarded payments--(i) Certain disregarded payments made by a foreign branch. Except in the case of disregarded payments in exchange for property described in §1.861-20(d)(3)(ii)(C), if in connection with a disregarded payment made by a foreign branch to another foreign branch or to a foreign branch owner that is described in §1.861-20(d)(3)(ii)(A), U.S. gross income that would otherwise be attributable to a foreign branch is attributed to another foreign branch or to the foreign branch owner under §1.904-4(f)(2)(vi)(A) (including by reason of §1.904-4(f)(2)(vi)(D)), the item of foreign gross income that arises by reason of the disregarded payment is assigned to the same separate category as the reattributed U.S. gross income.

(ii) Certain disregarded payments made by a foreign branch owner. Except in the case of disregarded payments in exchange for property described in §1.861-

20(d)(3)(ii)(C), an item that a United States person includes in foreign gross income solely by reason of the receipt of a disregarded payment that is described in §1.861-20(d)(3)(ii)(B) (payment to a foreign branch by a foreign branch owner) is assigned to the foreign branch category (or a specified separate category associated with the foreign branch category), or, in the case of a foreign branch owner that is a partnership, to the partnership's general category income that is attributable to the foreign branch. See §1.960-1(d)(3)(ii)(A) and (e) for rules providing that foreign income tax on a disregarded payment by a foreign branch owner that is a controlled foreign corporation is assigned to the residual grouping and cannot be deemed paid under section 960.

(3) Disposition of property resulting in reattribution of U.S. gross income to or from a foreign branch. If a disposition of property results in the recognition of U.S. gross income that is reattributed under §1.904-4(f)(2)(vi)(A) by reason of a disregarded payment described in §1.904-4(f)(2)(vi)(B)(2) (or by reason of §1.904-4(f)(2)(vi)(D)), any foreign gross income arising from that disposition of property under foreign law is assigned to a separate category under the rules in §1.861-20(d)(1) applied without regard to the reattribution of U.S. gross income under §1.904-4(f)(2)(vi)(A).

(c) Allocating and apportioning deductions. For purposes of applying §1.861-20(e) to allocate and apportion deductions allowed under foreign law to foreign gross income in the separate categories, before undertaking the steps outlined in §1.861-20(e), foreign gross income in the passive category is first reduced by any related person interest expense that is allocated to the income under the principles of section 954(b)(5) and §1.904-5(c)(2)(ii)(C). In allocating and apportioning expenses not specifically allocated under foreign law, the principles of foreign law are applied only after taking into account the reduction of passive income by the application of section 954(b)(5). In allocating and apportioning expenses when foreign law does not provide rules for the allocation or apportionment of expenses, losses or other deductions to particular items of foreign gross income, then the principles of section 954(b)(5), in addition to the principles of the section 861 regulations (as defined in §1.861-8(a)(1)), apply to allocate and apportion expenses, losses or other foreign law deductions to foreign gross income after reduction of passive income by the amount of related person interest expense allocated to passive income under section 954(b)(5) and §1.904-5(c)(2)(ii)(C).

(d) Apportionment of taxes for purposes of applying the high-tax income tests. If taxes have been allocated and apportioned to passive income under the rules of paragraph (a) this section, the taxes must further be apportioned to the groups of income described in §1.904-4(c)(3), (4) and (5) for purposes of determining if the group is high-taxed income that is recharacterized as income in another separate category under the rules of §1.904-4(c). See also §1.954-1(c)(1)(iii)(B) (defining a single item of passive category foreign personal holding company income by reference to the grouping rules under §1.904-4(c)(3), (4) and (5)). Taxes are related to income in a particular group under the same rules as those in paragraph (a) of this section except that those rules are applied by apportioning foreign income taxes to the groups described in §1.904-4(c)(3), (4) and (5) instead of separate categories.

* * * * *

(f) Treatment of certain foreign income taxes paid or accrued by United States shareholders. Some or all of the foreign gross income of a United States shareholder of a controlled foreign corporation that is a foreign law CFC described in §1.861-20(d)(3)(i)(D) or a reverse hybrid described in §1.861-20(d)(3)(iii) is assigned to the section 951A category if, were the controlled foreign corporation the taxpayer that recognizes the foreign gross income, the foreign gross income would be assigned to the controlled foreign corporation's tested income group (as defined in §1.960-1(b)(33)) within the general category to which an inclusion under section 951A is attributable. The amount of the United States shareholder's foreign gross income that is assigned to the section 951A category (or a specified separate category associated with the section 951A category) is based on the inclusion percentage (as defined in §1.960-2(c)(2)) of the United States shareholder. For example, if a United States shareholder has an inclusion percentage of 60 percent, then 60 percent of the foreign gross income of a United States shareholder that would be assigned (under §1.861-20(d)(3)(iii)) to the tested income group within the general category income of a reverse hybrid that is a controlled foreign corporation to which an inclusion under section 951A is attributable is assigned to the section 951A category or the specified separate category for income resourced under a tax treaty, and not to the general category.

(g) Examples. For examples illustrating the application of this section, see §1.861-20(g).

(h) Applicability date. This section applies to taxable years beginning after December 31, 2019. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also begin before January 1, 2020, see §1.904-6 as in effect on [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

Par. 15. Section 1.904(b)-3 is amended by adding paragraph (d)(2) and revising paragraph (f) to read as follows:

§1.904(b)-3 Disregard of certain dividends and deductions under section 904(b)(4).

* * * * *

(d) * * *

(2) Net operating losses. If the taxpayer has a net operating loss in the current taxable year, then solely for purposes of determining the source and separate category of the net operating loss, the overall foreign loss rules in section 904(f) and the overall domestic loss rules in section 904(g) are applied without taking into account the adjustments required under section 904(b) and this section.

* * * * *

(f) Applicability dates--(1) Except as provided in paragraph (f)(2) of this section, this section applies to taxable years beginning after December 31, 2017.

(2) Paragraph (d)(2) of this section applies to taxable years ending on or after [**INSERT DATE OF FILING IN THE FEDERAL REGISTER**].

Par. 16. Section 1.904(g)-3 is amended by:

1. Adding a sentence at the end of paragraph (b)(1).

2. Adding paragraph (j) and revising paragraph (l).

The addition and revisions read as follows:

§1.904(g)-3 Ordering rules for the allocation of net operating losses, net capital losses, U.S. source losses, and separate limitation losses, and for the recapture of separate limitation losses, overall foreign losses, and overall domestic losses.

* * * * *

(b) * * * (1) * * * See §§1.861-8(e)(8), 1.904(b)-3(d)(2), and 1.1502-4(c)(1)(iii) for rules to determine the source and separate category components of a net operating loss.

* * * * *

(j) Step Nine: Dispositions that result in additional income recognition under the branch loss recapture and dual consolidated loss recapture rules--(1) In general. If, after any gain is required to be recognized under section 904(f)(3) on a transaction that is otherwise a nonrecognition transaction, an additional amount of income is recognized under section 91(d), section 367(a)(3)(C) (as applicable to losses incurred before January 1, 2018), or §1.1503(d)-6, and that additional income amount is determined by taking into account an offset for the amount of gain recognized under section 904(f)(3) and so is not initially taken into account in applying paragraph (b) of this section, then paragraphs (b) through (h) of this section are applied to determine the allocation of any additional net operating loss deduction and other deductions or losses and the applicable increases in the taxpayer’s overall foreign loss, separate limitation loss, and overall domestic loss accounts, as well as any additional recapture and reduction of the taxpayer’s separate limitation loss, overall foreign loss, and overall domestic loss accounts.

(2) Rules for additional recapture of loss accounts. For the purpose of recapturing and reducing loss accounts under paragraph (j)(1) of this section, the taxpayer also takes into account any creation of or addition to loss accounts that result from the application of paragraphs (b) through (i) of this section in the current tax year. If any of the additional income described in paragraph (j)(1) of this section is foreign

source income in a separate category for which there is a remaining balance in an OFL account after applying paragraph (i) of this section, the section 904(f)(1) recapture amount under §1.904(f)-2(c) for that additional income is determined by first computing a hypothetical recapture amount as it would have been determined prior to the application of paragraph (i) of this section but taking into account the additional foreign source income described in this paragraph (j)(2) and then subtracting the actual OFL recapture determined prior to the application of paragraph (i) of this section (that did not take into account the additional foreign source income). The remainder is the OFL recapture amount with respect to the additional foreign source income described in this paragraph (j)(2).

* * * * *

(l) Applicability date. This section applies to taxable years ending on or after the date the final regulations are filed with the **Federal Register**.

Par. 17. Section 1.905-3 is amended by:

1. Revising the section heading and the first sentence of paragraph (a).

2. Adding paragraphs (b)(2) and (3).

3. Revising paragraph (d).

The revisions and additions read as follows:

§1.905-3 Adjustments to U.S. tax liability and to current earnings and profits as a result of a foreign tax redetermination.

(a) * * * For purposes of this section and §1.905-4, the term foreign tax redetermination means a change in the liability for foreign income taxes, as defined in §1.960-1(b)(5), or certain other changes described in this paragraph (a) that may affect a taxpayer's U.S. tax liability, including by reason of a change in the amount of its foreign tax credit, the amount of its distributions or inclusions under sections 951, 951A, or 1293, the application of the high-tax exception described in section 954(b)(4) (including for purposes of determining tested income under section 951A(c)(2)(A)(i)(III)), or the amount of tax determined under sections 1291(c)(2) and 1291(g)(1)(C)(ii). * * *

(b) * * *

(2) Foreign income taxes paid or accrued by foreign corporations--(i) In general. A redetermination of U.S. tax liability is required to account for the effect of a redetermination of foreign income taxes taken into account by a foreign corporation in the year accrued, or a refund of foreign income taxes taken into account by the foreign corporation in the year paid.

(ii) Required adjustments. If a redetermination of U.S. tax liability is required for any taxable year under paragraph (b)(2)(i) of this section, the foreign corporation's taxable income, earnings and profits, and current year taxes (as defined in §1.960-1(b)(4)) must be adjusted in the year to which the redetermined tax relates (or, in the case of a foreign corporation that receives a refund of foreign income tax and uses the cash basis of accounting, in the year the tax was paid). The redetermination of U.S. tax liability is made by treating the redetermined amount of foreign tax as the amount of tax paid or accrued by the foreign corporation in such year. For example, in the case of a refund of foreign income taxes taken into account in the year accrued, the foreign corporation's subpart F income, tested income, and earnings and profits are increased, as appropriate, in the year to which the foreign tax relates to reflect the functional currency amount of the foreign income tax refund. The required redetermination of U.S. tax liability must account for the effect of the foreign tax redetermination on the characterization and amount of distributions or inclusions under sections 951, 951A, or 1293 taken into account by each of the foreign corporation's United States shareholders, on the application of the high-tax exception described in section 954(b)(4) (including for purposes of determining tested income under section 951A(c)(2)(A)(i)(III)), and the amount of tax determined under sections 1291(c)(2) and 1291(g)(1)(C)(ii), as well as on the amount of foreign taxes deemed paid under section 960 in such year, regardless of whether any such shareholder chooses to deduct or credit its foreign income taxes in any taxable year. In addition, a redetermination of U.S. tax liability is required for any subsequent taxable year in which the characterization or amount of a United States shareholder's distribution or inclusion from the foreign corporation is affected by the foreign tax redetermination, up to and including the taxable year in which the foreign tax redetermination occurs, as well as any year to which unused foreign taxes from such year were carried under section 904(c).

(iii) Reduction of corporate level tax on distribution of earnings and profits. If a United States shareholder of a controlled foreign corporation receives a distribution out of previously taxed earnings and profits described in section 959(c)(1) and (2) and a foreign country has imposed tax on the income of the controlled foreign corporation, which tax is reduced on distribution of the earnings and profits of the corporation (resulting in a foreign tax redetermination), then the United States shareholder must redetermine its U.S. tax liability for the year or years affected.

(iv) Foreign tax redeterminations relating to taxable years beginning before January 1, 2018. In the case of a foreign tax redetermination of a foreign corporation that relates to a taxable year of the foreign corporation beginning before January 1, 2018, a redetermination of U.S. tax liability is required under the rules of §1.905-5.

(v) Examples. The following examples illustrate the application of this paragraph (b)(2).

(A) Presumed Facts. Except as otherwise provided, the following facts are assumed for purposes of the examples:

(1) All parties are accrual basis taxpayers that use the calendar year as their taxable year both for Federal income tax purposes and for foreign tax purposes and use the average exchange rate to translate accrued foreign income taxes;

(2) CFC, CFC1, and CFC2 are controlled foreign corporations organized in Country X that use the "u" as their functional currency;

(3) No income adjustment is required to reflect exchange gain or loss (within the meaning of §1.988-1(e)) with respect to the disposition of nonfunctional currency attributable to a refund of foreign income taxes received by any CFC, because all foreign income taxes are denominated and paid in the CFC's functional currency;

(4) The highest rate of U.S. tax in section 11 and the rate applicable to USP in all years is 21 percent; and

(5) USP's foreign tax credit limitation under section 904(a) exceeds the amount of foreign income taxes it is deemed to pay.

(B) Example 1: Refund of tested foreign income taxes--(1) Facts. CFC is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns 3,660u of general category gross tested income and accrues and pays 300u of foreign income taxes with respect to that income. CFC has no allowable deductions other than the foreign income tax expense. Accordingly, CFC has tested income of 3,360u in Year 1. CFC has no qualified business asset investment (within the meaning of section 951A(d) and §1.951A-3(b)). In Year 1, no portion of USP's deduction under section 250 ("section 250 deduction") is reduced by reason of section 250(a)(2)(B)(ii). USP's inclusion percentage (as defined in §1.960-2(c)(2)) is 100%. In Year 1, USP earns no other income and has no other expenses. The average exchange rate used to translate USP's inclusion under section 951A and CFC's foreign income taxes into dollars for Year 1 is $1x:1u. See section 989(b)(3) and §§1.951A-1(d)(1) and 1.986(a)-1(a)(1). Accordingly, for Year 1, USP's tested foreign income taxes (as defined in §1.960-2(c)(3)) with respect to CFC are $300x. In Year 3, CFC carries back a loss for foreign tax purposes and receives a refund of foreign tax of 100u that relates to Year 1.

(2) Analysis--(i) Result in Year 1. In Year 1, CFC has tested income of 3,360u and tested foreign income taxes of $300x. Under section 951A(a) and §1.951A-1(c)(1), USP has a GILTI inclusion amount of $3,360x (3,360u translated at $1x:1u). Under section 960(d) and §1.960-2(c), USP is deemed to have paid $240x (80% x 100% x $300x) of foreign income taxes. Under section 78 and §1.78-1(a), USP is treated as receiving a dividend of $300x (a "section 78 dividend"). USP's section 250 deduction is $1,830x (50% x ($3,360x + $300x)). Accordingly, for Year 1, USP has taxable income of $1,830x ($3,360x + $300x - $1,830x) and pre-credit U.S. tax liability of $384.3x (21% x $1,830x). Accordingly, USP pays U.S. tax of $144.3x ($384.3x - $240x).

(ii) Result in Year 3. The refund of 100u to CFC in Year 3 is a foreign tax redetermination under paragraph (a) of this section. Under paragraph (b)(2)(ii) of this section, USP must account for the effect of the foreign tax redetermination on its GILTI inclusion amount and foreign taxes deemed paid in Year 1. In redetermining USP's U.S. tax liability for Year 1, USP must increase CFC's tested income and its earnings and profits in Year 1 by the refunded tax amount of 100u, must determine the effect of that increase on its GILTI inclusion amount, and must adjust the amount of foreign taxes deemed paid and the section 78 dividend to account for CFC's refund of foreign tax. Under §1.986(a)-1(c), the refund is translated into dollars at the exchange rate that was used to translate such amount when initially accrued. As a result of the foreign tax redetermination, for Year 1, CFC has tested income of 3,460u (3,360u + 100u) and tested foreign income taxes of $200x ($300x - $100x). Under section 951A(a) and §1.951A-1(c)(1), USP has a redetermined GILTI inclusion amount of $3,460x (3,460u translated at $1x:1u). Under section 960(d) and §1.960-2(c), USP is deemed to have paid $160x (80% x 100% x $200x) of foreign income taxes. Under section 78 and §1.78-1(a), USP's section 78 dividend is $200x. USP's redetermined section 250 deduction is $1,830x (50% x ($3,460x + $200x)). Accordingly, USP's redetermined taxable income is $1,830x ($3,460x + $200x - $1,830x) and its pre-credit U.S. tax liability is $384.3x (21% x $1,830x). Therefore, USP's redetermined U.S. tax liability is $224.3x ($384.3x - $160x), an increase of $80x ($224.3x - $144.3x).

(C) Example 2: High tax exception election following a foreign tax redetermination--(1) Facts. CFC is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns 1,000u of general category gross foreign base company sales income and accrues and pays 100u of foreign income taxes with respect to that income. CFC has no allowable deductions other than the foreign income tax expense. The average exchange rate used to translate USP's subpart F inclusion and CFC's foreign income taxes into dollars for Year 1 is $1x:1u. See section 989(b)(3) and

§1.986(a)-1(a)(1). In Year 1, USP earns no other income and has no other expenses. In Year 5, pursuant to a Country X audit CFC accrues and pays additional foreign income tax of 80u with respect to its 1,000u of general category foreign base company sales income earned in Year 1. The spot rate (as defined in §1.988-1(d)) on the date of payment of the tax in Year 5 is $1x:0.8u. The foreign income taxes accrued and paid in Year 1 and Year 5 are properly attributable to CFC's foreign base company sales income that is included in income by USP under section 951(a)(1)(A) ("subpart F inclusion") in Year 1 with respect to CFC.

(2) Analysis--(i) Result in Year 1. In Year 1, CFC has subpart F income of 900u (1,000u - 100u). Accordingly, USP has a $900x (900u translated at $1x:1u) subpart F inclusion. Under section 960(a) and §1.960-2(b), USP is deemed to have paid $100x (100u translated at $1x:1u) of foreign income taxes. Under section 78 and §1.78-1(a), USP's section 78 dividend is $100x. Accordingly, for Year 1, USP has taxable income of $1,000x ($900x + $100x) and pre-credit U.S. tax liability of $210x (21% x $1,000x). Accordingly, USP's U.S. tax liability is $110x ($210x - $100x).

(ii) Result in Year 5. CFC's payment of 80u of additional foreign income tax in Year 5 with respect to Year 1 is a foreign tax redetermination as defined in paragraph (a) of this section. Under paragraph (b)(2)(ii) of this section, USP must reduce CFC's subpart F income and its earnings and profits in Year 1 by the additional tax amount of 80u. Further, USP must reduce its subpart F inclusion, adjust the amount of foreign taxes deemed paid, and adjust the amount of the section 78 dividend to account for CFC's additional payment of foreign tax. Under section 986(a)(1)(B)(i) and §1.986(a)-1(a)(2)(i), because CFC's payment of additional tax occurs more than 24 months after the close of the taxable year to which it relates, the additional tax is translated into dollars at the spot rate on the date of payment ($1x:0.8u). Therefore, CFC has foreign income taxes of $200x (100u translated at $1x:1u plus 80u translated at $1x:0.8u) that are properly attributable to CFC's foreign base company sales income that gives rise to USP's subpart F inclusion in Year 1. As a result of the foreign tax redetermination, for Year 1, USP has a subpart F inclusion of $820x (1,000u - 180u = 820u translated at $1x:1u). Under section 960(a) and §1.960-2(b), USP is deemed to have paid $200x of foreign income taxes. Under section 78 and §1.78-1(a), USP's section 78 dividend is $200x. For purposes of section 954(b)(4), the effective tax rate on the general category foreign base company sales income is determined by dividing $200x, the U.S. dollar amount of the foreign taxes deemed paid, by the U.S. dollar amount of the net item of foreign base company sales income ($820x) plus the amount of the foreign income tax ($200x). Thus, the effective rate imposed on the general category foreign base company sales income in Year 1 is 19.6% ($200x/$1020x), which exceeds 18.9% (90% of 21%, the highest tax rate in section 11). Therefore, after the foreign tax redetermination, USP is eligible to elect to exclude the item of subpart F income under section 954(b)(4) and §1.954-1(d). If USP makes the election under §1.954-1(d), USP's taxable income, pre-credit U.S. tax liability, and allowable foreign tax credit is zero, resulting in a decrease in USP's U.S. tax liability of $110x. If USP does not make the election under §1.954-1(d), then USP's redetermined U.S. taxable income is $1020x ($820x + $200x) and its pre-credit U.S. tax liability is $214.2x (21% x $1020x).

Therefore, USP's redetermined U.S. tax liability is $14.20x ($214.2x - $200x), a decrease of $95.80x ($110x - $14.20x). If USP makes a timely refund claim within the time period allowed by section 6511, USP will be entitled to a refund of any overpayment resulting from the redetermination of U.S. tax liability.

(D) Example 3: Two-year rule--(1) Facts. CFC is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns 1,000u of general category gross foreign base company sales income and accrues 210u of foreign income taxes with respect to that income. In Year 1, USP earns no other income and has no other expenses. The average exchange rate used to translate USP's subpart F inclusion and CFC's foreign income taxes into dollars for Year 1 is $1x:1u. See sections 989(b)(3) and 986(a)(1)(A) and §1.986(a)-1(a)(1). USP does not elect to treat CFC's subpart F income as high taxed income under section 954(b)(4). CFC does not pay its foreign income taxes for Year 1 until September 1, Year 5, when the spot rate is $0.8x:1u. The foreign income taxes accrued and paid in Year 1 and Year 5, respectively, are properly attributable to CFC's foreign base company sales income that gives rise to USP's subpart F inclusion in Year 1 with respect to CFC.

(2) Analysis--(i) Result in Year 1. In Year 1, CFC has subpart F income of 790u (1,000u - 210u). Accordingly, USP has a $790x (790u translated at $1x:1u) subpart F inclusion. Under section 960(a) and §1.960-2(b), USP is deemed to have paid $210x (210u translated at $1x:1u) of foreign income taxes. Under section 78 and §1.78-1(a), USP's section 78 dividend is $210x. Accordingly, for Year 1, USP has taxable income of $1,000x ($790x + $210x) and pre-credit U.S. tax liability of $210x (21% x $1,000x). Accordingly, USP owes no U.S. tax ($210x - $210x = 0).

(ii) Result in Year 3. CFC's failure to pay the tax by the end of Year 3 results in a foreign tax redetermination under paragraph (a) of this section. Because the taxes are not paid on or before the date 24 months after the close of the taxable year to which the tax relates, under paragraph (a) of this section CFC must account for the redetermination as if the unpaid 210u of taxes were refunded on the last day of Year 3. Under paragraph (b)(2)(ii) of this section, USP must increase CFC's subpart F income and its earnings and profits in Year 1 by the unpaid tax amount of 210u. Further, USP must increase its subpart F inclusion, and decrease the amount of foreign taxes deemed paid and the amount of the section 78 dividend to account for the unpaid taxes. As a result of the foreign tax redetermination, for Year 1, USP has a subpart F inclusion of $1,000x (1,000u translated at $1x:1u). Under section 960(a) and §1.960-2(b), USP is deemed to have paid no foreign income taxes. Under section 78 and §1.78-1(a), USP has no section 78 dividend. Accordingly, USP's redetermined taxable income is $1,000x and its pre-credit U.S. tax liability is unchanged at $210x (21% x $1,000x). However, USP has no foreign tax credits. Therefore, USP's redetermined U.S. tax liability for Year 1 is $210x, an increase of $210x.

(iii) Result in Year 5. CFC's payment of the Year 1 tax liability of 210u on September 1, Year 5, results in a second foreign tax redetermination under paragraph (a) of this section. Under paragraph (b)(2)(ii) of this section, USP must decrease CFC's subpart F income and its earnings and profits in Year 1 by the tax paid amount of 210u. Further, USP must reduce its subpart F inclusion, and increase the amount of foreign taxes deemed paid and the amount of the section 78 dividend to account for CFC's payment of foreign tax. Under section 986(a)(1)(B)(i) and §1.986(a)-1(a)(2)(i), because the tax was paid more than 24 months after the close of the year to which the tax relates, CFC must translate the 210u of tax at the spot rate on the date of payment of the foreign taxes in Year 5. Therefore, CFC has foreign income taxes of $168x (210u translated at $0.8x:1u) that are properly attributable to CFC's foreign base company sales income that gives rise to USP's subpart F inclusion in Year 1. As a result of the foreign tax redetermination, for Year 1, USP has a subpart F inclusion of $790x (1,000u - 210u = 790u translated at $1x:1u). Under section 960(a) and §1.960-2(b), USP is deemed to have paid $168x of foreign income taxes. Under section 78 and §1.78-1(a), USP's section 78 dividend is $168x. Accordingly, USP's redetermined taxable income is $958x ($790x + $168x) and its pre-credit U.S. tax liability is $201.18x (21% x $958x). Under section 904(a), USP's foreign tax credit limitation is $201.18x ($201.18x x $958x/$958x) and exceeds the $168x of foreign income tax that USP is deemed to have paid. Therefore USP's redetermined U.S. tax liability is $33.18 ($201.18x - $168x), a decrease of $176.82x ($210x - $33.18x).

(E) Example 4: Contested tax--(1) Facts. CFC is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns 360u of general category gross tested income and accrues and pays 160u of current year taxes with respect to that income. CFC has no allowable deductions other than the foreign income tax expense. Accordingly, CFC has tested income of 200u in year 1. CFC has no qualified business asset investment (within the meaning of section 951A(d) and §1.951A-3(b)). In Year 1, no portion of USP's section 250 deduction is reduced by reason of section 250(a)(2)(B)(ii). USP's inclusion percentage (as defined in §1.960-2(c)(2)) is 100%. In Year 1, USP earns no other income and has no other expenses. The average exchange rate used to translate USP's section 951A inclusion and CFC's foreign income taxes into dollars for Year 1 is $1x:1u. See section 989(b)(3) and §§1.951A-1(d)(1) and 1.986(a)-1(a)(1). Accordingly, for Year 1, USP's tested foreign income taxes (as defined in §1.960-2(c)(3)) with respect to CFC are $160x. In Year 3, Country X assessed an additional 30u of tax with respect to CFC's Year 1 income. CFC did not pay the additional 30u of tax and contested the assessment. After exhausting all effective and practical remedies to reduce, over time, its liability for foreign tax, CFC settled the contest with Country X in Year 4 for 20u, which CFC did not pay until January 15, Year 5, when the spot rate was $1.1x:1u. CFC did not earn any other income or accrue any other foreign income taxes in Years 2 through 6 and made no distributions to USP. The additional taxes paid in Year 5 are also tested foreign income taxes of USP with respect to CFC.

(2) Analysis--(i) Result in Year 1. In Year 1, CFC has tested income of 200u and tested foreign income taxes of $160x. Under section 951A(a) and §1.951A-1(c)(1), USP has a GILTI inclusion amount of $200x (200u translated at $1x:1u). Under section 960(d) and §1.960-2(c), USP is deemed to have paid $128x (80% x 100% x $160x) of foreign income taxes. Under section 78 and §1.78-1(a), USP's section 78 dividend is

$160x. USP's section 250 deduction is $180x (50% x ($200x + $160x)). Accordingly, for Year 1, USP has taxable income of $180x ($200x + $160x - $180x) and a pre-credit U.S. tax liability of $37.8x (21% $180x). Under section 904(a), because all of USP's income is section 951A category income (see §1.904-4(g)), USP's foreign tax credit limitation is $37.8 ($37.8x x $180x/$180x), which is less than the $128x of foreign income tax that USP is deemed to have paid. Accordingly, USP owes no U.S. tax ($37.8x - $37.8x = 0).

(ii) Result in Year 5. CFC's accrual and payment of the additional 20u of foreign income tax with respect to Year 1 is a foreign tax redetermination under paragraph (a) of this section. Under §1.461-4(g)(6)(iii)(B), the additional taxes accrue when the tax contest is resolved, that is, in Year 4. However, because the taxes, which relate to Year 1, were not paid on or before the date 24 months after close of CFC's taxable year to which the tax relates, that is, Year 1, under section 905(c)(2) and paragraph (a) of this section CFC cannot take these taxes into account when they accrue in Year 4. Instead, the taxes are taken into account when they are paid in Year 5. Under paragraph (b)(2)(ii) of this section, USP must decrease CFC's tested income and its earnings and profits in Year 1 by the additional tax amount of 20u. Further, USP must adjust its GILTI inclusion amount, the amount of foreign taxes deemed paid, and the amount of the section 78 dividend to account for CFC's additional payment of tax. Under section 986(a)(1)(B)(i) and §1.986(a)-1(a)(2)(i), because CFC's payment of additional tax occurs more than 24 months after the close of the taxable year to which it relates, the additional tax is translated into dollars at the spot rate on the date of payment ($1.1x:1u). Therefore, CFC has tested foreign income taxes of $182x (160u translated at $1x:1u plus 20u translated at $1.1x:1u). As a result of the foreign tax redetermination, for Year 1, CFC has tested income of 180u (200u - 20u). Under section 951A(a) and §1.951A-1(c)(1), USP has a redetermined GILTI inclusion amount of $180x (180u, translated at $1x:1u). Under section 960(d) and §1.960-2(c), USP is deemed to have paid $145.6x (80% x 100% x $182x) of foreign income taxes. Under section 78 and §1.78-1(a), USP's section 78 dividend is $182x. USP's redetermined section 250 deduction is $181x (50% x ($180x + $182x)). Accordingly, USP's redetermined taxable income is $181x ($180x + $182x – $181x) and its pre-credit U.S. tax liability is $38.01x (21% x $181x). Under section 904(a), USP's foreign tax credit limitation is $38.01x ($38.01x x $181x/$181x), which is less than the $145.6x of foreign tax credits that USP is deemed to have paid. Therefore, USP's redetermined U.S. tax liability is zero ($38.01x - $38.01x).

(3) Foreign tax redeterminations of successors or transferees. If at the time of a foreign tax redetermination the person with legal liability for the tax (or in the case of a refund, the legal right to such refund) (the "successor") is a different person than the person that had legal liability for the tax in the year to which the redetermined tax relates (the "original taxpayer"), the required redetermination of U.S. tax liability is made as if

the foreign tax redetermination occurred in the hands of the original taxpayer. Federal income tax principles apply to determine the tax consequences if the successor remits (or receives a refund of) a tax that in the year to which the redetermined tax relates was the legal liability of, and thus under §1.901-2(f) is considered paid by, the original taxpayer.

* * * * *

(d) Applicability dates. This section applies to foreign tax redeterminations occurring in taxable years ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER],** and to foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a United States shareholder ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]** and that relate to taxable years of foreign corporations beginning after December 31, 2017.

Par. 18. Section 1.905-4, as proposed to be added at 72 FR 62805 (November 7, 2007), is further revised to read as follows:

§1.905-4 Notification of foreign tax redetermination.

(a) Application of this section. The rules of this section apply if, as a result of a foreign tax redetermination (as defined in §1.905-3(a)), a redetermination of U.S. tax liability is required under section 905(c) and §1.905-3(b).

(b) Time and manner of notification--(1) Redetermination of U.S. tax liability--(i) In general. Except as provided in paragraphs (b)(1)(v) and (b)(2) through (b)(4) of this section, any taxpayer for which a redetermination of U.S. tax liability is required must notify the Internal Revenue Service (IRS) of the foreign tax redetermination by filing an amended return, Form 1118 (Foreign Tax Credit--Corporations) or Form 1116 (Foreign

Tax Credit), and the statement described in paragraph (c) of this section for the taxable year with respect to which a redetermination of U.S. tax liability is required. Such notification must be filed within the time prescribed by this paragraph (b) and contain the information described in paragraph (c) of this section. If a foreign tax redetermination requires an individual to redetermine the individual's U.S. tax liability, and if, after taking into account such foreign tax redetermination, the amount of creditable foreign taxes (as defined in section 904(j)(3)(B)) that are paid or accrued by such individual during the taxable year does not exceed the applicable dollar limitation in section 904(j), the individual is not required to file Form 1116 with the amended return for such taxable year if the individual satisfies the requirements of section 904(j).

(ii) Increase in amount of U.S. tax liability. Except as provided in paragraphs (b)(1)(iv) and (b)(2) through (b)(4) of this section, for each taxable year of the taxpayer with respect to which a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination that increases the amount of U.S. tax liability, for example, by reason of a downward adjustment to the amount of foreign income taxes paid or accrued by the taxpayer or a foreign corporation with respect to which the taxpayer computes an amount of foreign taxes deemed paid, the taxpayer must file a separate notification by the due date (with extensions) of the original return for the taxpayer's taxable year in which the foreign tax redetermination occurs.

(iii) Decrease in amount of U.S. tax liability. Except as provided in paragraphs (b)(1)(iv) and (b)(2) through (b)(4) of this section, for each taxable year of the taxpayer with respect to which a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination that decreases the amount of U.S. tax liability and results in an overpayment, for example, by reason of an increase in the amount of foreign income taxes paid or accrued by the taxpayer or a foreign corporation with respect to which the taxpayer computes an amount of foreign taxes deemed paid, the taxpayer must file a claim for refund with the IRS within the period provided in section 6511. See section 6511(d)(3)(A) for the special refund period for refunds attributable to an increase in foreign tax credits.

(iv) Multiple redeterminations of U.S. tax liability for same taxable year. The rules of this paragraph (b)(1)(iv) apply except as provided in paragraphs (b)(1)(v), (b)(2) through (b)(4) of this section. If more than one foreign tax redetermination requires a redetermination of U.S. tax liability for the same affected taxable year of the taxpayer and those foreign tax redeterminations occur within the same taxable year or within two consecutive taxable years of the taxpayer, the taxpayer may file for the affected taxable year one amended return, Form 1118 or Form 1116, and the statement described in paragraph (c) of this section that reflects all such foreign tax redeterminations. If the taxpayer chooses to file one notification for such redeterminations, one or more of such redeterminations would increase the U.S. tax liability, and the net effect of all such redeterminations is to increase the U.S. tax liability for the affected taxable year, the taxpayer must file such notification by the due date (with extensions) of the original return for the taxpayer's taxable year in which the first foreign tax redetermination that would result in an increased U.S. tax liability occurred. If the taxpayer chooses to file one notification for such redeterminations, one or more of such redeterminations would decrease the U.S. tax liability, and the net effect of all such redeterminations is to decrease the total amount of U.S. tax liability for the affected taxable year, the taxpayer must file such notification as provided in paragraph (b)(1)(iii) of this section, within the period provided by section 6511. If a foreign tax redetermination with respect to the taxable year for which a redetermination of U.S. tax liability is required occurs after the date for providing such notification, more than one amended return may be required with respect to that taxable year.

(v) Amended return required only if there is a change in amount of U.S. tax due. If a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination, but does not change the amount of U.S. tax due for any taxable year, the taxpayer may, in lieu of applying the applicable rules of paragraphs (b)(1)(i) through (iv) of this section, notify the IRS of such redetermination by attaching a statement to the original return for the taxpayer's taxable year in which the foreign tax redetermination occurs. Such statement must be filed by the due date (with extensions) of the original return for the taxpayer's taxable year in which the foreign tax redetermination occurs and contain the information described in §1.904-2(f). If a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination (either alone, or if the taxpayer chooses to apply paragraph (b)(1)(iv) of this section, in combination with other foreign tax redeterminations, as provided therein) and the redetermination of U.S. tax liability results in a change to the amount of U.S. tax due for a taxable year, but does not change the amount of U.S. tax due for other taxable years, for example, because of a carryback or carryover of an unused foreign tax under section 904(c), the notification requirements for such other taxable years are deemed to be satisfied if the taxpayer complies with the applicable rules of paragraphs (b)(1)(i) through (iv) of this section with respect to each taxable year for which the foreign tax redetermination changes the amount of U.S. tax due.

(2) Notification with respect to a change in the amount of foreign tax reported to an owner by a pass-through entity--(i) In general. If a partnership, trust, or other pass-through entity that reports to its beneficial owners (or to any intermediary on behalf its beneficial owners), including partners, shareholders, beneficiaries, or similar persons, an amount of creditable foreign income taxes, such pass-through entity must notify both the IRS and its owners of any foreign tax redetermination described in §1.905-3(a) with respect to the foreign tax so reported. For purposes of this paragraph (b)(2), whether or not a redetermination has occurred within the meaning of §1.905-3(a) is determined as if the pass-through entity were a domestic corporation which had elected to and claimed foreign tax credits in the amount reported for the year to which such foreign taxes relate. The notification required under this paragraph (b)(2) must include the statement described in paragraph (c) of this section along with any information necessary for the owners to redetermine their U.S. tax liability.

(ii) Partnerships subject to subchapter C of chapter 63. Except as provided in paragraph (b)(4) of this section, if a redetermination of U.S. tax liability that is required under §1.905-3(b) by reason of a foreign tax redetermination described in §1.905-3(a) would require a partnership adjustment as defined in §301.6241-1(a)(6) of this chapter, the partnership must file an administrative adjustment request under section 6227 and make any adjustments required under section 6227. See §301.6227-2 and §301.6227-3 of this chapter for procedures for making adjustments with respect to an administrative adjustment request. An administrative adjustment request required under this paragraph (b)(2)(ii) must be filed by the due date (with extensions) of the original return for the partnership's taxable year in which the foreign tax redetermination occurs, and the restrictions in section 6227(c) do not apply to such filing. However, unless the administrative adjustment request may otherwise be filed after applying the limitations contained in section 6227(c), such a request is limited to adjustments that are required to be made under section 905(c). The requirements of paragraph (b)(2)(i) of this section are deemed to be satisfied with respect to any item taken into account in an administrative adjustment request filed under this paragraph (b)(2)(ii).

(3) Alternative notification requirements. An amended return and Form 1118 (Foreign Tax Credit--Corporations) or Form 1116 (Foreign Tax Credit), is not required to notify the IRS of the foreign tax redetermination and redetermination of U.S. tax liability if the taxpayer satisfies alternative notification requirements that may be prescribed by the IRS through forms, instructions, publications, or other guidance.

(4) Taxpayers under examination within the jurisdiction of the Large Business and International Division--(i) In general. The alternative notification requirements of this paragraph (b)(4) apply if all of the following conditions are satisfied:

(A) A foreign tax redetermination occurs while the taxpayer is under examination within the jurisdiction of the Large Business and International Division (or a successor division);

(B) The foreign tax redetermination results in a downward adjustment to the amount of foreign income taxes paid or accrued by the taxpayer or a foreign corporation with respect to which the taxpayer computes an amount of foreign income taxes deemed paid;

(C) The foreign tax redetermination requires a redetermination of U.S. tax liability and accordingly, but for this paragraph (b)(4), the taxpayer would be required to notify the IRS of such foreign tax redetermination under paragraph (b)(1)(ii) of this section (determined without regard to paragraphs (b)(1)(iv) and (v) of this section) or (b)(2)(ii) of this section;

(D) The return for the taxable year for which a redetermination of U.S. tax liability is required is under examination; and

(E) The due date specified in paragraph (b)(1)(ii) or (b)(2) of this section for providing notice of such foreign tax redetermination is not before the later of the opening conference or the hand-delivery or postmark date of the opening letter concerning an examination of the return for the taxable year for which a redetermination of U.S. tax liability is required by reason of such foreign tax redetermination.

(ii) <u>Notification requirements</u>--(A) <u>Foreign tax redetermination occurring before commencement of the examination</u>. If a foreign tax redetermination described in paragraph (b)(4)(i)(B) and (C) of this section occurs before the later of the opening conference or the hand-delivery or postmark date of the opening letter and if the condition provided in paragraph (b)(4)(i)(E) of this section with respect to such foreign tax redetermination is met, the taxpayer, in lieu of applying the rules of paragraph (b)(1)(i) and (ii) of this section (requiring the filing of an amended return, Form 1118, and the statement described in paragraph (c) of this section) or (b)(2)(ii) of this section (requiring the filing of an administrative adjustment request), must notify the IRS of such redetermination by providing the statement described in paragraph (b)(4)(iii) of this section to the examiner no later than 120 days after the later of the date of the opening conference of the examination, or the hand-delivery or postmark date of the opening letter concerning the examination.

(B) Foreign tax redetermination occurring within 180 days after commencement of the examination. If a foreign tax redetermination described in paragraph (b)(4)(i)(B) and (C) of this section occurs on or after the latest of the opening conference or the hand-delivery or postmark date of the opening letter and on or before the date that is 180 days after the later of the opening conference or the hand-delivery or postmark date of the opening letter, the taxpayer, in lieu of applying the rules of paragraph (b)(1)(i) and (ii) of this section or (b)(2) of this section, must notify the IRS of such redetermination by providing the statement described in paragraph (b)(4)(iii) of this section to the examiner no later than 120 days after the date the foreign tax redetermination occurs.

(C) Foreign tax redetermination occurring more than 180 days after commencement of the examination. If a foreign tax redetermination described in paragraphs (b)(4)(i)(B) and (C) of this section occurs after the date that is 180 days after the later of the opening conference or the hand-delivery or postmark date of the opening letter, the taxpayer must either apply the rules of paragraphs (b)(1)(i) and (ii) of this section or (b)(2) of this section, or, in lieu of applying paragraphs (b)(1)(i) and (ii) of this section or (b)(2) of this section, provide the statement described in paragraph (b)(4)(iii) of this section to the examiner within 120 days after the date the foreign tax redetermination occurs. However, the IRS, in its discretion, may either accept such statement or require the taxpayer to comply with the rules of paragraphs (b)(1)(i) and (ii) of this section or (b)(2) of this section, as applicable.

(iii) Statement. The statement required by paragraphs (b)(4)(ii)(A) and (B) of this section must provide the original amount of foreign income taxes paid or accrued, the revised amount of foreign income taxes paid or accrued, and documentation with respect to the revisions, including exchange rates and dates of accrual or payment, and, if applicable, the information described in paragraph (c)(8) of this section. The statement must include the following declaration signed by a person authorized to sign the return of the taxpayer: "Under penalties of perjury, I declare that I have examined this written statement, and to the best of my knowledge and belief, this written statement is true, correct, and complete."

(iv) Penalty for failure to file notice of a foreign tax redetermination. A taxpayer subject to the rules of this paragraph (b)(4) must satisfy the rules of paragraph (b)(4)(ii) of this section in order not to be subject to the penalty relating to the failure to file notice of a foreign tax redetermination under section 6689 and §301.6689-1 of this chapter.

(5) Examples. The following examples illustrate the application of paragraph (b) of this section.

(i) Example 1--(A) X, a domestic corporation, is an accrual basis taxpayer and uses the calendar year as its U.S. taxable year. X conducts business through a branch in Country M, the currency of which is the m, and also conducts business through a branch in Country N, the currency of which is the n. X uses the average exchange rate to translate foreign income taxes. Assume that X is able to claim a credit under section 901 for all foreign income taxes paid or accrued.

(B) In Year 1, X accrued and paid 100m of Country M income taxes with respect to 400m of foreign source foreign branch category income. The average exchange rate for Year 1 was $1:1m. Also in Year 1, X accrued and paid 50n of Country N income taxes with respect to 150n of foreign source foreign branch category income. The average exchange rate for Year 1 was $1:1n. On its Year 1 Federal income tax return, X claimed a foreign tax credit under section 901 of $150 ($100 (100m translated at $1:1m) + $50 (50n translated at $1:1n)) with respect to its foreign source foreign branch category income. See §1.986(a)-1(a)(1).

(C) In Year 2, X accrued and paid 100n of Country N income taxes with respect to 300n of foreign source foreign branch category income. The average exchange rate for Year 2 was $1.50:1n. On its Year 2 Federal income tax return X claimed a foreign tax credit under section 901 of $150 (100n translated at $1.5:1n). See §1.986(a)-1(a)(1).

(D) On June 15, Year 5, when the spot rate was $1.40:1n, X received a refund of 10n from Country N, and, on March 15, Year 6, when the spot rate was $1.20:1m, X was assessed by and paid Country M an additional 20m of tax. Both payments were with respect to X's foreign source foreign branch category income in Year 1. On May 15, Year 6, when the spot rate was $1.45:1n, X received a refund of 5n from Country N with respect to its foreign source foreign branch category income in Year 2.

(E) Both the refunds and the assessment are foreign tax redeterminations under §1.905-3(a). Under §1.905-3(b)(1), X must redetermine its U.S. tax liability for both Year 1 and Year 2. With respect to Year 1, under paragraph (b)(1)(ii) of this section, X must notify the IRS of the June 15, Year 5, refund of 10n from Country N that increased X's U.S. tax liability by filing an amended return, Form 1118, and the statement required in paragraph (c) of this section for Year 1 by the due date of the original return (with extensions) for Year 5. The amended return and Form 1118 reduces the amount of foreign income taxes claimed as a credit under section 901 and increases X’s U.S. tax liability by $10 (10n refund translated at the average exchange rate for Year 1, or $1:1n (see §1.986(a)-1(c)). With respect to the March 15, Year 6, additional assessment of 20m by Country M, under paragraph (b)(1)(iii) of this section, X must notify the IRS within the time period provided by section 6511, increasing the foreign income taxes available as a credit and reducing X’s U.S. tax liability by $24 (20m translated at the spot rate on the date of payment, or $1.20:1m). See sections 986(a)(1)(B)(i) and 986(a)(2)(A) and §1.986(a)-1(a)(2)(i). X may so notify the IRS by filing a second amended return, Form 1118, and the statement described in paragraph (c) of this section for Year 1, within the time period provided by section 6511. Alternatively, under paragraph (b)(1)(iv) of this section, when X redetermines its U.S. tax liability for Year 1 to take into account the 10n refund from Country N that occurred in Year 5, X may also take into account the 20m additional assessment by Country M that occurred on March 15, Year 6. If X reflects both foreign tax redeterminations on the same amended return, Form 1118, and in the statement described in paragraph (c) of this section for Year 1, the amount of X's foreign income taxes available as a credit would be reduced by $10 (10n refund translated at $1:1n), and increased by $24 (20m additional assessment translated at the spot rate on the date of payment, March 15, Year 6, or $1.20:1m). The foreign income taxes available as a credit therefore would be increased by $14 ($24 (additional assessment) – $10 (refund)). Because the net effect of the foreign tax redeterminations is to increase the amount of foreign taxes paid or accrued and decrease X’s U.S. tax liability, under paragraph (b)(1)(iv) of this section the Year 1 amended return, Form 1118, and the statement required in paragraph (c) of this section reflecting foreign tax redeterminations in both years must be filed within the time period provided by section 6511.

(F) With respect to Year 2, under paragraph (b)(1)(ii) of this section, X must notify the IRS by filing an amended return, Form 1118, and the statement required in paragraph (c) of this section for Year 2 that is separate from that filed for Year 1. The amended return, Form 1118, and the statement required in paragraph (c) of this section for Year 2 must be filed by the due date (with extensions) of X's original return for Year 6. The amended return and Form 1118 reduces the amount of foreign income taxes claimed as a credit under section 901 and increases X's U.S. tax liability by $7.50 (5n refund translated at the average exchange rate for Year 2, or $1.50:1n).

(ii) Example 2. X, a taxpayer within the jurisdiction of the Large Business and International Division, uses the calendar year as its U.S. taxable year. On November 15, Year 2, X receives a refund of foreign income taxes that constitutes a foreign tax redetermination and necessitates a redetermination of U.S. tax liability for X's Year 1 taxable year. Under paragraph (b)(1)(ii) of this section, X is required to notify the IRS of the foreign tax redetermination that increased its U.S. tax liability by filing an amended return, Form 1118, and the statement described in paragraph (c) of this section for its Year 1 taxable year by October 15, Year 3 (the due date (with extensions) of the original return for X's Year 2 taxable year). On December 15, Year 3, the IRS hand delivers an opening letter concerning the examination of the return for X's Year 1 taxable year, and the opening conference for such examination is scheduled for January 15, Year 4. Because the date for notifying the IRS of the foreign tax redetermination under paragraph (b)(1)(ii) of this section (October 15, Year 3) is before the date of the opening conference concerning the examination of the return for X's Year 1 taxable year (January 15, Year 4), the condition of paragraph (b)(4)(i)(E) of this section is not met, and so paragraph (b)(4)(i) of this section does not apply. Accordingly, X must notify the IRS of the foreign tax redetermination by filing an amended return, Form 1118, and the statement described in paragraph (c) of this section for the Year 1 taxable year by October 15, Year 3.

(c) Notification contents. The statement required by paragraphs (b)(1)(i) through (iv) of this section and (b)(2) of this section must contain information sufficient for the IRS to redetermine U.S. tax liability if such a redetermination is required under section 905(c). The information must be in a form that enables the IRS to verify and compare the original computation of U.S. tax liability, the revised computation resulting from the foreign tax redetermination, and the net changes resulting therefrom. The statement must include the following:

(1) The taxpayer's name, address, identifying number, the taxable year or years of the taxpayer that are affected by the foreign tax redetermination, and, in the case of

foreign taxes deemed paid, the name and identifying number, if any, of the foreign corporation;

(2) The date or dates the foreign income taxes were accrued, if applicable; the date or dates the foreign income taxes were paid; the amount of foreign income taxes paid or accrued on each date (in foreign currency) and the exchange rate used to translate each such amount, as provided in §1.986(a)-1(a) or (b);

(3) Information sufficient to determine any change to the characterization of a distribution, the amount of any inclusion under section 951(a), 951A, or 1293, or the deferred tax amount under section 1291;

(4) Information sufficient to determine any interest due from or owing to the taxpayer, including the amount of any interest paid by the foreign government to the taxpayer and the dates received;

(5) In the case of any foreign income tax that is refunded in whole or in part, the taxpayer must provide the date of each such refund; the amount of such refund (in foreign currency); and the exchange rate that was used to translate such amount when originally claimed as a credit (as provided in §1.986(a)-1(c)) and the spot rate (as defined in §1.988-1(d)) for the date the refund was received (for purposes of computing foreign currency gain or loss under section 988);

(6) In the case of any foreign income taxes that are not paid on or before the date that is 24 months after the close of the taxable year to which such taxes relate, the amount of such taxes in foreign currency, and the exchange rate that was used to translate such amount when originally claimed as a credit or added to PTEP group taxes (as defined in §1.960-3(d)(1));

(7) If a redetermination of U.S. tax liability results in an amount of additional tax due, and the carryback or carryover of an unused foreign income tax under section 904(c) only partially eliminates such amount, the information required in §1.904-2(f); and

(8) In the case of a pass-through entity, the name, address, and identifying number of each beneficial owner to which foreign taxes were reported for the taxable year or years to which the foreign tax redetermination relates, and the amount of foreign tax initially reported to each beneficial owner for each such year and the amount of foreign tax allocable to each beneficial owner for each such year after the foreign tax redetermination is taken into account.

(d) Payment or refund of U.S. tax. The amount of tax, if any, due upon a redetermination of U.S. tax liability is paid by the taxpayer after notice and demand has been made by the IRS. Subchapter B of chapter 63 of the Internal Revenue Code (relating to deficiency procedures) does not apply with respect to the assessment of the amount due upon such redetermination. In accordance with sections 905(c) and 6501(c)(5), the amount of additional tax due is assessed and collected without regard to the provisions of section 6501(a) (relating to limitations on assessment and collection). The amount of tax, if any, shown by a redetermination of U.S. tax liability to have been overpaid is credited or refunded to the taxpayer in accordance with subchapter B of chapter 66 (section 6511 et seq.).

(e) Interest and penalties--(1) In general. If a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination, interest is computed on the underpayment or overpayment in accordance with sections 6601 and 6611. No interest is assessed or collected on any underpayment resulting from a refund of foreign income taxes for any period before the receipt of the refund, except to the extent interest was paid by the foreign country or possession of the United States on the refund for the period before the receipt of the refund. See section 905(c)(5). In no case, however, will interest assessed and collected pursuant to the preceding sentence for any period before receipt of the refund exceed the amount that otherwise would have been assessed and collected under section 6601 for that period. Interest is assessed from the time the taxpayer (or the foreign corporation, partnership, trust, or other pass-through entity of which the taxpayer is a shareholder, partner, or beneficiary) receives a refund until the taxpayer pays the additional tax due the United States.

(2) Imposition of penalty. Failure to comply with the provisions of this section subjects the taxpayer to the penalty provisions of section 6689 and §301.6689-1 of this chapter.

(f) Applicability date. This section applies to foreign tax redeterminations (as defined in §1.905-3(a)) occurring in taxable years ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]**, and to foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a United States shareholder ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]**.

Par. 19. Section 1.905-5, as proposed to be added at 72 FR 62805 (November 7, 2007), is further revised to read as follows:

§1.905-5 Foreign tax redeterminations of foreign corporations that relate to taxable years of the foreign corporation beginning before January 1, 2018.

(a) In general--(1) Effect of foreign tax redetermination of a foreign corporation. A foreign tax redetermination (as defined in §1.905-3(a)) of a foreign corporation that relates to a taxable year of the foreign corporation beginning before January 1, 2018, and that may affect a taxpayer's foreign tax credit in any taxable year, must be accounted for by adjusting the foreign corporation's taxable income and earnings and profits, post-1986 undistributed earnings as defined in §1.902-1(a)(9), and post-1986 foreign income taxes as defined in §1.902-1(a)(8) (or its pre-1987 accumulated profits as defined in §1.902-1(a)(10)(i) and pre-1987 foreign income taxes as defined in §1.902-1(a)(10)(iii), as applicable) in the taxable year of the foreign corporation to which the foreign taxes relate.

(2) Requirement of U.S. tax redetermination. A redetermination of U.S. tax liability is required to account for the effect of the foreign tax redetermination on the earnings and profits and taxable income of the foreign corporation, the taxable income of a United States shareholder, and the amount of foreign taxes deemed paid by the United States shareholder under section 902 or 960 (as in effect before December 22, 2017), in the year to which the redetermined foreign taxes relate. For example, in the case of a refund of foreign income taxes, the subpart F income, earnings and profits, and post-1986 undistributed earnings (or pre-1987 accumulated profits, as applicable) of the foreign corporation are increased in the year to which the foreign tax relates to reflect the functional currency amount of the foreign income tax refund. The required redetermination of U.S. tax liability must account for the effect of the foreign tax redetermination on the characterization and amount of distributions or inclusions under sections 951 or 1293 taken into account by each of the foreign corporation's United

States shareholders and on the application of the high-tax exception described in section 954(b)(4), as well as on the amount of foreign income taxes deemed paid in such year. In addition, a redetermination of U.S. tax liability is required for any subsequent taxable year in which the United States shareholder received or accrued a distribution or inclusion from the foreign corporation, up to and including the taxable year in which the foreign tax redetermination occurs, as well as any year to which unused foreign taxes from such year were carried under section 904(c).

(b) Notification requirements--(1) In general. The notification requirements of §1.905-4, as modified by paragraphs (b)(2) and (3) of this section, apply if a redetermination of U.S. tax liability is required under paragraph (a) of this section.

(2) Notification relating to post-1986 undistributed earnings and post-1986 foreign income taxes. In the case of foreign tax redeterminations with respect to taxes included in post-1986 foreign income taxes, in addition to the information required by §1.905-4(c), the taxpayer must provide the balances of the pools of post-1986 undistributed earnings and post-1986 foreign income taxes before and after adjusting the pools, the dates and amounts of any dividend distributions or other inclusions made out of earnings and profits for the affected year or years, and the amount of earnings and profits from which such dividends were paid or such inclusions were made for the affected year or years.

(3) Notification relating to pre-1987 accumulated profits and pre-1987 foreign income taxes. In the case of foreign tax redeterminations with respect to pre-1987 accumulated profits, in addition to the information required by §1.905-4(c), the taxpayer must provide the following: the dates and amounts of any dividend distributions made

out of earnings and profits for the affected year or years; the rate of exchange on the date of any such distribution; and the amount of earnings and profits from which such dividends were paid for the affected year or years.

(c) Currency translation rules for adjustments to pre-1987 foreign income taxes. Foreign income taxes paid with respect to pre-1987 accumulated profits that are deemed paid under section 960 (or under section 902 in the case of an amount treated as a dividend under section 1248) are translated into dollars at the spot rate for the date of the payment of the foreign income taxes, and refunds of such taxes are translated into dollars at the spot rate for the date of the refund. Foreign income taxes deemed paid by a taxpayer under section 902 with respect to an actual distribution of pre-1987 accumulated profits and refunds of such taxes are translated into dollars at the spot rate for the date of the distribution of the earnings to which the foreign income taxes relate. See section 902(c)(6) (as in effect before December 22, 2017) and §1.902-1(a)(10)(iii). For purposes of this section, the term spot rate has the meaning provided in §1.988-1(d).

(d) Adjustments to pools of post-1986 foreign income taxes. The redetermination of U.S. tax liability required by paragraph (a) of this section is made in accordance with section 905(c) as in effect for those taxable years, without regard to rules that required prospective adjustments to a foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the year of the foreign tax redetermination in lieu of redeterminations of U.S. tax liability. No underpayment or overpayment of U.S. tax liability results from a foreign tax redetermination unless the required adjustments change the U.S. tax liability. Consequently, no interest is paid by or to a taxpayer as a result of adjustments, required by reason of a foreign tax redetermination, to a foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the year to which the redetermined foreign tax relates that did not result in a change to U.S. tax liability, for example, because no foreign taxes were deemed paid in that year.

(e) Applicability date. This section applies to foreign tax redeterminations (as defined in §1.905-3(a)) of foreign corporations occurring in taxable years that end with or within taxable years of a United States shareholder ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER],** and that relate to taxable years of foreign corporations beginning before January 1, 2018.

Par. 20. Section 1.954-1 is amended by:

1. Removing the language “reduced by related person” and adding the language “reduced (but not below zero) by related person” in its place in paragraph (c)(1)(i)(C).

2. Adding two sentences to the end of paragraph (d)(3)(iii) and revising paragraph (h)(1).

The revisions and additions read as follows:

§1.954-1 Foreign base company income.

* * * * *

(d) * * *

(3) * * *

(iii) * * * In addition, foreign income taxes that have not been paid or accrued because they are contingent on a future distribution of earnings are not taken into account for purposes of this paragraph (d)(3). If, pursuant to section 905(c) and §1.905-3(b)(2), a redetermination of U.S. tax liability is required to account for the effect of a foreign tax redetermination (as defined in §1.905-3(a)), this paragraph (d) is applied in the adjusted year taking into account the adjusted amount of the redetermined foreign tax.

* * * * *

(h) * * * (1) Paragraph (d)(3) of this section. Paragraph (d)(3) of this section applies to taxable years of a controlled foreign corporation ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]**. For taxable years of a controlled foreign corporation ending on or after December 4, 2018, but ending before **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]**, see §1.954-1(d)(3) as in effect on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

* * * * *

Par. 21. Section 1.954-2 is amended by:

1. Removing the text “and” from paragraph (h)(2)(i)(H).
2. Redesignating paragraph (h)(2)(i)(I) as paragraph (h)(2)(i)(J).
3. Adding a new paragraph (h)(2)(i)(I).
4. Adding a sentence to the end of paragraph (i)(2).

The additions read as follows:

§1.954-2 Foreign personal holding company income.

* * * * *

(h) * * * (2) * * * (i) * * *

(I) Any guaranteed payments for the use of capital under section 707(c); and

* * * * *

(i) * * *

(2) * * * Paragraph (h)(2)(i)(I) of this section applies to taxable years of controlled foreign corporations ending on or after [**<u>INSERT DATE OF FILING IN THE FEDERAL REGISTER</u>**], and to taxable years of United States shareholders in which or with which such taxable years end.

Par 22. Section 1.960-1 is amended by:

1. Adding a sentence at the end of paragraph (c)(2).

2. Revising the first three sentences, and adding two new sentences after the third sentence, in paragraph (d)(3)(ii)(A).

3. Removing and reserving paragraph (d)(3)(ii)(B).

4. Revising the second, third, and seventh sentences of paragraph (d)(3)(ii)(C).

The addition and revisions read as follows:

<u>§1.960-1 Overview, definitions, and computational rules for determining foreign income taxes deemed paid under section 960(a), (b), and (d)</u>.

* * * * *

(c) * * *

(2) * * * An item of income with respect to a current taxable year does not include an amount included as subpart F income of a controlled foreign corporation by reason of the recharacterization of a recapture account established in a prior U.S. taxable year (and the corresponding earnings and profits) of the controlled foreign corporation under section 952(c)(2) and §1.952-1(f).

* * * * *

(d) * * *

(3) * * *

(ii) * * *

(A) In general. * * * A current year tax is allocated and apportioned among the section 904 categories under the rules of §1.904-6. An amount of the current year tax that is allocated and apportioned to a section 904 category is then allocated and apportioned among the income groups within the section 904 category under §1.861-20 (as modified by §1.904-6(c)) by treating each income group as a statutory grouping and treating the residual income group as the residual grouping. Therefore, the portion of a current year tax that is attributable to foreign taxable income arising from a transaction that does not result in the recognition of gross income or loss for Federal income tax purposes in the current taxable year is assigned under §1.861-20(d)(2)(i) to the section 904 category and income group within a section 904 category to which the corresponding U.S. item would be assigned if the event giving rise to the foreign taxable income resulted in the recognition of income or loss under Federal income tax law in that year. Foreign gross income arising from the receipt of a disregarded payment made by a disregarded entity or other foreign branch to its foreign branch owner that is a controlled foreign corporation is assigned to the income group or groups from which the payment is considered to be made under §1.861-20(d)(3)(ii)(A). Foreign gross income attributable to a base difference, or resulting from the receipt of a disregarded payment made to a foreign branch, is assigned to the residual income grouping under §§1.861-20(d)(2)(ii)(B) and 1.861-20(d)(3)(ii)(B). * * *

(B) [Reserved]

(C) * * * In such case, under §1.861-20, the portion of the foreign gross income (as defined in §1.861-20(b)(5)) that is characterized under Federal income tax principles as a distribution of previously taxed earnings and profits that results in the increase in the PTEP group in the current taxable year is assigned to that PTEP group. If a PTEP group is not treated as an income group under the first sentence of this paragraph (d)(3)(ii)(C), and the rules of §1.861-20 would otherwise apply to assign foreign gross income to a PTEP group, that foreign gross income is instead assigned to the subpart F income group or tested income group to which the income that gave rise to the previously taxed earnings and profits would be assigned if the income were recognized by the recipient controlled foreign corporation under Federal income tax principles in the current taxable year. * * * That foreign gross income, however, may be assigned to a subpart F income group or tested income group.

Par 23. Section 1.960-2 is amended by adding a sentence at the end of paragraph (b)(3)(iii) to read as follows:

<u>§1.960-2 Foreign income taxes deemed paid under sections 960(a) and (d)</u>.

* * * * *

(b) * * *

(3) * * *

(iii) * * * <u>See</u> §1.960-1(c)(2) for rule regarding the treatment of an increase in the subpart F income of a controlled foreign corporation by reason of the recharacterization of a recapture account and the corresponding accumulated earnings and profits under section 952(c) and §1.952-1(f).

Par. 24. Section 1.960-7 is revised to read as follows:

<u>§1.960-7 Applicability dates</u>.

(a) Except as provided in paragraph (b) of this section, §§1.960-1 through 1.960-6 apply to each taxable year of a foreign corporation ending on or after December 4, 2018, and to each taxable year of a domestic corporation that is a United States shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends.

(b) Section 1.960-1(d)(3)(ii) applies to taxable years of a foreign corporation beginning after December 31, 2019, and to each taxable year of a domestic corporation that is a United States shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends. For taxable years of a foreign corporation that end on or after December 4, 2018, and also begin before January 1, 2020, see §1.960-1(d)(3)(ii) as in effect on [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

Par. 25. Section 1.965-5 is amended by:

1. Redesignating paragraph (b) as paragraph (b)(1).
2. Adding new introductory text for paragraph (b).
3. Revising the heading of newly redesignated paragraph (b)(1).
4. Adding paragraph (b)(2).

The revision and additions read as follows:

§1.965-5 Allowance of a credit or deduction for foreign income taxes.

* * * * *

(b) Rules for foreign income taxes paid or accrued--(1) In general. * * *

(2) Attributing taxes to section 959(a) distributions of section 965 previously taxed earnings and profits. For purposes of paragraph (b)(1) of this section, foreign income taxes are attributable to a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits if such taxes would be allocated and apportioned to a distribution of such previously taxed earnings and profits under the principles of §1.904-6(a)(1)(iv), regardless of whether an actual

distribution is made or recognized for Federal income tax purposes. Therefore, for example, a credit or deduction for the applicable percentage of foreign income taxes imposed on a United States shareholder that pays foreign tax on a distribution that is not recognized for Federal income tax purposes (for example, in the case of a consent dividend or stock dividend upon which a withholding tax is imposed) is not allowed under paragraph (b)(1) of this section to the extent it is attributable to a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits under the principles of §1.904-6(a)(1)(iv). For taxable years of foreign corporations beginning after December 31, 2019, in lieu of applying the principles of §1.904-6 under this paragraph (b)(2), the rules in §1.861-20 apply by treating the portion of a distribution attributable to section 965(a) previously taxed earnings and profits and the portion of a distribution attributable to section 965(b) previously taxed earnings and profits each as a statutory grouping, and the portion of the distribution that is attributable to other earnings and profits as the residual grouping. <u>See</u> §1.861-20(g)(7) (<u>Example 6</u>).

* * * * *

Par. 26. Section 1.965-9 is amended by adding a sentence to the end of paragraph (c) to read as follows:

<u>§1.965-9 Applicability dates</u>.

* * * * *

(c) * * * Section 1.965-5(b)(2) applies to taxable years of foreign corporations that end on or after [**<u>INSERT DATE OF FILING IN THE FEDERAL REGISTER</u>**], and with respect to a United States person, to the taxable years in which or with which such taxable years of the foreign corporations end.

Par. 27. Section 1.1502-4 is revised to read as follows:

§1.1502-4 Consolidated foreign tax credit.

(a) In general. The credit under section 901 for taxes paid or accrued to any foreign country or possession of the United States is allowed to the group only if the agent for the group (as defined in §1.1502-77(a)) chooses to use the credit in the computation of the consolidated tax liability of the group for the consolidated return year. If that choice is made, section 275(a)(4) provides that no deduction against taxable income may be taken on the consolidated return for foreign taxes paid or accrued by any member. However, if section 275(a)(4) does not apply, a deduction against consolidated taxable income may be allowed for certain taxes for which a credit is not allowed, even though the choice is made to claim a credit for other taxes. See, for example, sections 901(j)(3), 901(k)(7), 901(l)(4), 901(m)(6), and 908(b).

(b) Computation of foreign tax credit. The foreign tax credit for the consolidated return year is determined on a consolidated basis under the principles of sections 901 through 909 and 960. Taxes paid or accrued to all foreign countries and possessions by members of the group for the year (including those deemed paid under section 960 and paragraph (d) of this section) must be aggregated.

(c) Computation of limitation on credit. For purposes of computing the group's limiting fraction under section 904, the following rules apply:

(1) Computation of taxable income from foreign sources--(i) Separate categories. The group must compute a separate foreign tax credit limitation for income in each separate category (as defined in §1.904-5(a)(4)(v) for purposes of this section). The numerator of the limiting fraction in any separate category is the consolidated taxable income of the group determined in accordance with §1.1502-11, taking into account

adjustments required under section 904(b), if any, from sources without the United States in that category, determined in accordance with the rules of §1.904-4, 1.904-5, and the section 861 regulations (as defined in §1.861-8(a)(1)).

(ii) Adjustments under sections 904(f) and (g). The rules for allocation and recapture of separate limitation losses and overall foreign losses under section 904(f) and §1.1502-9 apply to determine the foreign source and U.S. source taxable income in each separate category of the consolidated group. Similarly, the rules for allocation and recapture of overall domestic losses under section 904(g) and §1.1502-9 apply to determine the foreign source and U.S. source taxable income in each separate category of the consolidated group. See §1.904(g)-3 for allocation rules under sections 904(f) and 904(g). The rules of sections 904(f) and 904(g) do not operate to recharacterize foreign income tax attributable to any separate category.

(iii) Computation of consolidated net operating loss. The source and separate category of the group's consolidated net operating loss ("CNOL"), as that term is defined in §1.1502-21(e), for the taxable year, if any, is determined based on the amounts of any separate limitation losses and U.S. source loss that are not allocated to reduce U.S. source income or income in other separate categories under the rules of sections 904(f) and 904(g) in computing the group's consolidated foreign tax credit limitations for the taxable year under paragraphs (c)(1)(i) and (ii) of this section.

(iv) Characterization of CNOL carried to a separate return year--(A) In general. The total amount of CNOL attributable to a member that is carried to a separate return year is determined under the rules of §1.1502-21(b)(2). The source and separate category of the portion of the CNOL that is attributable to a member is determined under this paragraph (c)(1)(iv).

(B) Tentative apportionment. For the portion of the CNOL that is attributable to the member described in paragraph (c)(1)(iv) of this section, the consolidated group determines a tentative allocation and apportionment to each statutory and residual grouping (as described in §1.861-8(a)(4) with respect to section 904 as the operative section) under the principles of §1.1502-9(c)(2)(i), (ii), (iv) and (v) by treating the portion of the group's CNOL in each statutory and residual grouping as if it were a CSLL account, as that term is described in §1.1502-9(b)(4). This determination is made as of the end of the taxable year of the consolidated group in which the CNOL arose or, if earlier and applicable, when the member leaves the consolidated group.

(C) Adjustments--(1) If the total tentative apportionment for all statutory and residual groupings exceeds the portion of the CNOL attributable to the member described in paragraph (c)(1)(iv)(A) of this section (the "excess amount"), then the tentative apportionment in each grouping is reduced by an amount equal to the excess amount multiplied by a fraction, the numerator of which is the tentative apportionment in that grouping, and the denominator of which is the total tentative apportionments in all groupings.

(2) If the total tentative apportionment for all statutory and residual groupings is less than the total CNOL attributable to the member described in paragraph (c)(1)(iv)(A) (the "deficiency"), then the tentative apportionment in each grouping is increased by an amount equal to the deficiency multiplied by a fraction, the numerator of which is the CNOL in that grouping that was not tentatively apportioned, and the denominator of which is the total CNOL in all groupings that was not tentatively apportioned.

(v) Consolidated net capital losses. The principles of the rules in paragraphs (c)(1)(i) through (iv) of this section apply for purposes of determining the source and separate category of consolidated net capital losses described in §1.1502-22(e).

(2) Computation of consolidated taxable income. The denominator of the limiting fraction in any separate category is the consolidated taxable income of the group determined in accordance with §1.1502-11, taking into account adjustments required under section 904(b), if any.

(3) Computation of tax against which credit is taken. The tax against which the limiting fraction under section 904(a) is applied will be the consolidated tax liability of the group determined under §1.1502-2, but without regard to §1.1502-2(a)(2), (3), (4), (8), and (9), and without regard to any credit against such liability. See sections 26(b) and 901(a).

(d) Carryover and carryback of unused foreign tax--(1) Allowance of unused foreign tax as consolidated carryover or carryback. The consolidated group's carryovers and carrybacks of unused foreign tax (as defined in §1.904-2(c)(1)) to the taxable year is determined on a consolidated basis under the principles of section 904(c) and §1.904-2 and is deemed to be paid or accrued to a foreign country or possession for that year. The consolidated group's unused foreign tax carryovers and carrybacks to the taxable year consist of any unused foreign tax of the consolidated group, plus any unused foreign tax of members for separate return years, which may be carried over or back to the taxable year under the principles of section 904(c) and §1.904-2. The consolidated group's unused foreign tax carryovers and carrybacks do not include any unused foreign taxes apportioned to a corporation for a separate return year pursuant to §1.1502–79(d). A consolidated group's unused foreign tax in each separate category is the excess of the foreign taxes paid, accrued or deemed paid under section 960 by the consolidated group over the limitation in the applicable separate category for the consolidated return year. See paragraph (c) of this section.

(2) Absorption rules. For purposes of determining the amount, if any, of an unused foreign tax which can be carried to a taxable year (whether a consolidated or separate return year), the amount of the unused foreign tax that is absorbed in a prior consolidated return year under section 904(c) shall be determined by—

(i) Applying all unused foreign taxes which can be carried to a prior year in the order of the taxable years in which those unused foreign taxes arose, beginning with the taxable year that ends earliest, and

(ii) All the unused foreign taxes which can be carried to such prior year from taxable years ending on the same date on a pro rata basis.

(e) Example. The following example illustrates the application of this section:

(1) Facts--(i) Domestic corporation P is incorporated on January 1, Year 1. On that same day, P incorporates domestic corporations S and T as wholly owned subsidiaries. P, S, and T file consolidated returns for Years 1 and 2 on the basis of a calendar year. T engages in business solely through a qualified business unit in Country A. S engages in business solely through qualified business units in countries A and B. P does business solely in the United States. During Year 1, T sold an item of

inventory to P at a gain of $2,000. Under § 1.1502-13 the intercompany gain has not been taken into account as of the close of Year 1. The taxable income of each member for Year 1 from foreign and U.S. sources, and the foreign taxes paid on such foreign income, are as follows:

Table 1 to paragraph (e)(1)(i)

Corporation	**U.S. Source taxable income**	**Foreign branch category foreign source taxable income**	**Foreign branch category foreign tax paid**	**Total taxable income**
P	$40,000			$40,000
T		$20,000	$12,000	20,000
S		20,000	9,000	20,000
Group				$80,000

(ii) The separate taxable income of each member was computed by taking into account the rules under §1.1502-12. Accordingly, T's intercompany gain of $2,000 is not included in T's taxable income for Year 1. The group's consolidated taxable income (computed in accordance with §1.1502-11) is $80,000. The consolidated tax liability against which the credit may be taken (computed in accordance with paragraph (c)(3) of this section) is $16,800.

(2) Analysis. The aggregate taxes paid to all foreign countries with respect to the foreign branch category income of $21,000 ($12,000 + $9,000) is limited to $8,400 ($16,800 x $40,000/$80,000). Assuming P, as the agent for the group, chooses to use the foreign taxes paid as a credit, the group may claim a $8,400 foreign tax credit.

(f) Applicability date. This section applies to taxable years for which the original consolidated Federal income tax return is due (without extensions) after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Par. 28. Section 1.1502-21 is amended by adding a sentence to the end of paragraph (b)(2)(iv)(B) to read as follows:

§1.1502-21. Net operating losses.

* * * * *

(b) * * *

(2) * * *

(iv) * * *

(B) * * * The source and section 904(d) separate category of the CNOL attributable to a member is determined under §1.1502-4(c)(1)(iii).

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 29. The authority citation for part 301 is amended by adding an entry for §301.6689-1, to read in part as follows:

Authority: 26 U.S.C. 7805.

* * * * *

Section 301.6689-1 also issued under 26 U.S.C. 6689(a), 26 U.S.C. 6227(d), and 26 U.S.C. 6241(11).

* * * * *

Par. 30. Section 301.6227-1 is amended by adding paragraph (g) to read as follows:

§301.6227-1 Administrative adjustment request by partnership.

* * * * *

(g) Notice requirement and partnership adjustments required as a result of a foreign tax redetermination. For special rules applicable when an adjustment to a partnership related item (as defined in section 6241(2)) is required as part of a redetermination of U.S. tax liability under section 905(c) and §1.905-3(b) of this chapter as a result of a foreign tax redetermination (as defined in §1.905-3(a) of this chapter), see §1.905-4(b)(2)(ii) of this chapter.

* * * * *

Par. 31. Section 301.6689-1, as proposed to be added at 72 FR 62807 (November 7, 2007), is further revised to read as follows:

§301.6689-1 Failure to file notice of redetermination of foreign income taxes.

(a) Application of civil penalty. If a foreign tax redetermination occurs, and the taxpayer failed to notify the Internal Revenue Service (IRS) on or before the date and in the manner prescribed in §1.905-4 of this chapter, or as required under section 404A(g)(2), for giving notice of a foreign tax redetermination, then, unless paragraph (d) of this section applies, there is added to the deficiency (or the imputed underpayment as determined under section 6225) attributable to such redetermination an amount determined under paragraph (b) of this section. Subchapter B of chapter 63 of the Internal Revenue Code (relating to deficiency proceedings) does not apply with respect to the assessment of the amount of the penalty.

(b) Amount of the penalty. The amount of the penalty shall be equal to--

(1) Five percent of the deficiency (or imputed underpayment) if the failure is for not more than one month, plus

(2) An additional five percent of the deficiency (or imputed underpayment) for each month (or fraction thereof) during which the failure continues, but not to exceed in the aggregate twenty-five percent of the deficiency (or imputed underpayment).

(c) Foreign tax redetermination defined. For purposes of this section, a foreign tax redetermination is any redetermination for which a notice is required under sections 905(c) or 404A(g)(2). See §§1.905-3 through 1.905-5 of this chapter for rules relating to the notice requirement under section 905(c).

(d) Reasonable cause. The penalty set forth in this section shall not apply if it is established to the satisfaction of the IRS that the failure to file the notification within the prescribed time was due to reasonable cause and not due to willful neglect. An affirmative showing of reasonable cause must be made in the form of a written statement that sets forth all the facts alleged as reasonable cause for the failure to file the notification on time and that contains a declaration by the taxpayer that the statement is made under the penalties of perjury. This statement must be filed with the Internal Revenue Service Center in which the notification was required to be filed. The taxpayer must file this statement with the notice required under section 905(c) or section 404A(g)(2). If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the notification within the prescribed time, then the delay will be considered to be due to reasonable cause and not willful neglect.

(e) Applicability date. This section applies to foreign tax redeterminations occurring in taxable years ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]**, and to foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a United States shareholder ending on or after **[INSERT DATE OF FILING IN THE FEDERAL REGISTER]**.

Deputy Commissioner for Services and Enforcement