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I. Introduction

A. The Foreign Tax Credit has been significantly impacted by the tax law changes from TCJA. Application of the FTC impacts a number of areas of TCJA changes such as Section 965, Base Erosion Anti-Abuse Tax (BEAT), and Foreign Derived Intangible Income (FDII). However, perhaps the most significant impact of FTCs is as applied to the Global Intangible Low-Taxed Income (GILTI). This panel will focus on FTC as it relates to the GILTI provisions and the recent guidance released by Treasury and IRS in this area. First we will address the overarching policy goals.

II. Policy Goals of GILTI

A. Over the past 15 months, it should be clear that GILTI is not intended to be a pure minimum tax:

a. Expense Apportionment
b. Loss CFCs
c. FTC haircut
d. QBAI
e. Not QBU by QBU

B. On the other end of the spectrum, it appears that the policy goal of recent guidance is to permit Previously Taxed Earnings & Profits (PTEP) to be returned to the US. It is not so clear the FTC rules always have the same preference.

a. Treasury Comments:

i. Allocated expenses may reduce the amount of section 951A category income included in U.S. taxable income below the amount of the foreign base on which the CFC paid at least a 13.125 percent foreign effective tax rate, with the effect that the United States shareholder's foreign taxes deemed paid may exceed the pre-credit U.S. tax on its section 951A category income, resulting in excess credits that may not offset U.S. tax on other income. This result flows from the fact that the foreign tax credit limitation under section 904 is calculated with respect to the pre-credit U.S. tax on the shareholder's net foreign source taxable income in each separate category. The comments nevertheless suggest that taxpayers' inability to reduce U.S. tax on non-section 951A category income (such as U.S. source income) with the excess

credits is tantamount to imposing U.S. "residual tax" on section 951A category income, even though the actual U.S. tax liability on that income, as reduced by foreign tax credits, is zero. The comments suggest that in order to assure full utilization of foreign tax credits associated with section 951A category income that is subject to a foreign effective tax rate of 13.125 percent or greater, no expenses should be allocated and apportioned to the section 951A category income.

ii. The Treasury Department and the IRS have determined that the Act is not consistent with this view of how the section 904 limitation should apply to the section 951A category. Congress added a new separate category under section 904(d)(1) for amounts includible under section 951A and amended section 904(c) to disallow carryovers of excess foreign tax credits in that category, but did not modify the existing rules under section 904 or sections 861 through 865 to provide for special treatment of expenses allocable to the section 951A category. Other provisions added in the Act are inconsistent with the notion described by comments that Congress intended effectively to exempt section 951A category income that was subject to a certain foreign effective tax rate from U.S. tax, since those provisions may result in U.S. tax being imposed on income derived through a CFC even if the foreign effective tax rate on the income exceeds 13.125 percent. See, for example, sections 59A (limiting the benefits of foreign tax credits) and 250(a)(2)(B)(ii) (limiting the deduction under section 250 in certain cases). In addition, numerous provisions in the Code that were unamended by the Act apply by their terms to section 951A category income, also indicating that Congress did not intend to eliminate generally-applicable limitations on foreign tax credits associated with foreign earnings of a CFC even if such earnings were subject to a certain foreign effective tax rate. For example, the Act did not amend provisions that limit the availability of foreign tax credits (such as sections 901(j), (k), (l), or (m)) or that reduce (or increase) the foreign tax credit limitation in the section 951A category based on U.S. or foreign losses in other separate categories or losses in other years (sections 904(f) and (g)). These provisions apply to a GILTI inclusion and related taxes under section 960(d), and as applied the provisions are not consistent with the policy of determining allowable foreign tax credits based solely on a CFC's foreign effective tax rate because they may reduce the amount of taxes that may be credited without regard to the foreign effective tax rate of the CFC. The Act did, however, add section 904(b)(4)(B), which disregards certain deductions other than those that are "properly allocable or apportioned to" amounts includible under sections 951A(a) or 951(a)(1) and stock that produces amounts includible under section 951A(a) or 951(a)(1). This new provision plainly contemplates that deductions will be allocated and apportioned to the section 951A category.

iii. Accordingly, the proposed regulations generally apply the existing approach of the expense allocation rules to determine taxable income in the section 951A category, as well as the new foreign branch category described in section 904(d)(1)(B). However, as discussed in Part I.A of this Explanation of Provisions, the proposed regulations also provide for exempt income and exempt asset treatment with respect to income in the section 951A category that is offset by the deduction allowed under section 250(a)(1) for inclusions

under section 951A(a) and a corresponding percentage of the stock of CFCs that generates such income. This will generally have the effect of reducing the amount of expenses apportioned to the section 951A category.

iv. The Treasury Department and the IRS recognize that in light of the significant reduction in the corporate tax rate and the enactment of section 951A, the foreign tax credit limitation and the related expense allocation rules will have a broader impact on taxpayers than before the Act. In particular, although all U.S. taxpayers claiming foreign tax credits were subject to the foreign tax credit limitation under section 904, many taxpayers were not significantly affected by the limitation so long as the U.S. corporate tax rate was higher than the effective foreign tax rate. In addition, the pre-Act deferral system that taxed non-passive income earned through foreign subsidiaries (and allowed deemed paid foreign tax credits) only upon repatriation allowed taxpayers to manage their foreign tax credit limitation by timing repatriations. However, the Act's reduction in the U.S. corporate tax rate, limitations on deferral, and introduction of a participation exemption regime without deemed paid credits has limited the benefits of this type of planning. The Treasury Department and the IRS welcome comments on the proposed approach and anticipated impacts.

III. Proposed Regulation

A. Overview

a. TCJA made several significant changes to the Internal Revenue Code with respect to the foreign tax credit rules and related rules for allocating and apportioning expenses for purposes of determining the foreign tax credit limitation.
   i. Act repealed the fair market value method of asset valuation for purposes of allocating and apportioning interest expense under section 864(e)(2),
   ii. added section 904(b)(4),
   iii. added two foreign tax credit limitation categories in section 904(d),
   iv. amended section 960(a) through (c),
   v. added section 960(d) through (f),
   vi. and repealed section 902 along with making other conforming changes.
   vii. The Act also added section 951A, which requires a United States shareholder of a controlled foreign corporation ("CFC") to include certain amounts in income (a "global intangible low-taxed income inclusion" or "GILTI inclusion").

B. Areas of proposed regulations

a. the allocation and apportionment of deductions under sections 861 through 865 and adjustments to the foreign tax credit limitation under section 904(b)(4);
b. transition rules for overall foreign loss, separate limitation loss, and overall domestic loss accounts under section 904(f) and (g), and for the carryover and carryback of unused foreign taxes under section 904(c);
c. the addition of separate categories under section 904(d) and other necessary updates to the regulations under section 904, including revisions to the look-through rules and other updates to reflect pre-Act statutory amendments;

d. the calculation of the exception from subpart F income for high-taxed income under section 954(b)(4);
e. the determination of deemed paid credits under section 960 and the gross up under section 78; and (6) the application of the election under section 965(n).

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

a. Regulations under sections 861 through 865 provide rules for allocating and apportioning deductions to determine, among other things, a taxpayer's taxable income from sources without the United States for purposes of applying section 904.
b. Section 904(b)(4) makes certain adjustments to both the taxpayer's taxable income from sources without the United States and the taxpayer's entire taxable income for purposes of computing the applicable foreign tax credit limitation.
c. Proposed §§1.861-8 through 1.861-13 and 1.861-17 amend existing regulations to clarify how deductions are allocated and apportioned in general, and provide new rules to account for the specific changes made to sections 864(e) and 904 by the Act.
d. Proposed §1.904(b)-3 provides rules regarding the application of section 904(b)(4) for purposes of determining a taxpayer's foreign tax credit limitation.

D. Rationale for apportionment analysis

a. Many of the existing expense allocation rules have not been significantly modified since 1988. Furthermore, for taxable years beginning after December 31, 2020, a worldwide affiliated group will be able to elect to allocate and apportion interest expense on a worldwide basis. See section 864(f). The Treasury Department and the IRS expect the implementation of section 864(f) will have a significant impact on the effect of interest expense apportionment and will necessitate a reexamination of the existing expense allocation rules.
b. Therefore, the Treasury Department and the IRS expect to reexamine the existing approaches for allocating and apportioning expenses, including in particular the apportionment of interest, research and experimentation ("R&E"), stewardship, and general & administrative expenses, as well as to reexamine the "CFC netting rule" in §1.861-10(e). The Treasury Department and the IRS request comments with respect to specific revisions to the regulations that should be made in connection with this review.

E. Allocation and apportionment of foreign income taxes, the section 250 deduction, and a distributive share of partnership deductions

a. Section 1.861-8(e) provides rules for allocating and apportioning certain deductions. Section 1.861-8(e)(6) provides rules for the allocation and apportionment of deductions for state, local, and foreign income, war profits and excess profits taxes. In the case of deductions for foreign income, war profits and excess profits taxes, the allocation and apportionment rules under §1.861-8(e) are intended to be consistent with the principles of §1.904-6. The proposed regulations clarify this result by expressly incorporating the principles of §1.904-6(a)(1)(i), (ii), and (iv) in allocating and apportioning taxes to the relevant statutory and residual groupings (and not just to separate categories of income for purposes of determining the foreign tax credit limitation).
b. The proposed regulations include rules for allocating and apportioning the section 250 deduction. For these purposes, although the section 250 deduction is a single deduction that equals the sum of the amounts specified in section 250(a)(1)(A) and (B), the

proposed regulations provide separate rules with respect to (i) the portion of the section 250 deduction for FDII and (ii) the portion of the section 250 deduction for the GILTI inclusion and the amount of the section 78 gross up attributable to foreign taxes deemed paid with respect to the GILTI inclusion. The amount of each portion of the section 250 deduction to be allocated and apportioned takes into account any reductions required under section 250(a)(2)(B).

F. Valuation of assets for purposes of apportioning interest expense and other deductions

a. Repeal of Fair Market Value Method and Transition Relief
    i. Section 864(e)(2) requires taxpayers to apportion interest expense on the basis of assets rather than income. Under the asset method, a taxpayer apportions interest expense to the various statutory groupings based on the average total value of assets within each grouping for the taxable year as determined under the asset valuation rules of §1.861-9T(g). Before the Act, taxpayers could elect to determine the value of their assets under the tax book value, alternative tax book value, or the fair market value method, and were required to obtain the Commissioner's approval to switch from the fair market value method to the tax book or alternative tax book value methods. See §1.861-8T(c)(2). In light of the Act's repeal of the fair market value method for apportioning interest for taxable years beginning after December 31, 2017, taxpayers using the fair market value method must switch to the tax book or alternative tax book value method for purposes of apportioning interest expense for the taxpayer's first taxable year beginning after December 31, 2017. Proposed §§1.861-8(c)(2) and 1.861-9(i)(2) provide that the Commissioner's approval is not required for this change.

G. Allocation and apportionment of research and experimental expenditures

a. In general, R&E expenditures are apportioned between groupings within product categories according to either a sales or gross income method of apportionment at the taxpayer's election. §1.861-17(c) and (d). Under §1.861-17(e)(1), a taxpayer may choose to use either the sales method or gross income method for its original return for its first taxable year. The taxpayer's use of either method constitutes a binding election to use the method chosen for that year and for the subsequent four years. Within this five-year period, the election can only be revoked with the Commissioner's consent. A taxpayer may change the election at any time after five years, but the new election is binding for a new five-year period. §1.861-17(e)(2).
b. In light of the numerous amendments to the foreign tax credit rules made by the Act, the proposed regulations provide a one-time exception to the five-year binding election period. Accordingly, under proposed §1.861-17(e)(3), even if a taxpayer is subject to the binding election period, for the taxpayer's first taxable year beginning after December 31, 2017, the taxpayer may change its apportionment method without obtaining the Commissioner's consent. This one-time change of method constitutes a binding election to use the method chosen for that year and for the next four taxable years.
c. The Treasury Department and the IRS request comments on whether other aspects of §1.861-17 should be revised in light of the changes to section 904(d), in particular the addition of the section 951A category. For example, because the look-through rules in section 904(d)(3)(C) do not assign interest, rents, or royalties that reduce tested income to the section 951A category, royalties paid by a CFC to a United States shareholder are generally general category income even though the sales by the CFC to which the royalties relate may generate income in the section 951A category to the United States

shareholder. This could result in R&E expenditures being apportioned under the sales method solely to the section 951A category, even though the royalty income is assigned to the general category. However, under the gross income method, R&E expenditures would be apportioned to both the general and section 951A category. Comments are requested on whether and how the regulations governing either or both methods should be revised to account for the addition of the section 951A category.

H. Section 904(b)(4)

a. Effect of Section 904(b)(4) on the Foreign Tax Credit Limitation

i. Under new section 904(b)(4), for purposes of the foreign tax credit limitation in section 904(a), a domestic corporation that is a United States shareholder with respect to a specified 10-percent owned foreign corporation disregards the "foreign-source portion" of any dividend received from the foreign corporation and any deductions properly allocable or apportioned to income (other than amounts includible under section 951(a)(1) or 951A(a)) with respect to the stock of the foreign corporation or to the stock itself (to the extent income with respect to the stock is other than amounts includible under section 951(a)(1) or 951A(a)). Dividends and deductions that are disregarded under section 904(b)(4) result in an adjustment to both the taxpayer's foreign source taxable income in the relevant separate category (the numerator of the fraction under section 904(a)) and its worldwide taxable income (the denominator of the fraction under section 904(a)) in all separate categories.

ii. In general, under section 904(b)(4), disregarding both the dividend income eligible for a deduction under section 245A as well as the associated deduction under section 245A has no effect on the foreign tax credit limitation in any separate category because they generally net to zero. However, additional deductions that are disregarded under section 904(b)(4)(B) generally have the effect of increasing the foreign tax credit limitation with respect to the separate category to which the deductions are allocated and apportioned, because both the numerator (foreign source taxable income in the category) and the denominator (worldwide taxable income) of the fraction under section 904(a) are increased by the same amount. In contrast, the limitation in other categories will generally decrease because the numerator (foreign source taxable income in the category) is unchanged but the denominator (worldwide taxable income) of the fraction is increased.

b. Coordination with OFL/ODL rules

i. Because the section 904(b)(4) adjustments apply in computing the foreign tax credit limitation under section 904(a), proposed §1.904(b)-3(d) provides that the adjustments under section 904(b)(4), like the adjustments under section 904(b)(2) to account for foreign source capital gain net income and rate differentials, apply before the operation of both the separate limitation loss and overall foreign loss rules in section 904(f) and the overall domestic loss rules in section 904(g). This rule permits loss accounts to be recaptured out of income that is added to the foreign tax credit limitation calculation by reason of the section 904(b)(4) adjustments.

I. Foreign Tax Credit Limitation Under Section 904

a. The proposed regulations update §§1.904-1 through 1.904-6 (the "section 904 regulations") to eliminate deadwood and reflect statutory amendments made to section 904 before the Act. For example, proposed §§1.904-1 through 1.904-3 reflect the repeal of the overall limitation and per-country limitation. Proposed §1.904-4 reflects statutory amendments made before the Act eliminating various separate categories described in section 904(d)(1).
b. The proposed regulations also propose revisions and additions to the section 904 regulations to reflect the changes made under the Act. Part II.A of this Explanation of Provisions describes proposed transition rules to account for the addition of separate categories for section 951A category income and foreign branch category income. Part II.B of this Explanation of Provisions describes (1) proposed amendments to the rules relating to the passive category with respect to high-taxed income, export financing interest, and financial services income; (2) rules relating to the foreign branch category, section 951A category, and separate category described in section 904(d)(6) for items resourced under a treaty; and (3) rules for assigning the section 78 gross up and section 986(c) gain or loss to a separate category. Part II.C of this Explanation of Provisions describes updates relating to amendments made by the Act replacing references to "noncontrolled section 902 corporations" with "non-controlled 10 percent owned foreign corporations." Part II.D of this Explanation of Provisions describes proposed amendments to the look-through rules under sections 904(d)(3) and (d)(4) to account for the addition of the foreign branch category and section 951A category under the Act. Part II.E of this Explanation of Provisions describes the proposed changes to the rules for allocating and apportioning foreign taxes to separate categories.

J. Separate Limitation Losses, Overall Foreign Losses, and Overall Domestic Losses

a. Similar to the transition rules for carryovers and carrybacks of unused foreign taxes, the proposed regulations provide transition rules for recapture in a post-2017 taxable year of an overall foreign loss (OFL) or separate limitation loss (SLL) in a pre-2018 separate category that offset U.S. source income or income in another pre-2018 separate category, respectively, in a pre-2018 taxable year, as well as for recapture of an overall domestic loss (ODL) that offset income in a pre-2018 separate category in a pre-2018 taxable year.
b. Proposed §1.904(f)-12(j) provides that any SLL or OFL accounts in the pre-2018 separate category for passive category income or income in a specified separate category remain in the same post-2017 separate category. Any SLL or OFL account in the pre-2018 separate category for general category income is allocated between the post-2017 separate categories for general category income and foreign branch category income in the same proportion that any unused foreign taxes with respect to the pre-2018 separate category for general category income are allocated to those post-2017 separate categories. Therefore, in the case of a taxpayer that does not apply the exception described in proposed §1.904-2(j)(1)(iii), all of its SLL or OFL accounts in the pre-2018 separate category for general category income remain in the general category. In addition, if there were no unused foreign taxes in the pre-2018 general category to be allocated, proposed §1.904(f)-12(j)(3)(i) provides that all SLL or OFL accounts in the pre-2018 separate category for general category income remain in the general category. Similar rules are provided with respect to the recapture of SLLs or ODLs that reduced income in a separate category in a pre-2018 taxable year, as well as for foreign losses that are part of a net operating loss that is incurred in a pre-2018 taxable year and carried forward to post-2017 taxable years.

K. Foreign Branch Category Income

a. Gross income in the category

i. Section 904(d)(1)(B) provides a new separate category for foreign branch category income, which is defined in section 904(d)(2)(J) as the business profits of a United States person attributable to a qualified business unit (QBU) in a foreign country (excluding passive category income). Section 904(d)(1)(B) further provides that the amount of business profits attributable to a QBU is determined under rules established by the Secretary.

ii. Section 904(d)(2)(J) limits foreign branch income to income of a United States person. Therefore, foreign persons (including CFCs) cannot have foreign branch category income. While a domestic partnership (or other pass-through entity) that is a United States person may earn income that is attributable to a foreign branch of such partnership, a distributive share of income earned by a domestic partnership cannot be foreign branch category income to foreign partners of the partnership. To avoid any conflict, the proposed regulations define foreign branch category income as the gross income of a United States person (other than a pass-through entity).

iii. Specifically, proposed §1.904-4(f)(1)(i) provides that foreign branch category income means the gross income of a United States person (other than a pass-through entity) that is attributable to foreign branches held directly or indirectly through disregarded entities by the United States person. Foreign branch category income also includes a United States person's (other than a pass-through entity) distributive share of partnership income that is attributable to a foreign branch held by the partnership directly or indirectly through another partnership or other pass-through entity. Similar principles apply for income of any other type of pass-through entity that is attributable to a foreign branch. All the income described is aggregated in a single foreign branch category; there are not separate categories for each foreign branch. Conforming changes are made to the rules for allocating and apportioning partnership deductions and creditable foreign tax expenditures. See proposed §§1.861-9(e)(9) and 1.904-6(b)(4)(ii).

iv. In general, gross income is attributable to a foreign branch to the extent it is reflected on a foreign branch's separate set of books and records. For this purpose, items of gross income must be adjusted to conform to Federal income tax principles. In addition, the proposed regulations provide several rules adjusting the gross income attributable to a foreign branch from what is reflected on the foreign branch's separate set of books and records.

1. First, the proposed regulations provide that gross income attributable to a foreign branch does not include items arising from activities carried out in the United States. Proposed §1.904-4(f)(2)(ii).
2. Second, the regulations provide that gross income attributable to a foreign branch does not include items of gross income arising from stock, including dividend income, income included under section 951(a)(1), 951A(a), or 1293(a) or gain from the disposition of stock. Proposed §1.904-4(f)(2)(iii)(A); cf. §1.987-2(b)(2) (providing a similar rule in connection with attribution of items of income, gain, deduction, or loss to a section 987 QBU). An exception is provided for gain from the disposition of stock, where the stock would be dealer property. Proposed §1.904-4(f)(2)(iii)(B).

3. Third, the proposed regulations provide that foreign branch category income does not include gain realized by a foreign branch owner on the disposition of an interest in a disregarded entity or an interest in a partnership or other pass-through entity. Proposed §1.904-4(f)(2)(iv)(A). However, an exception is provided for the sale of a partnership interest if the gain is reflected on the books and records of a foreign branch and the interest is held in the ordinary course of the foreign branch owner's trade or business. Proposed §1.904-4(f)(2)(iv)(B).
4. Fourth, the proposed regulations provide anti-abuse rules relating to the reflection of income on the books and records of a branch. The Treasury Department and the IRS are concerned that in certain cases gross income items could be inappropriately recorded on the books and records of a foreign branch or a foreign branch owner. Therefore, the proposed regulations include an anti-abuse rule providing for the reattribution of gross income if a principal purpose of recording, or failing to record, an item on the books and records of a foreign branch is the avoidance of Federal income tax or avoiding the purposes of section 904 or section 250. Proposed §1.904-4(f)(2)(v). The rule further provides a presumption that interest income received by a foreign branch from a related party is not gross income attributable to the foreign branch unless the interest income meets the definition of financial services income.
5. Finally, in order to accurately reflect the gross income attributable to a foreign branch, a determination that affects not only the application of section 904(a) but also the determination of deduction eligible income under section 250(b)(3)(A), the proposed regulations provide that gross income attributable to a foreign branch that is not passive category income must be adjusted to reflect certain transactions that are disregarded for Federal income tax purposes. Proposed §1.904-4(f)(2)(vi). This rule applies to transactions between a foreign branch and its foreign branch owner, as well as transactions between or among foreign branches, involving payments that would be deductible or capitalized if the payment were regarded for Federal income tax purposes. For example, a payment made by a foreign branch to its foreign branch owner may, to the extent allocable to non-passive category income, result in a downward adjustment to the gross income attributable to the foreign branch and an increase in the general category gross income of the United States person. Each payment in a series of disregarded back-to-back payments, for example, a payment from one foreign branch to another foreign branch followed by a payment to the foreign branch owner, must be accounted for separately under these rules. Comments are requested on whether special rules are required in the case of a true branch (generally, a branch that is taxable solely on profits from a business conducted in the country and not taxable as a resident of that country) with respect to amounts that are deemed to be made to or from the home office of the branch under the foreign jurisdiction's rules for attributing profits to the branch.

v. In general, the proposed regulations do not treat disregarded transactions as "regarded" for Federal income tax purposes; rather, they provide that certain disregarded transactions result in a redetermination of whether gross income of the United States person is attributable to its foreign branch or to the foreign branch owner. Thus, while disregarded transactions may allocate income

between the foreign branch category and the general category, those transactions have no effect on the amount, character, or source of a United States person's gross income. U.S. source gross income that is reallocated from the general category to the foreign branch category and that is properly subject to foreign tax may be eligible to be treated as foreign source income under the terms of an income tax treaty, in which case the resourced income would be subject to a separate foreign tax credit limitation for income resourced under a tax treaty. See section 904(d)(6).

vi. The proposed regulations provide an exception from the special rules regarding disregarded transactions that applies to contributions, remittances, and payments of interest (including certain interest equivalents). Proposed §1.904-4(f)(2)(vi)(C). Generally, contributions, remittances, and interest payments to or from a foreign branch reflect a shift of, or return on, capital rather than a payment for goods and services. However, the different treatment of contributions and remittances, on the one hand, and other disregarded transactions, on the other, could allow for non-economic reallocations of the amount of gross income attributable to the foreign branch category. To prevent this in connection with certain transactions, the proposed regulations require the amount of gross income attributable to a foreign branch (and the amount attributable to the foreign branch owner) to be adjusted to account for consideration that would be due in any disregarded transactions in which property described in section 367(d)(4) is transferred to or from a foreign branch if the transactions were regarded, whether or not a disregarded payment is made in connection with the transfer. Proposed §1.904-4(f)(2)(vi)(D). The proposed regulations further require that the amount of any adjustment under the disregarded payment provisions must be determined under the arm's length principle of section 482 and the regulations under that section. Proposed §1.904-4(f)(2)(vi)(E).

vii. The proposed regulations do not propose any special rules for determining the amount of deductions allocated and apportioned to foreign branch category income, including deductions reflected on the books and records of foreign branches. Therefore, the proposed regulations provide that the rules for allocating and apportioning deductions in §§1.861-8 through 1.861-17 that apply with respect to the other separate categories also apply to the foreign branch category. The Treasury Department and the IRS request comments on whether any special rules should be issued for determining the allocation and apportionment of deductions between the foreign branch category and the general category. In addition, the Treasury Department and the IRS request comments on whether special rules should be provided for financial institutions with branches subject to regulatory capital requirements, including for example, rules similar to those in §1.882-5.

L. Definition of a foreign branch

a. The proposed regulations define a foreign branch by reference to the regulations under section 989 ("section 989 regulations") by providing that a foreign branch is a QBU described in §1.989(a)-1(b)(2)(ii) and (b)(3) that carries on a trade or business outside the United States. Proposed §1.904-4(f)(3)(iii). In general, §1.989(a)-1(b)(2)(ii) provides rules for treating activities of a branch of a taxpayer as a QBU. Specifically, it provides that the activities of a corporation, partnership, trust, estate, or individual qualify as a separate QBU if the activities constitute a trade or business, and a separate set of books and records is maintained with respect to the activities. Section 1.989(a)-1(b)(3) includes

a special rule treating activities generating income effectively connected with the conduct of a trade or business as a separate QBU.

b. The section 989 regulations treat partnerships and trusts as per se QBUs. See §1.989(a)-1(b)(2)(i). As a result, they do not include a rule treating the activities of a partnership or trust that constitute a trade or business, but for which a separate set of books and records is not maintained, as a QBU. For example, §1.989(a)-1(b)(2)(ii) would not treat the activities of a partnership QBU as a QBU if no separate set of books is maintained with respect to the activities.
c. In order to ensure that foreign branch category income does not include income reflected on the books and records of a QBU unless the QBU conducts a trade or business, the proposed regulations' definition of foreign branch does not incorporate the section 989 regulations' per se QBU rules, and instead requires that a foreign branch carry on a trade or business. In addition, the proposed regulations include a special rule, as illustrated by an example, providing that a foreign branch may consist of activities conducted through a partnership or trust that constitute a trade or business conducted outside the United States, but for which no separate set of books and records is maintained. See §1.904-4(f)(4)(i), Example 1.
d. The proposed regulations also modify the trade or business requirements in the section 989 regulations for purposes of the foreign branch definition. Specifically, to constitute a foreign branch, a QBU must carry on a trade or business outside the United States. For this purpose, activities that constitute a permanent establishment in a foreign country under a bilateral U.S. tax treaty, whether or not the activities also rise to the level of a separate trade or business, are presumed to constitute a trade or business. See proposed §1.904-4(f)(3)(iii)(B).
e. Under §1.989(a)-1(c), for activities to constitute a trade or business, they must ordinarily include the collection of income and the payment of expenses. The proposed regulations provide that, for purposes of determining whether a set of activities satisfy the trade or business requirement of §1.989(a)-1(c) in the context of the definition of a foreign branch, activities that relate to disregarded transactions are taken into account and may give rise to a trade or business for this purpose. See proposed §1.904-4(f)(3)(iii)(B).

M. Items Resourced Under a Treaty

a. Legislation commonly referred to as the Education Jobs and Medicaid Assistance Act (EJMAA), enacted on August 10, 2010, added section 904(d)(6), which, as amended by the Tax Cuts and Jobs Act, provides that if, without regard to any treaty obligation of the United States, any item of income would be treated as derived from sources within the United States, under a treaty obligation of the United States the item of income would be treated as arising from sources outside the United States, and the taxpayer chooses the benefits of the treaty obligation to treat the income as arising from sources outside the United States, then subsections 904(a), (b), and (c) and sections 907 and 960 shall be applied separately with respect to each item. Thus, section 904(d)(6)(A) applies a separate foreign tax credit limitation to each item of resourced income, without regard to the separate category to which the item would otherwise be assigned.
    i. Grouping methodology
        1. Proposed §1.904-4(k)(2) adopts a grouping methodology similar to that employed in §1.904-5(m)(7) with respect to income treated as in a separate category under the separate treaty resourcing rules of section 904(h)(10). Under the proposed regulations, the taxpayer must segregate income treated as foreign source under each treaty and then compute a

separate foreign tax credit limitation for income in each separate category that is resourced under that treaty.

2. For purposes of allocating foreign taxes to each grouping of section 904(d)(6) income, the principles of §1.904-6 apply to allocate to the section 904(d)(6) separate category all foreign income taxes related to the income included in that group, including taxes imposed by a third country. The Treasury Department and the IRS are considering whether the regulations should provide a special rule limiting the tax assigned to a section 904(d)(6) separate category to tax paid to the foreign country that is a party to the income tax treaty pursuant to which the income is resourced, and request comments on this issue.

ii. Coordination with certain treaty and Code provisions

1. Some U.S. income tax treaties contain provisions for the tax treatment in both Contracting States of certain types of income derived from sources within the United States by U.S. citizens who are residents of the other Contracting State. See, for example, paragraph 3 of Article 24 (Relief from Double Taxation) of the income tax convention between the United States and Ireland, signed on July 28, 1997. These rules generally use a three-step approach to determine the U.S. citizen's ultimate U.S. income tax liability with respect to an applicable item of income. First, the other Contracting State provides a credit against its tax for the notional U.S. tax that would apply under the treaty to a resident of the other Contracting State who is not a U.S. citizen. Second, the United States provides a credit against U.S. tax for the income tax paid or accrued to the other Contracting State after the application of the credit for notional U.S. tax by the other Contracting State. Finally, the income is deemed to arise in the other Contracting State to the extent necessary to avoid double taxation under these rules.

2. These treaty rules are generally designed to preserve the United States' primary right to tax U.S. source income and to resource only enough income to allow a taxpayer to claim a credit for the related foreign taxes, as reduced by the notional credit for U.S. source-based tax. Although excess foreign tax credits may arise from the operation of these rules, excess limitation permitting the use of unrelated foreign tax credits to offset the U.S. tax on the resourced income generally cannot. Since U.S. citizens subject to these provisions generally cannot generate excess limitation, and it would be burdensome to subject individuals to the operation of section 904(d)(6) when they are already subject to the three-step treaty rule, the proposed regulations exclude the income of these individuals from the operation of section 904(d)(6). Accordingly, proposed §1.904-4(k)(4)(i) provides that income resourced under the relief from double taxation provisions in U.S. income tax treaties that are solely applicable to U.S. citizens who are residents of the other Contracting State is not subject to section 904(d)(6)(A) and §1.904-4(k)(1).

3. In addition, under the mutual agreement procedures of U.S. income tax treaties, U.S. taxpayers may request assistance from the U.S. competent authority, such as for the relief of double taxation in cases not provided for in the treaty. Where the U.S. competent authority agrees to grant relief to a taxpayer that involves resourcing, the taxpayer has effectively chosen the benefit of a treaty obligation of the United States to treat the

item of income as foreign source. Accordingly, proposed §1.904-4(k)(4)(ii) clarifies that section 904(d)(6) separate category treatment applies to items of income resourced pursuant to a competent authority agreement.

N. Allocation and apportionment of foreign taxes

a. Special Rule for Base and Timing Differences

i. Section 904(d)(2)(H)(i) and §1.904-6(a)(1)(iv) provide a special rule for allocating foreign tax that is imposed on an amount that does not constitute income under Federal income tax principles (a "base difference"). Section 1.904-6(a)(1)(iv) also provides special rules for timing differences.

ii. The proposed regulations clarify that base differences arise only in limited circumstances, such as in the case of categories of items such as life insurance proceeds or gifts, which are excluded from income for Federal income tax purposes but may be taxed as income under foreign law. In contrast, a computational difference attributable to differences in the amounts, as opposed to the types, of items included in U.S. taxable income and the foreign tax base does not give rise to a base difference. See proposed §1.904-6(a)(1)(iv). For example, a difference between U.S. and foreign tax law in the amount of deductions that are allowed to reduce gross income, like a difference in depreciation conventions or in the timing of recognition of gross income, is not considered to give rise to a base difference.

iii. In addition, the proposed regulations clarify that the fact that a distribution of previously taxed earnings and profits is exempt from Federal income tax does not mean that a tax imposed on the distribution is attributable to a base difference. Instead, because the previously taxed earnings and profits were included in U.S. taxable income in a prior year, the tax imposed on the distribution is treated as attributable to a timing difference and is allocated to the separate category to which the earnings and profits from which the distribution was paid are attributable.

b. Taxes Imposed in Connection with Foreign Branches

i. The regulations in §1.904-6(a) generally provide that foreign taxes are allocated and apportioned to separate categories by reference to the separate category of the income to which the foreign tax relates. Disregarded transactions between a foreign branch and the United States owner of the foreign branch (or between two foreign branches of the same United States person) may involve disregarded payments that are subject to foreign tax, including disregarded payments that result in the reallocation of gross income between the foreign branch category and the general category under the proposed regulations in §1.904-4(f)(2)(vi). See proposed §1.904-4(f) and Part II.B.2 of this Explanation of Provisions. While existing regulations under §1.904-6(a) provide general rules for allocating and apportioning foreign taxes imposed with respect to income of a foreign branch, proposed §1.904-6(a)(2) provides special rules to coordinate the existing regulations under §1.904-6(a)(1) with the computation of foreign branch category income in proposed §1.904-4(f).

ii. The proposed regulations are consistent with the general principles and purpose of §1.904-6(a)(1) and are intended to provide clarity where the application of these principles would be difficult or uncertain. The Treasury Department and the IRS recognize that there may be additional circumstances where the application

of these rules may be ambiguous and request comments on whether further guidance is needed to clarify how foreign taxes should be allocated and apportioned between the foreign branch category and other separate categories.

O. Deemed Paid Taxes Under New Section 960 and New Section 78

a. Section 960(a) and (d), as revised by the Act, deems a domestic corporation that is a United States shareholder of a CFC to pay the portion of the foreign income taxes paid or accrued by the CFC that is properly attributable to income of the CFC that the United States shareholder takes into account in computing its subpart F or GILTI inclusion, subject to certain limitations. Section 960(b), as revised by the Act, provides rules for taxes that are deemed paid in connection with distributions by a CFC of previously taxed earnings and profits to either a United States shareholder that is a domestic corporation or to a shareholder that is a CFC. Cf. section 960(a)(3) (as in effect on December 21, 2017). Proposed §§ 1.960-1 through 1.960-3 provide rules for determining a domestic corporation's deemed paid taxes under section 960(a), (b), and (d).

b. Additionally, the Act redesignated former section 960(b), relating to excess limitation accounts, without change, as section 960(c). The proposed regulations treat a GILTI inclusion amount as a subpart F inclusion for purposes of section 960(c). See section 951A(f)(1)(B). Therefore, the proposed regulations modify §§1.960-4 and 1.960-5 to reflect the additional application of section 960(c) to GILTI inclusion amounts. Comments are requested on whether additional amendments to the proposed regulations are appropriate, including additional rules in §1.960-4 to account for unique aspects of the section 951A category.

c. The Act also amended section 78 to, among other things, reflect the addition of deemed paid credits under section 960(d) and to provide that any amount of taxes deemed paid under section 960 that is treated as a dividend under section 78 (a "section 78 dividend") is not eligible for a section 245A deduction. The proposed regulations revise §1.78-1 to reflect changes made to section 78. Part IV.A of this Explanation of Provisions describes computational and grouping rules relating to the calculation of deemed paid taxes under section 960(a), (b), and (d). Part IV.B of this Explanation of Provisions describes specific rules for the calculation of deemed paid taxes under section 960(a) and (d). Part IV.C of this Explanation of Provisions describes specific rules for the calculation of deemed paid taxes under section 960(b). Part IV.D of this Explanation of Provisions describes the application of the rules under section 960(a), (b), and (d) when the domestic corporation owns the CFC through a domestic partnership. Part IV.E of this Explanation of Provisions describes revisions to §1.78-1.

P. Computational and grouping rules for purposes of calculating taxes deemed paid under section 960

a. Current Year Taxes

i. For a particular taxable year, a CFC may have subpart F income or tested income that is taken into account by a domestic corporation that is a United States shareholder of the CFC under sections 951(a)(1)(A) or 951A(a), and may incur foreign income taxes related to that income that may be treated as deemed paid by the United States shareholder under sections 960(a) or (d). Additionally, a CFC may receive distributions of previously taxed earnings and profits and incur foreign income taxes with respect to those distributions that may subsequently be

treated as deemed paid by the United States shareholder or an upper-tier CFC under section 960(b).

ii. Proposed §1.960-1 provides definitions as well as computational and grouping rules that associate the current year foreign income taxes ("current year taxes") of the CFC with current year income of the CFC or a distribution of previously taxed earnings and profits received by the CFC. These taxes, in turn, may be deemed paid by the United States shareholder or upper-tier CFC under section 960. Foreign income taxes generally include income, war profits, and excess profits taxes that are imposed by a foreign country or a possession of the United States. See proposed §1.960-1(b)(5). The term "possession of the United States" means American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands.

iii. Current year taxes of a CFC are foreign income taxes paid or accrued by the CFC in its current taxable year, and the rules of section 461 and the "relation-back" doctrine apply to determine the timing of the accrual of foreign income taxes and the year for which they are taken into account. See proposed §1.960-1(b)(4). Thus, for example, foreign income taxes calculated on the basis of net income accrue in the U.S. taxable year of the CFC with or within which its foreign taxable year ends, and are eligible to be deemed paid in the taxable year of the United States shareholder with or within which the U.S. taxable year of the CFC ends, even if a portion of the foreign taxable year of the CFC falls within an earlier or later U.S. taxable year of the CFC or its United States shareholder. Current year taxes of a CFC that are imposed on an amount under foreign law that would be income under U.S. law in a different taxable year are eligible to be deemed paid in the year in which the foreign tax accrues, and not in the earlier or later year when the related income is recognized for U.S. tax purposes. The current taxable year of the CFC is its U.S. taxable year for which a domestic corporation that is a United States shareholder of the CFC has a subpart F or GILTI inclusion with respect to the CFC, or during which the CFC receives a section 959(b) distribution or makes a section 959(a) distribution or a section 959(b) distribution.

Q. Computational Rules

a. Proposed §1.960-1(c)(1) describes and orders the computations involved in calculating the foreign income taxes deemed paid by either a domestic corporation that is a United States shareholder of a CFC or by a CFC that is a shareholder of another CFC. These steps are applied by each CFC in a chain of ownership beginning with the lowest-tier CFC with respect to which the domestic corporation is a United States shareholder.

b. Under these computational rules, a United States shareholder first applies the grouping rules described in Part IV.A.3 of this Explanation of Provisions to assign the income of the CFC to separate categories of income described in proposed §1.904-5(a)(4)(v) (each a "section 904 category") and then to groups that correspond to certain types of income (each, an "income group") in a section 904 category. If the CFC receives a distribution of previously taxed earnings and profits ("PTEP"), it increases the group or groups (each, a "PTEP group") within an annual PTEP account that corresponds both to the taxable year for which a CFC took into account the income from which the previously taxed earnings and profits arose, and to the separate category of the United States shareholder to which the amount of the resulting inclusion under sections 951(a)(1)(A) or 951A was assigned. The rules for grouping previously taxed earnings and profits within an annual PTEP account are described in Part IV.C.1 of this Explanation of Provisions. The income and

PTEP groups, which are discussed in more detail below, are the mechanism for computing taxes deemed paid under section 960.

c. Second, deductions of the CFC, including for expenses attributable to current year taxes, are allocated and apportioned to the income groups. Current year taxes are also allocated and apportioned to a PTEP group that was increased in the first step. Third, taxes deemed paid by the United States shareholder under section 960(a) and (d), and taxes deemed paid by the CFC under section 960(b)(2) in connection with its receipt of a section 959(b) distribution, are calculated. Fourth, the previously taxed earnings and profits resulting from the subpart F inclusion or GILTI inclusion of the United States shareholder are added to an annual PTEP account and further assigned to the relevant PTEP groups within the account. Fifth, the first four steps are repeated for each higher-tier CFC. Sixth, with respect to the highest-tier CFC, the United States shareholder computes its taxes deemed paid under section 960(b)(1).

d. Proposed § 1.960-1(c)(2) provides that only items that the CFC takes into account during its current taxable year are used in the computational rules of §1.960-1(c)(1). The items of gross income and expense that are in a section 904 category and income group within a section 904 category are therefore items that the CFC accrues and takes into account in its current taxable year, and the foreign income taxes that are eligible to be deemed paid are foreign income taxes that the CFC pays or accrues in its current taxable year. Proposed §1.960-1(c)(3) provides rules relating to foreign currency and translation.

R. Associating Current Year Taxes with Income Groups

a. In order to determine the foreign income taxes paid or accrued by the CFC that are properly attributable to amounts that a domestic corporation that is a United States shareholder of the CFC takes into account in determining its subpart F or GILTI inclusions, proposed §1.960-1(d) provides rules associating current year taxes of the CFC with the types of income earned by the CFC from which the inclusions arise. Proposed §1.960-1(d) requires a CFC to assign its income to one or more income groups within each section 904 category. Deductions of the CFC, including for current year taxes, are allocated and apportioned to the income groups in order to determine net income (or loss) in each income group and to identify the current year foreign income taxes that relate to the income in each income group for section 960 purposes.

b. Income Group Definitions

   i. Proposed §1.960-1(d)(2)(ii) defines several separate income groups with respect to the subpart F income of the CFC (”subpart F income groups”) within each applicable section 904 category. Each single item of foreign base company income as defined in §1.954-1(c)(1)(iii) is a separate subpart F income group. For example, with respect to a CFC, §1.954-1(c)(1)(iii)(A)(2) identifies as a single item of income all foreign base company income (other than foreign personal holding company income) that falls within both a single separate category (typically, general category income) and a single category of foreign base company income described in each of §1.954-1(c)(1)(iii)(A)(2)(i) through (v). Therefore, there is a single subpart F income group within the general category that consists of all of a CFC's foreign base company sales income. Section 1.954-1(c)(1)(iii)(B) provides grouping rules for items of passive category foreign personal holding company income, each of which is also treated as a separate subpart F income group under §1.960-1. Proposed §1.960-1(d)(2)(ii)(B)(2) also defines a separate subpart F income group for the CFC's insurance income described in section 952(a)(1), for its international boycott income described in section 952(a)(3), for the sum of its illegal bribes and kickbacks described in

section 952(a)(4), and for income included in a section 901(j) separate category described in section 952(a)(5).

ii. Proposed §1.960-1(d)(2)(ii)(C) also defines separate income groups for tested income (each, a "tested income group") in each section 904 category. In general, tested income will be in a single tested income group within the general category. Because a CFC cannot earn section 951A category income or foreign branch category income at the CFC level, there is no tested income group within either section 904 category. With respect to the CFC's general category tested income group, GILTI inclusion amounts and taxes with respect to the tested income group will generally be treated as income and deemed paid taxes in the section 951A category. See §§1.904-4(g), 1.904-6(b)(1).

iii. Income in a section 904 category that is not of a type that is included in one of the subpart F income groups or tested income groups is assigned to the residual income group. See proposed §1.960-1(d)(2)(ii)(D).

iv. Computing Net Income in an Income Group and Assigning Current Year Taxes to an Income Group

1. In order to determine its net income in each income group, a CFC first assigns its items of gross income to a section 904 category and to the appropriate income group within the category, and then allocates and apportions its deductions and expenses, including current year taxes, to the categories and to the income groups within the categories under the rules of sections 861 through 865 and 904(d) and the regulations under those sections.
2. Current year taxes are allocated and apportioned to income groups for two purposes. The first purpose is to deduct current year taxes (in functional currency) from gross income in the income group in computing the net income in the income group. The second purpose is to associate an amount of current year taxes (in U.S. dollars) with an income group. These current year taxes associated with an income group are eligible to be deemed paid by a United States shareholder that has a subpart F or GILTI inclusion that is attributable to that income group. The rules for allocating and apportioning current year taxes are the same for both purposes. See also proposed §1.861-8(e)(6) (clarifying that the rules for allocating and apportioning deductions for foreign income tax expense are the same as the rules for allocating and apportioning foreign income taxes to separate categories under §1.904-6).
3. Proposed §1.960-1(d)(3)(ii) applies the rules of §1.904-6 to allocate and apportion current year taxes to and among the section 904 categories based upon the amount of taxable income, as calculated under foreign law, of the CFC that is in each section 904 category. Proposed §1.960-1(d)(3)(ii) then applies the principles of §1.904-6 to allocate and apportion current year taxes to and among the income groups. If a PTEP group of the CFC is increased as a result of a section 959(b) distribution that it receives in the current taxable year, then for purposes of allocating and apportioning current year taxes that are imposed solely by reason of the section 959(b) distribution, the PTEP group is treated as an income group within the section 904 category. Part IV.C of this Explanation of Provisions discusses the rules for tracking amounts in PTEP groups and for computing deemed paid credits with respect to distributions of previously taxed earnings and profits from a PTEP group. Current year taxes that are not allocated and apportioned to a subpart F or tested

income group, or to a PTEP group that is treated as an income group, are allocated and apportioned to a residual income group. Current year taxes allocated and apportioned to a residual income group cannot be deemed paid under section 960 for any taxable year. Proposed §1.960-1(e).

4. Under §1.904-6, Federal income tax principles apply to determine the separate category, income group, or PTEP group of the CFC's gross items of income and expense, the amounts of which are computed under foreign law, that are included in the foreign tax base. For example, if the United States treats a distribution as resulting in capital gain that is passive category income, but foreign law treats the item as a dividend that would be general category income, the item is assigned to the passive category for purposes of allocating and apportioning current year taxes of the CFC to the item. See also proposed §1.904-6(a)(1)(i). The amount of the item, however, is determined under foreign law, and expenses (also determined under foreign law) are allocated and apportioned to the income under foreign law principles or as otherwise provided in §1.904-6(a)(1)(ii).
5. Proposed §1.960-1(d)(3)(ii)(B) also provides a rule for addressing base and timing differences (within the meaning of proposed §1.904-6(a)(1)(iv)) for purposes of allocating and apportioning current year taxes of a CFC to income groups and PTEP groups. Current year taxes that are attributable to a base difference are allocated to the residual income group, and therefore are ineligible to be deemed paid. Current year taxes that are attributable to a timing difference — namely, current year tax imposed on an amount that is income of the CFC in a different taxable year under Federal income tax law — are allocated and apportioned to a section 904 category and income group as though the income that foreign law recognizes in the CFC's current taxable year were also recognized for Federal income tax purposes in that year. Proposed §1.960-1(d)(3)(ii)(B) includes a special rule, which is discussed in Part IV.C.2 of this Explanation of Provisions, for current year taxes that are attributable to a timing difference resulting from a section 959(b) distribution.

S. Taxes deemed paid under section 960(a) and (d) for subpart F inclusions and GILTI inclusion amounts

a. Section 960(a) provides that a domestic corporation that is a United States shareholder of a CFC is deemed to have paid the CFC's foreign income taxes that are properly attributable to the item of income of the CFC that the United States shareholder includes in gross income under section 951(a)(1) as a subpart F inclusion.
b. Section 960(d) provides that a domestic corporation that is a United States shareholder is deemed to have paid 80 percent of an amount that is equal to the product of the United States shareholder's inclusion percentage and the aggregate of the tested foreign income taxes paid or accrued by the CFCs of the United States shareholder. The inclusion percentage of the United States shareholder is the ratio of the United States shareholder's GILTI inclusion amount with respect to its CFCs to the aggregate amount of the United States shareholder's pro rata share of tested income of those CFCs. Section 960(d)(3) defines tested foreign income taxes as the foreign income taxes paid or accrued by a CFC of a United States shareholder that are properly attributable to the tested income of the

CFC that the United States shareholder takes into account in computing its GILTI inclusion amount.

c. Subpart F Inclusions
   i. Under proposed §1.960-2(b), the amount of the foreign income taxes of a CFC that its United States shareholder that is a domestic corporation is deemed to pay under section 960(a) is computed with respect to the income of the CFC, determined under Federal income tax principles in each subpart F income group within a section 904 category. A domestic corporate shareholder that has a subpart F inclusion with respect to its CFC is deemed to pay the CFC's foreign income taxes that are properly attributable to the items of income of the CFC that give rise to the subpart F inclusion of that shareholder. The amount of taxes that are properly attributable to an item of income for this purpose is equal to the domestic corporate shareholder's proportionate share of the current year taxes of the CFC that are allocated and apportioned to the subpart F income group within a section 904 category of the CFC to which the item of income is attributable. The proportionate share for each subpart F income group is equal to the current year taxes that are allocated and apportioned to a subpart F income group within a section 904 category multiplied by a fraction equal to the portion of the subpart F inclusion that is attributable to that subpart F income group to the total income in that subpart F income group. Therefore, no tax is deemed paid by a corporate United States shareholder of a CFC with respect to a subpart F income group to which current year taxes of the CFC are allocated and apportioned (including by reason of the rule for timing differences) but with respect to which no portion of a subpart F inclusion is attributable.
   ii. The denominator of the fraction, the net income in the subpart F income group, is not reduced to reflect any prior year deficits because those deficits do not reduce the subpart F income of the CFC in the current year. A pro rata share of a prior year qualified deficit reduces the amount of a United States shareholder's subpart F inclusion, and therefore by its own account reduces the numerator of the fraction. Proposed §1.960-2(b)(3)(ii). The denominator of the fraction is, however, reduced to reflect the limitation in section 952(c)(1)(A) of the subpart F income of the CFC to its current year earnings and profits. The denominator is also reduced to reflect any reduction in the subpart F income of a CFC under section 952(c)(1)(C), which allows a CFC to reduce certain of its subpart F income by an amount of certain current year deficits of certain CFCs in the same chain of ownership. Proposed §1.960-2(b)(3)(iii).
   iii. Section 960(a) treats foreign income taxes of a CFC as deemed paid by a United States shareholder only with respect to an item of income of a CFC that is included in the gross income of the United States shareholder under section 951(a)(1). Proposed §1.960-2(b)(1) treats taxes as deemed paid under section 960(a) specifically with respect to subpart F inclusions because the inclusions are with respect to items of income of the CFC. In contrast, an inclusion under section 951(a)(1)(B) is not an inclusion of an “item of income” of the CFC but instead is an inclusion equal to an amount that is determined under the formula in section 956(a). Therefore, proposed §1.960-2(b)(1) provides that no foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B).

d. GILTI Inclusion Amounts
    i. Proposed §1.960-2(c) provides that the amount of the tested foreign income taxes that a United States shareholder is deemed to pay under section 960(d) is computed with respect to the income of the CFC in each tested income group within a section 904 category. For purposes of determining a United States shareholder's tested foreign income taxes, the CFC's current year taxes are first allocated and apportioned to the tested income group within a section 904 category in order to determine the foreign income taxes "properly attributable" to the tested income group. The United States shareholder's tested foreign income taxes for a tested income group within a section 904 category is equal to its proportionate share of the CFC's current year taxes, determined by multiplying the CFC's current year taxes that are allocated and apportioned to a tested income group within a section 904 category by a fraction that is equal to the tested income of the CFC in the tested income group that is included in computing the domestic corporation's aggregate amount described in section 951A(c)(1)(A) and proposed §1.951A-1(c)(2)(i), divided by the total income in the tested income group.
    ii. The United States shareholder's inclusion percentage is required to determine the amount of taxes deemed paid by the United States shareholder. In general, current year taxes allocated and apportioned to a tested income group will be in the general category at the level of the CFC, although in limited cases involving passive category tested income, current year taxes may be allocated and apportioned to the passive category. However, the domestic corporation computes only a single inclusion percentage with respect to all of its tested income, regardless of the section 904 category to which the tested income is assigned.
    iii. In the case of a United States shareholder that is a member of a consolidated group, the numerator of the inclusion percentage is computed using the GILTI inclusion amount of a United States shareholder as determined under §1.1502-51. See §1.951A-1(c)(4).

T. Taxes deemed paid under section 960(b) with respect to section 959 distributions

a. Section 960(b)(1) provides that a United States shareholder of a CFC is deemed to have paid the CFC's foreign income taxes that the United States shareholder has not been previously deemed to pay and that are properly attributable to a distribution from the CFC that the United States shareholder excludes from its income under section 959(a) (a "section 959(a) distribution"). Section 960(b)(2) provides that a CFC is deemed to have paid the foreign income taxes of another CFC that have not previously been deemed paid by a United States shareholder and that are properly attributable to a distribution from the other CFC to which section 959(b) applies (a "section 959(b) distribution," and together with a section 959(a) distribution, a "section 959 distribution").
b. PTEP Groups in Annual PTEP Accounts and Associated Taxes
    i. Proposed §1.960-3(c)(1) requires a CFC to establish a separate, annual account ("annual PTEP account") for its earnings and profits for its current taxable year to which subpart F or GILTI inclusions of United States shareholders of the CFC are attributable. Each account must correspond to the inclusion year of the previously taxed earnings and profits and to the section 904 category of the inclusions at the United States shareholder level. Accordingly, a CFC may have an annual PTEP account in the section 951A category or a treaty category (as defined in §1.861-13(b)(6)), even though income of the controlled foreign

corporation cannot initially be assigned to the section 951A category or a treaty category. The previously taxed earnings and profits in each annual account are then assigned to one of ten possible groups of previously taxed earnings and profits described in proposed §1.960-3(c)(2) (each, a "PTEP group"). The PTEP groups serve a similar function to the subpart F income groups and tested income groups — they are the mechanism for associating foreign taxes paid or accrued, or deemed paid, by a CFC with section 959 distributions of previously taxed earnings and profits. If, following the issuance of new guidance under section 959 (which will be addressed in a separate guidance project), it is determined that maintaining all ten of the PTEP groups is unnecessary, or that grouping of annual accounts into multi-year accounts is permissible, the Treasury Department and the IRS will consider consolidating PTEP groups as part of finalizing the proposed regulations.

ii. A CFC accounts for a section 959(b) distribution that it receives by adding the distribution amount to an annual PTEP account and PTEP group that corresponds to the annual PTEP account and PTEP group from which the distributing CFC made the distribution. Proposed §1.960-3(c)(3). A CFC that makes a section 959 distribution must similarly reduce the annual PTEP account and PTEP group within the account from which the distribution is made by the distribution amount. A CFC must also reduce PTEP groups that relate to previously taxed earnings and profits described in section 959(c)(2) ("section 959(c)(2) PTEP") to account for reclassification of amounts into those groups as previously taxed earnings and profits described in section 959(c)(1) ("reclassified PTEP"), and increase the PTEP group that corresponds to the reclassified amount. Proposed §1.960-3(c)(4).

c. Associating Foreign Income Taxes with PTEP Groups

i. A CFC must also account for the foreign income taxes that it pays, accrues or is deemed to pay with respect to the amount in each PTEP group ("PTEP group taxes"). PTEP group taxes are accounted for with respect to previously taxed earnings and profits assigned to a PTEP group within an annual PTEP account. PTEP group taxes consist of (1) the current year taxes paid or accrued by the CFC as the result of its receipt of a section 959(b) distribution that are allocated and apportioned to the PTEP group; (2) foreign income taxes that are deemed paid by the CFC with respect to an amount in a PTEP group; and (3) in the case of a reclassified PTEP group, foreign income taxes that were paid, accrued or deemed paid with respect to an amount that was initially included in a section 959(c)(2) PTEP group and subsequently added to a corresponding reclassified PTEP group. Proposed §1.960-3(d)(1). PTEP group taxes are reduced by the amount of foreign income taxes in the group that are deemed paid by a United States shareholder under section 960(b)(1) or by another CFC under section 960(b)(2), and foreign income taxes relating to a PTEP group that is reclassified to a section 959(c)(1) PTEP group. Proposed §1.960-3(d)(2).

ii. As discussed in Part IV.A.3.ii of this Explanation of Provisions, proposed §1.960-1(d)(3)(ii)(A) associates current year taxes of a CFC with a PTEP group for purposes of section 960(b) only in the case of an increase in a PTEP group as a result of the receipt of a section 959(b) distribution. The increased PTEP group is treated as an income group to which current year taxes that are imposed solely by reason of that section 959(b) distribution are allocated and apportioned. For example, a withholding tax imposed on a section 959(b) distribution received by an upper-tier CFC is allocated and apportioned to the PTEP group that is

increased by the section 959(b) distribution. The withholding tax also reduces (as a deduction) the amount in that same PTEP group.

iii. Proposed §1.960-1(d)(3)(ii)(B) generally applies the timing difference rule of §1.904-6(a)(1)(iv) to allocate and apportion current year taxes that are attributable to a timing difference to a section 904 category and income group as if the CFC recognized the related income under Federal income tax principles in its current taxable year. Proposed §1.960-1(d)(3)(ii)(B) also clarifies the rule for previously taxed earnings and profits by providing that if current year taxes are attributable to a timing difference, the taxes are only treated as related to a PTEP group if the taxes are imposed solely by reason of a section 959(b) distribution that increases the PTEP group. For example, a timing difference described in proposed §1.904-6(a)(1)(iv) could include a situation in which Federal income tax principles require marking-to-market gain on an asset, resulting in an inclusion under section 951A(a), but the foreign jurisdiction only imposes tax when the asset is disposed of in a later year. Under proposed §1.960-1(d)(3)(ii)(B), the later-imposed foreign income tax is treated as related to the tested income group (if any) for the year in which the tax is imposed, and not to a PTEP group in an annual PTEP account for the earlier year in which the gain was recognized for Federal income tax purposes. In addition, an income tax imposed on a distributing CFC (in contrast to a tax, such as a withholding tax, imposed on the recipient of the distribution) by reason of a section 959 distribution is treated as a timing difference and is treated as related to the subpart F income group or tested income group for the current taxable year (if any) in which the distribution is made, and not to a PTEP group in an annual PTEP account for the earlier year in which the distributed earnings and profits were recognized for Federal income tax purposes.

iv. Therefore, under proposed §1.960-1(d)(3)(ii)(B), the only taxes that are allocated and apportioned to a PTEP group are taxes that are imposed solely by reason of a CFC's receipt of a section 959(b) distribution and that are otherwise allocated and apportioned to the PTEP group under §1.904-6 principles. For example, a net basis tax imposed on a CFC's receipt of a section 959(b) distribution by the CFC's country of residence is treated as related to a PTEP group. Similarly, a withholding tax imposed with respect to a CFC's receipt of a section 959(b) distribution is allocated and apportioned to a PTEP group. In contrast, a withholding tax imposed on a disregarded payment from a disregarded entity to a CFC owner is treated as a timing difference and is never treated as related to a PTEP group (even if all of the CFC's earnings and profits are previously taxed earnings and profits from income earned by the disregarded entity), because the tax is not imposed solely by reason of a section 959(b) distribution. The withholding tax, however, may be treated as related to a subpart F income group or tested income group under the rule for timing differences.

U. Computational Rules

a. Proposed §1.960-3(b) provides rules for determining the amount of taxes deemed paid with respect to a section 959(a) distribution. A domestic corporation that receives a section 959(a) distribution is deemed to have paid the foreign income taxes that are properly attributable to the section 959(a) distribution from the PTEP group of the distributing CFC, to the extent the PTEP group taxes have not already been deemed to have been paid in the current taxable year or any prior taxable year. Proposed §1.960-3(b)(1). The amount of foreign income taxes that are properly attributable to a domestic

corporation's receipt of a section 959(a) distribution from a PTEP group within a section 904 category are its proportionate share of PTEP group taxes associated with the PTEP group. The domestic corporation's proportionate share of foreign income taxes associated with a section 959(a) distribution from a PTEP group is determined by a fraction equal to the amount of the section 959(a) distribution attributable to the PTEP group over the total amount of previously taxed earnings and profits in the PTEP group.

b. A single section 959(a) distribution could be attributable to multiple PTEP groups, with respect to multiple different inclusion years, of the distributing CFC. The proposed regulations, including the order of the list of PTEP groups in §1.960-3(c)(2), do not provide rules for the allocation of distributions among different kinds of previously taxed earnings and profits under section 959(c). The Treasury Department and the IRS anticipate that future regulations under section 959 will provide ordering rules for determining the annual PTEP account and PTEP group to which a section 959 distribution is attributable.
c. Proposed §1.960-3(b)(2) provides similar rules to those in proposed §1.960-3(b)(1) for taxes deemed paid under section 960(b)(2) with respect to a CFC's receipt of a section 959(b) distribution.
d. Proposed §1.960-3(d)(3) provides a rule relating to foreign income taxes paid or accrued in a taxable year of a CFC that began before January 1, 2018, with respect to an annual PTEP account, and a PTEP group within such account, that was established for an inclusion year of a CFC that began before January 1, 2018. Specifically, in certain cases, the foreign income taxes may be deemed paid under section 960(b) with respect to a section 959 distribution in a year of the CFC that begins after December 31, 2017.
e. However, the Treasury Department and the IRS recognize that with respect to CFC taxable years beginning before January 1, 2018, the application of section 960(a)(3) was uncertain and some taxpayers may have added taxes paid or accrued with respect to a section 959 distribution to post-1986 foreign income taxes described in section 902(c)(2) (as in effect on December 21, 2017). In that case, those foreign income taxes could have been included in computing foreign taxes deemed paid under section 902 with respect to a distribution or inclusion of post-1986 undistributed earnings (including by reason of sections 960 and 965) in taxable years of CFCs beginning before January 1, 2018, in which case the taxes are not available to be deemed paid under section 960(b).
f. The proposed regulations under section 965, see 83 Fed. Reg. 39,514, reserved on the application of section 965(g) to taxes deemed paid under new section 960(b). The preamble to the regulations under section 965 indicated that future regulations would provide rules for new section 960(b) similar to the rules that apply for section 960(a)(3) (as in effect on December 21, 2017).
g. The proposed regulations in this document provide a rule in proposed §1.965-5(c)(1)(iii) similar to the rule that applies to taxes deemed paid under section 960(a)(3) that is in proposed §1.965-5(c)(1)(i) and (ii). In particular, no credit is allowed for the applicable percentage of taxes deemed paid under section 960(b) that are attributable to the PTEP groups described in §1.960-3(c)(2) that relate to section 965.
h. In order to ensure that the disallowance under section 965(g) only applies once, the rule in proposed §1.965-5(c)(1)(iii) does not apply to taxes deemed paid under section 960(b)(2) with respect to a section 959(b) distribution, but only applies when previously taxed earnings and profits are distributed to a domestic corporate shareholder.

V. Section 78 dividend

a. The proposed regulations revise §1.78-1 to reflect the amended section 78, as well as make conforming changes to reflect pre-Act statutory amendments. In addition, the

proposed regulations provide that section 78 dividends that relate to taxable years of foreign corporations that begin before January 1, 2018, are not treated as dividends for purposes of section 245A. This rule is necessary by reason of the enactment of section 245A to ensure that similarly situated taxpayers do not have different tax consequences under section 245A with respect to section 78 dividends. Absent this rule, a United States shareholder of a CFC using a fiscal year beginning in 2017 as its U.S. taxable year (a "fiscal year CFC") could potentially claim a section 245A deduction with respect to its section 78 dividend attributable to the United States shareholder's inclusion under section 951 (including by reason of section 965) for the CFC's fiscal year ending in 2018, whereas a United States shareholder of a CFC using the calendar year as its U.S. taxable year could not claim a section 245A deduction with respect to any section 78 dividend for any taxable year. There is no indication that Congress intended to treat these similarly situated taxpayers differently with respect to the section 78 dividend given that the purpose of the section 78 dividend — to prevent a taxpayer from obtaining the benefit of both a credit under section 901 and a deduction with respect to the same foreign tax — is unrelated to the CFC's U.S. taxable year. Accordingly, proposed §1.78-1(c) includes a special applicability date to prevent this potential disparate treatment and double benefit to taxpayers with fiscal year CFCs.

W. Applicability Dates

a. In general, the portions of the proposed regulations that relate to statutory amendments made by the Act apply to taxable years beginning after December 22, 2017. See section 7805(b)(2). Other portions of the proposed regulations that do not relate to the Act apply for taxable years ending on or after December 4, 2018. Certain portions of the proposed regulations contain rules that relate to the Act as well as rules that do not relate to the Act. These regulations generally apply to taxable years that satisfy both of the following two conditions: (1) the taxable year begins after December 22, 2017, and (2) ends on or after December 4, 2018. See section 7805(b)(1)(B).
b. A special applicability date is provided is provided in §1.861-12(k) in order to apply §1.861-12(c)(2)(i)(B)(1)(ii) to the last taxable year of a foreign corporation beginning before January 1, 2018, since there may be an inclusion under section 965 for that taxable year. A special applicability date is also provided in §1.904(b)-3(f) with respect to that section because section 904(b)(4) applies to deductions with respect to taxable years ending after December 31, 2017. Finally, a special applicability date is provided in §1.78-1(c) in order to apply the second sentence of §1.78-1(a) to section 78 dividends received after December 31, 2017, with respect to a taxable year of a foreign corporation beginning before January 1, 2018. See Part IV.E of this Explanation of Provisions.
c. Proposed §§1.965-5(c)(1)(iii) and 1.965-7(e)(1)(i) and (iv) have the applicability dates provided in proposed §1.965-9

BACKGROUND TO THE PROPOSED REGULATIONS:

Before the Act, the United States taxed its citizens, residents, and domestic corporations on their worldwide income. However, to the extent that both the foreign jurisdiction and the U.S. taxed the same income, this would have resulted in double taxation. The U.S. foreign tax credit (FTC) regime alleviated the double taxation issue by allowing a non-refundable credit for foreign income taxes paid or accrued to reduce U.S. tax on foreign source income.

Under the Code, the FTC calculation is applied separately to different categories of income (a "separate category"). For example, suppose a domestic corporate taxpayer has $100 of active foreign source income in the "general category," $100 of passive foreign source income in the "passive category," $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 different categories of income (general and passive). 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 with respect to active foreign source income in the general category. The taxpayer carries over the remaining $29 of foreign taxes ($50 minus $21) and can generally apply the taxes as a credit in the prior taxable year or over the next 10 years against U.S. tax on general category foreign source income, subject to certain restrictions.

Further, certain expenses borne by U.S. parents and domestic affiliates that support foreign operations are allocated to separate categories based, for example, on gross income or assets. These allocations reduce foreign source taxable income and therefore reduce the allowable FTCs for the separate category, since FTCs are limited to the U.S. income tax on the foreign source taxable income (i.e., foreign source income less allocated expenses) in that separate category. The foreign income and related taxes from one separate category generally cannot be combined with another category. Prior to 2007, there were generally nine separate categories. In general, the American Jobs Creation Act of 2004 reduced the number of separate categories to two — the passive and general categories of income. These two separate categories generally prevailed until passage of the Act.1

The 2017 Act made several significant changes to the FTC rules and related rules for allocating expenses to foreign income for the purpose of calculating the allowable FTCs. In particular, the Act repealed the fair market value method of asset valuation used to apportion interest expense to separate categories based on the fair market value of assets, added new separate categories for global intangible low-taxed income (the section 951A category) and foreign branch income, and amended Code sections which address deemed paid credits for subpart F income, global intangible low-taxed income (GILTI), and distributions of previously taxed earnings and profits. Further, because repatriated dividends are no longer taxable, the Act also repealed section 902 (which allowed a domestic corporation to claim FTCs with respect to dividends paid from a foreign corporation) and made other conforming changes.

These regulations provide the detail, structure and language required to implement the changes made by the statute. The following analysis describes the need for the proposed regulations, as well as provides an overview of the regulations, discussion of the costs and benefits of these regulations as compared with the baseline, and a discussion of alternative policy choices that were considered.

B. The need for proposed regulations

The numerous changes to the FTC rules in the Act require practical guidance for implementation. The proposed regulations provide the details, methodology, and approaches necessary to conform the existing

FTC regulations to the many changes specified in the Act; for example, they provide structure and detail concerning how to incorporate the new separate categories of income into the foreign tax credit calculation, including how expenses will be allocated to separate categories. The regulations also update outdated portions of the existing regulations to help conform the existing regulations to the post-Act world. Thus, the guidance provides certainty, clarity, and consistency regarding FTC computations, which promotes efficiency and equity, contingent on the overall Code.

D. Overview of the proposed regulations

As noted above, the proposed regulations specify the methodologies and approaches necessary to conform the existing regulations to the many changes specified in the Act. Several aspects of the proposed regulations are particularly noteworthy, as they involve more discretion on the part of the Treasury Department and the IRS. These are the aspect of the regulations governing expense allocation, the aspect of the regulations governing FTC carryovers to the new foreign income categories, the special applicability date regarding the section 78 gross up, and the anti-abuse rules addressing certain loans made to partnerships. The ultimate rules proposed, as well as the alternatives that were considered are discussed below.

Most notably, in response to taxpayer requests for guidance, these regulations help interpret the statute by providing details regarding how expenses must be apportioned to the new separate categories created by the Act. In particular, the proposed regulations specify that, for purposes of applying the expense allocation and apportionment rules, the gross income offset by the section 250 deduction is treated as exempt income, and the stock giving rise to GILTI that is offset by the section 250 deduction is treated as an exempt asset (see Part I.A of the Explanation of Provisions). Such treatment implies that fewer expenses will be allocated to the section 951A category as a result of this rule, leading to higher computed foreign source taxable income, a larger foreign tax credit limitation, and a larger foreign tax credit offset with respect to GILTI income. Because these expenses are now allocated to another separate category (where they may be less likely to displace FTCs) or to U.S. source income, this rule will in general reduce the tax burden of U.S. multinational corporations with GILTI income and allocable expenses.

The regulations also address how FTC carryovers are to be allocated across the new separate categories. The formation of two new separate categories requires a determination regarding how pre-Act FTC carryovers must be allocated across new and existing separate categories. The Treasury Department and the IRS determined that, because continuity in the definition of income and assignment of tax attributes is appropriate, taxpayers should be able to analyze their general category income earned in prior years to determine the extent to which it would have been considered to belong in the new separate category for foreign branch income under the rules described here (see Part II.A of the Explanation of Provisions). However, because allocation of pre-Act income to hypothetical post-Act separate categories has the potential to be administratively burdensome, the regulation provides that the allocation of FTC carryovers to the new foreign branch category is optional, which allows for continuity of income treatment while minimizing administrative and compliance burdens during the transition. For taxpayers that do not choose to allocate FTC carryovers to the new foreign branch category, their FTC carryovers will remain in the general category. See Part I.E.2 of this Special Analyses for a discussion of alternatives considered and additional reasoning regarding the approach taken under the proposed regulations.

Further, as described in section IV.E of the Explanation of Provisions, the proposed regulations include an updated applicability date for the new section 78 provisions. In particular, the proposed regulations provide that section 78 dividends relating to taxable years of foreign corporations beginning before January 1, 2018, are not treated as dividends for purposes of the section 245A deduction. As further noted in section IV.E of the Explanation of Provisions, absent this rule, taxpayers that have calendar year CFCs instead of fiscal year CFCs would be treated differently with respect to their section 78 dividends solely on the basis of this difference in tax year status; and taxpayers with fiscal year CFCs could receive the

double benefit of a section 245A deduction and a FTC under section 960 with respect to the same foreign taxes. Allowing a double benefit for a single expense erodes the U.S. tax base and treats otherwise similar taxpayers (those who have different CFC tax years) inequitably. Based on these equity considerations, the Treasury Department and the IRS expect that the proposed regulation will provide greater net benefits than the alternative of not issuing a regulation on this issue.

The regulations also address certain potentially abusive borrowing arrangements, such as when a U.S. person lends money to a foreign partnership in order to artificially increase foreign source income (and therefore the FTC limitation) without affecting U.S. taxable income (see Part I.C. of the Explanation of Provisions). This is accomplished, for example, by lending to a controlled partnership, which has no effect on U.S. taxable income, because the interest income received from the partnership is offset by the lender's share of the interest expense incurred by the partnership. However, the transaction can increase foreign source income and allowable foreign tax credits, because the existing interest expense allocation rules do not generally allocate interest income and interest expenses similarly. To prevent such artificial inflation of foreign tax credits, the regulations specify that interest income attributable to borrowing through a partnership will be allocated across foreign tax credit separate categories in the same manner as the associated interest expense. See Part I.E.2 of this Special Analyses for a discussion of alternatives considered and additional reasoning regarding the approach taken under the proposed regulations.

In addition, the regulations clarify and provide guidance on numerous other technical issues. For example, they clarify the regulatory environment by updating inoperative language in §§1.904-1 through 1.904-3; parts of the regulations have not previously been updated to reflect changes to section 904 made in 1978. They also ease transitional administrative burdens associated with the implementation of the Act; for example, allowing a one-time exception to the 5 year waiting period for the election of the gross income or sales method for R&D expense allocation (See Part I.G of the Explanation of Provisions), or by allowing a simplified definition of average basis for the first year taxpayers are required to use the tax book method of valuation (See Part I.E.1 of the Explanation of Provisions).

The regulations further clarify the §1.904-6 rules concerning how allocation of taxes across separate categories should be calculated in the presence of base and timing differences. A base difference occurs, for example, if the foreign jurisdiction taxes income, such as life insurance proceeds or gifts, which are excluded from income for U.S. tax purposes. A timing difference occurs, for example, if the U.S. tax rules define income as being earned by marking an asset to market, but a domestic corporation operates a CFC in a foreign jurisdiction that defines income as being earned by realization upon sale. Regulatory guidance instructs taxpayers how to appropriately navigate these cross jurisdictional base and timing differences in the assignment of taxes to FTC separate categories. They also fill technical gaps in how to implement the statute in practice, for example, by providing a clear rule for how to characterize the value of stock in each separate category in the context of the new separate categories.

The guidance, clarity, and specificity provided by the regulations help ensure that all taxpayers calculate foreign income and the foreign tax credit in a similar manner. The economic analysis that follows discusses the costs and benefits of these regulations, and the alternative choices that could have been made, in greater detail.

E. Economic analysis

1. Anticipated benefits and costs of the proposed regulations

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations against a no-action baseline — which, as explained above, is the status quo in the absence of the proposed regulations. The Treasury Department and IRS expect that the certainty and clarity provided by these proposed regulations, relative to the no-action baseline, will improve U.S. economic efficiency. For example, because separate categories for GILTI and foreign branch income did not previously exist,

taxpayers can benefit from the enhanced specificity regarding how income, expenses, and carryover foreign tax credits should be allocated across these separate categories. In the absence of this enhanced clarity, similarly situated taxpayers might interpret the statute differently, potentially resulting in inequitable outcomes. For example, some taxpayers may forego specific investments that other taxpayers deem worthwhile based on different interpretations of the tax consequences alone. The guidance provided in these regulations helps to ensure that taxpayers face more uniform incentives when making economic decisions, which will generally improve economic efficiency. In order to give a rough sense of the population potentially affected by these regulations, a table reporting the number of affected filers is provided in Part II of this Special Analyses.

In the absence of the enhanced specificity provided by the regulations described above, similarly situated taxpayers might interpret the statutory rules differently, and different taxpayers might then pursue or forego economic activities based on different interpretations of the tax consequences alone. By providing clear rules to eliminate ambiguity and to fill in technical gaps, the guidance provided in these regulations helps to ensure that taxpayers face more uniform incentives. Such uniformity across economic decision-makers is a tenet of economic efficiency. Clear and consistent rules also increase transparency and decrease the incentives and opportunities for tax evasion. Rules to combat abusive transactions also help to ensure that taxpayers make decisions based on market conditions rather than on tax considerations.

Further, because the changes introduced in the Act are substantial, the start-up costs and learning curves involved in complying with the Act will also be substantial. In particular, the Act's elimination of tax imposed on repatriations going forward, the creation of the tax on global intangible low taxed income (and the corresponding section 951A category), and the creation of a deduction for foreign-derived intangible income each embody a completely new component of U.S. international tax law, and together restructure a U.S. international tax system that had remained relatively constant since 1987. By definition, transitioning to such a completely new system will involve substantial start-up costs in terms of learning the nuances of the new rules, and revamping record keeping, documentation, and software systems to aid in filling out the new tax forms and to ensure the availability of all the records required to benefit from new exclusions and deductions (such as the section 250 deduction). The proposed regulations assist taxpayers in this process by providing definitional clarity in order to minimize the disruption caused by the move to the new system. When possible and appropriate, they further provide significant transitional flexibility in order to help relieve compliance burdens and reduce transition administrative costs. Additional details, including the types of cost savings and benefits expected, are discussed below, as well as in Part I.E.2 of this Special Analyses.

Notably, as mentioned in Part I of the Explanation of Provisions, taxpayers have repeatedly requested regulatory guidance concerning appropriate expense allocation in light of the new separate categories for GILTI and foreign branch income; in the absence of new regulations, the correct approach for allocating expenses is subject to interpretation. Therefore, the proposed regulations seek to clarify the allowable expense allocation rules that are consistent with legislative history's description of the section 250 deduction as effectively exempting income, by specifying that the income associated with the section 250 deduction is, for foreign tax credit purposes, treated as partially exempt. The regulations therefore potentially increase the competitiveness of U.S. corporations relative to the no-action baseline, which includes proposed though not yet final regulations under section 951A, by generally reducing the amount of U.S. parent expenses that are allocated to the section 951A category. They also provide certainty and clarity for taxpayers, which, as noted above, increases efficiency and transparency, and reduces the incentive for evasion, relative to the no-action baseline.

However, the reduced expense allocation to the section 951A category resulting from these proposed regulations has the potential to reduce Federal tax revenue relative to the statute and in consideration of proposed though not yet final regulations related to section 951A. In addition, it could also provide some

taxpayers with the incentive to locate more of their worldwide expenses in the United States, because U.S. expenses will have the potential to reduce U.S. taxable income, and also increase allowable foreign tax credits relative to the no-action baseline. However, the post-Act U.S. interest expense limitation rules under section 163(j) make it more difficult to use excessive interest expense to reduce U.S. taxable income, and the significantly lower U.S. statutory corporate rate reduces the (previously strong) incentive to locate "fungible" deductions such as interest expense in the United States. Therefore, any increase in the incentive to report interest expense in the United States resulting from the reduced expense allocation to the section 951A category is likely to be relatively minor. The Treasury Department and the IRS welcome comments on this estimated impact of the reduced expense allocation.

In addition to the provisions described in the overview section above, the look-through rules provide an example of a proposed rule that fills a technical gap left by the implementation of the Act that if left unaddressed would impose significant tax uncertainty on taxpayers and negatively impact taxpayers' economic decision making. Before the Act, dividends, interest, rents and royalties ("look-through payments") paid to a United States shareholder by its CFC were generally allocated to the general category to the extent that they were not treated as passive category income. The Act split the general category income into three categories: general category, section 951A category, and foreign branch category, creating a question of how to assign non-passive category look-through payments to the two new separate categories. The Treasury Department and the IRS studied this issue and propose to revise the look-through rules to clarify that non-passive look-through payments cannot be assigned to the section 951A category but instead are generally assigned to the general category or foreign branch category. This treatment is consistent with the fact that the new section 951A category by definition cannot include payments of dividends, interest, rents, and royalties made directly to a United States shareholder. On the other hand, certain interest, rents, and royalties earned by a foreign branch can meet the definition of foreign branch category income, and the general category is a residual category that encompasses all income that is not specifically assigned to any other category.

Whether a deduction is disallowed under section 267A with respect to a payment of interest or royalties does not affect the treatment of such payment in the hands of the recipient for purposes of section 904(d)(3). Furthermore, future regulations issued under section 267A will address whether such payments that are subject to U.S. tax are subject to the disallowance under section 267A.

2. Alternatives Considered

The Treasury Department and the IRS next considered the benefits and costs of providing these specific methodologies and definitions regarding FTC calculations relative to possible alternatives. In choosing among alternatives, the Treasury Department and the IRS strive to adhere to Congressional intent and consistency with existing law, while minimizing economic distortions and compliance burdens imposed on taxpayers, and promoting market-driven decision making and administrative feasibility.

The Act created two new separate categories with respect to FTCs, splitting the existing general category into general, section 951A, and foreign branch categories. The Act did not, however, specify how FTC carryovers were to be treated. The Treasury Department and the IRS considered alternative methods of allocating FTC carryovers originally associated with the general category to the new section 951A and foreign branch categories. One option that was considered would have required taxpayers to reassign existing general category FTC carryovers to the section 951A category as if that category existed prior to the adoption of the statute. Allocating carryovers to the section 951A category was deemed infeasible because it would be extraordinarily burdensome on taxpayers to attempt to recreate historical GILTI and would present numerous technical challenges. Such an approach would also result in eliminating the ability of taxpayers to credit those FTC carryovers since no carryovers are allowed for FTCs attributable to the section 951A category. This outcome would negatively impact taxpayers that had potentially structured their prior decisions on their presumed ability to use these FTC carryovers against U.S. tax on

general category income and could result in costly and undesirable financial statement adjustments for some companies without providing any corresponding economic efficiency gains.

By contrast, allocating carryovers to the foreign branch category would be technically feasible and therefore does not present the same technical challenges as allocating FTC carryovers to the section 951A category would. However, with respect to FTC carryovers and the foreign branch category, the Treasury Department and the IRS first considered providing no additional guidance beyond the existing statutory language, which would mean that FTC carryovers would remain in the general category and none would be reassigned to the foreign branch category. However, requiring FTC carryovers to remain in the general category would potentially prevent taxpayers with substantial historic and continuing branch operations and who previously incurred taxes on their branch income from being able to utilize FTC carryovers in future years because general category carryovers would not be available to offset U.S. tax on future foreign branch category income. This outcome would negatively impact taxpayers that had potentially structured their prior decisions on their presumed ability to use these FTC carryovers to reduce U.S. tax on what became their future foreign branch category income.

As an alternative, the Treasury Department and the IRS considered requiring that all taxpayers do a computation to assign general category FTC carryovers to the foreign branch category. The concept of branch income existed prior to TCJA, and thus there would have been continuity in the assignment of pre- and post-TCJA FTCs associated with foreign branch category income. However, these FTC carryovers had previously been allocated to the general category and hence some taxpayers had potentially structured their prior decisions on their presumed ability to use these taxes against U.S. tax on general category income. Therefore, reassigning such FTC carryovers after the fact could create perverse incentives for some taxpayers to restructure their ongoing operations into branch form in order to generate foreign branch category income that can absorb FTC carryovers that were reassigned to the foreign branch category. Furthermore, requiring taxpayers to reconstruct prior year events in order to determine what income and FTCs would have been associated with the foreign branch category would be burdensome for taxpayers, again with no corresponding efficiency gains. The benefit of matching income and FTCs which applies more generally as a principle of economically efficient taxation is less relevant in this context because the foreign taxes have already been incurred.

On the basis of these considerations of compliance burden and efficiency gains (or lack thereof), the proposed regulations settled on an approach whereby FTC carryovers would by default remain in the general category but the regulations also provide an option to allow taxpayers to allocate transitional FTC carryovers to the foreign branch category. The Treasury Department and the IRS chose this approach in response to some taxpayers' concerns that their business and investment plans were based on the presumption that FTC carryovers could be used against U.S. tax on general category income and precluding them from using FTCs in this way would have negative economic implications. On the other hand, taxpayers whose foreign branch category income could absorb greater levels of FTCs can self-select into reconstructing what income and FTCs would have been associated with the foreign branch category income. Thus, taxpayers for whom the costs exceed the benefits would choose to retain the FTCs in the general category, while taxpayers for whom the benefits exceed the costs would choose to incur the costs of doing the computation. This rule provides the most flexibility, continuity, and compliance cost savings to taxpayers with respect to these transitional FTC carryovers.

The Treasury Department and the IRS also faced the question of how to align interest income and interest expenses related to loans to a partnership from a U.S. partner. The Treasury Department and the IRS chose to match interest income allocation to interest expense allocation, rather than the reverse, because this minimizes distortions that could arise in the apportionment of other types of expenses. Under the matching rule in the proposed regulations, the gross interest income is apportioned between U.S. and foreign sources in each separate category based on a taxpayer's interest expense apportionment ratios. The

Treasury Department and the IRS considered an alternative approach of tracing expenses to gross income under which the gross interest income would, under the general rules for sourcing interest income, be 100 percent foreign source income if paid by a foreign partnership not engaged in a U.S. trade or business. Some deductions, such as general and administrative expenses, can be apportioned on the basis of gross income to foreign sources. A rule that did not alter the source of the gross interest income would affect the allocation and apportionment of these other expenses, such as general and administrative expenses, that can be allocated on the basis of gross income to foreign sources. The matching rule limits these distortions because it minimizes the artificial increase in gross foreign source income based solely on a related party loan to a partnership. Accordingly, the proposed matching rule achieves a more neutral foreign tax credit limitation result and better minimizes the impact of related party loans on a taxpayer's foreign tax credit limitation.

The Treasury Department and the IRS considered two options with respect to the application of the section 245A deduction to section 78 dividends. The first option considered was to do nothing and allow taxpayers with fiscal year CFCs to get a double benefit, leaving taxpayers with calendar year CFCs at a relative disadvantage. An additional drawback of this approach is that taxpayers with fiscal year CFCs would likely face uncertainty with respect to their tax positions, as the availability of a section 245A deduction to a section 78 dividend may be anticipated to be deemed inappropriate and ultimately be reversed. Such delayed changes would force taxpayers that are publicly traded companies to issue costly restatements of their financial accounts, which could result in stock market volatility. The second option considered was to eliminate this inequity of tax treatment between taxpayers with calendar year CFCs versus fiscal year CFCs by providing that section 78 dividends relating to taxable years beginning before January 1, 2018, are not treated as dividends for purposes of the section 245A deduction. The advantage of this approach is that it eliminates the disparate tax treatment of otherwise similarly situated taxpayers because it removes the unintended benefit for taxpayers with fiscal year CFCs. This approach also promotes economic efficiency by resolving the uncertainty related to the availability of a section 245A deduction to a section 78 dividend. The latter option is the approach adopted in the proposed regulations.