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KPMG report: Analysis of final and proposed foreign tax credit regulations

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Definition of terms

CFC = controlled foreign corporation

CNOL = consolidated net operating loss

Conference Report = Conference Report to Accompany H.R. 1 - Tax Cuts and Jobs Act [Senate Amendment to the House bill as passed on December 20, 2017]

CSA = cost sharing arrangement

DEI = deduction eligible income

DRE = disregarded entity

FDDEI = foreign derived deduction eligible income

FDII = foreign-derived intangible income

FPHCI = foreign personal holding company income

FTC = foreign tax credit

GILTI = global intangible low-taxed income inclusion

ODL = overall domestic loss

OFL = overall foreign loss

PTEP = previously taxed earnings and profits

QBU = qualified business unit

R&E = research and experimentation

SIC = standard industrial classification

SLL = separate limitation loss

The U.S. Treasury Department and IRS (collectively, "Treasury") in early December 2019 released final regulations (T.D. 9882) (the "final regulations") that finalize the proposed regulations that were issued on November 28, 2018 (the "2018 proposed regulations") relating to sections 78, 864, 901, 904, and 960, as amended by the 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017 and often referred to as the "Tax Cuts and Jobs Act" or "TCJA").

In addition to the final regulations, Treasury issued proposed regulations (REG-105495-19) (the "2019 proposed regulations") that provide additional guidance relevant to foreign tax credits ("FTCs")—including with respect to the allocation and apportionment of research and experimentation ("R&E") and stewardship expenses, foreign tax redeterminations under section 905(c), and the allocation and apportionment of foreign income taxes to categories of income.

The final regulations and 2019 proposed regulations were published in the Federal Register on December 17, 2019.

- Read the **final regulations** [PDF 717 KB] (102 pages as published in the Federal Register)
- Read the **2019 proposed regulations** [PDF 545 KB] (57 pages as published in the Federal Register)

Read a more detailed discussion about the 2018 proposed regulations in ***TaxNewsFlash***.

The following discussion provides initial analysis and observations about the final regulations and 2019 proposed regulations.

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Applicability dates and reliance

Final regulations

The portions of the final regulations that relate to statutory amendments made by the TCJA apply to tax years beginning after December 31, 2017.

Other provisions apply to tax years ending on or after December 4, 2018.

Provisions that contain both rules that relate to the TCJA and rules not related to the TCJA apply to tax years that begin after December 31, 2017, and end on or after December 4, 2018.

The provisions on overall foreign losses and foreign tax redeterminations apply to tax years ending on or after December 16, 2019.

2019 proposed regulations

Various applicability dates apply to the 2019 proposed regulations. Some of the key provisions are summarized below:

- Prop. Reg. §§ 1.861-8, 1.861-9, 1.861-12, 1.861-14, 1.904-4(c)(7) and (8), 1.904(b)-3, 1.954-1 and 1.954-2 are proposed to apply to tax years that end on or after December 16, 2019. In contrast, Prop. Reg. §§ 1.861-17, 1.861-20 and 1.904-6 (as well as Prop. Reg. §§ 1.704-1(b)(4)(viii)(d)(1) and 1.960-1) are proposed to apply to tax years beginning after December 31, 2019.

- Taxpayers that are on the sales method of apportioning R&E expense for tax years beginning after December 31, 2017, and before January 1, 2020, are permitted to rely on Prop. Reg. § 1.861-17, provided they apply it consistently.

- Regulations proposed under section 905 are generally proposed to apply to foreign tax redeterminations occurring in tax years that end on or after, and to foreign tax redeterminations of foreign corporations occurring in tax years that end with or within a tax year of a U.S. shareholder ending on or after December 16, 2019. In the case of foreign tax redeterminations of foreign corporations, however, Prop. Reg. § 1.905-3 is only proposed to apply to foreign tax determinations that relate to tax years of foreign corporations beginning after December 31, 2017, and Prop. Reg. § 1.905-5 is instead proposed to apply to foreign tax redeterminations that relate to tax years of foreign corporations beginning before January 1, 2018.

Comment period and hearing

The preamble to the 2019 proposed regulations includes a number of requests for comment. Any comments or requests for a public hearing must be submitted by February 18, 2020.

Overview

In implementing the sweeping changes to the foreign tax credit regime made by the TCJA, the final regulations and 2019 proposed regulations impact all aspects relevant to the calculation of a taxpayer's foreign tax credit. The insights and observations about these regulations included in this document are focused primarily on clarifications of and changes to the 2018 proposed regulations, including regulations on topics that were not included in the 2018 proposed regulations. Read ***TaxNewsFlash*** (November 2018) for a more detailed discussion of rules that remained largely unchanged from the 2018 proposed regulations.

The discussion in this report generally is ordered according to the steps a taxpayer will take with respect to calculating its foreign tax credit.

- The first section highlights important concepts implemented by these regulations with respect to the initial basketing of a taxpayer's gross income into the four categories provided under section 904(d).

- Second, significant changes with respect to the allocation and apportionment of deductions to determine a taxpayer's net income in each category are discussed.

- Third, there is a discussion regarding the taxpayer's calculation of its deemed paid tax credit under section 960, which now applies granularly to groupings of income.

- Fourth is a discussion of the rules in the regulations regarding the carryover and characterization of certain tax attributes such as overall foreign losses ("OFLs"), separate limitation losses ("SLLs"), and FTC carryforwards, including rules for transitioning from the rules in place before the TCJA to those in place afterward.

- Fifth, the discussion continues with the provisions in the final regulations and 2019 proposed regulations related to section 905 (and related sections) that apply to a redetermination of the foreign income taxes with respect to which a taxpayer previously calculated its foreign tax credit, as well as other significant items affecting U.S. tax liability such as subpart F income, tested income, and earnings and profits ("E&P").

- Finally, certain updates to the consolidated foreign tax credit rules are discussed.

Rules for basketing gross income

Following the enactment of the TCJA, a U.S. taxpayer calculates its foreign tax credit limitation separately in respect of four categories (or "baskets") of income provided by section 904(d): (1) any amount included in gross income under section 951A (other than passive category income) ("GILTI basket" or "section 951A category income"), (2) foreign branch income, (3) passive category income, and (4) general category income. As discussed in more detail below with respect to deemed paid credits, a CFC earns income in only two baskets—passive and general; however, the taxes of a CFC that a U.S. taxpayer is deemed to have paid under section 960 can be assigned to the GILTI basket, in addition to the passive and general baskets. Therefore, special grouping rules apply at the CFC level to enable a U.S. taxpayer to allocate an inclusion of general basket income earned by a CFC to the GILTI basket as well as to identify income of the CFC that might never be subject to tax in the hands of a 10% U.S. corporate shareholder by reason of section 245A.

The 2018 proposed regulations addressing the calculation of GILTI basket and foreign branch category income were adopted without significant modification. For a detailed discussion of these rules, read ***TaxNewsFlash*** (November 2018).

Foreign branch basket income

The TCJA established a new foreign tax credit limitation category for foreign branch income, generally effective for tax years beginning after 2017.

Section 904(d)(2)(J) defines foreign branch income (subject to an exclusion for passive category income) as "business profits … attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries." The foreign branch category is maintained on an aggregate foreign branch basis—that is, there are not separate categories for separate foreign branches or foreign jurisdictions. This aggregate approach allows a taxpayer to cross-credit foreign taxes paid by its high-taxed and low-taxed branches.

The final regulations generally adopt and clarify the 2018 proposed regulations' approach to the determination of foreign branch income. For a detailed discussion of these rules, and in particular the rules with respect to "disregarded reallocation transactions," which adjust the income in the foreign branch and general baskets based on disregarded payments made between the branch and its regarded owner, read ***TaxNewsFlash*** (November 2018).

KPMG observation

The determination of foreign branch income is also relevant for purposes of determining a taxpayer's foreign-derived intangible income ("FDII"). Specifically, foreign branch income is a category of income excluded from gross income for purposes of determining a taxpayer's deduction eligible income ("DEI"), which exclusion generally has the effect of reducing the taxpayer's FDII.

Definition of a foreign branch

The 2018 proposed regulations defined a foreign branch by reference to the section 989 regulations, with modifications, such that a foreign branch must carry on a trade or business outside the United States and maintain a separate set of books and records. Thus, activities undertaken within the United States would be excluded when determining whether activities rise to the level of a trade or business outside the United States.

The final regulations provide a bright-line rule that activities conducted outside the United States that constitute a permanent establishment under a bilateral U.S. income tax treaty constitute a trade or business outside the United States for purposes of the foreign branch definition; this rule was originally proposed in the 2018 proposed regulations as a presumption.

The foreign branch definition does not import the section 989 regulations' per se QBU rule for partnerships, but rather provides that if a partnership's activities constitute a trade or business conducted outside the United States, then those activities will constitute a foreign branch even if the partnership does not maintain books and records for the trade or business that are separate from the partnership's books and records.

The final regulations provide that rules similar to those that apply under the dual consolidated loss regime for genuine branches also apply for purposes of constructing hypothetical books and records where none are actually kept by the partnership. See Reg. § 1.1503(d)-5(c).

Disposition of a foreign branch

Generally, the 2018 proposed regulations attributed gross income to a foreign branch to the extent such gross income is reflected on the foreign branch's separate books and records, subject to certain exclusions. Thus, when a foreign branch owner sells its interests in a disregarded entity through which it operates a foreign branch, and the gain or loss is not reflected on the books and records of the foreign branch that is sold, gain or loss from the sale is not attributable to the foreign branch. The final regulations retain this rule.

With respect to the disposition of an interest in a partnership or other pass-through entity by a foreign branch, the 2018 proposed regulations provided that gain or loss on the sale is foreign branch income only if the gain is reflected on the branch's books and records and the disposition occurs in the ordinary course of the foreign branch's active trade or business. For this purpose, a disposition is treated as occurring in the ordinary course of a foreign branch's active trade or business if the branch "engages in the same or a related trade or business as the partnership or other pass-through entity (other than through a less than 10% interest)." The final regulations clarify that this rule applies only if the foreign branch owns 10% or more of the interests in the partnership or other pass-through entity and the foreign branch directly engages in the same or related trade or business.

KPMG observation

While the proposed FDII regulations generally would determine foreign branch income by reference to the rules for determining foreign branch income in section 904 and the section 904 regulations, the proposed FDII regulations include a special rule that would include in foreign branch income for FDII purposes (and thus exclude from DEI) income or gain from the direct or indirect sale of branch assets (other than stock), including through the sale of a disregarded entity or an interest in a partnership. See Prop. Reg. § 1.250(b)-1(c)(11).

Section 951A and passive category income

The 2018 proposed regulations generally provided that section 951A category income includes amounts included in a U.S. shareholder's gross income under section 951A and does not include passive income. However, income that is initially categorized as passive income may nonetheless be recharacterized as income in the section 951A basket if such income is considered to be high-taxed income pursuant to the high-tax kickout rule in section 904(d)(2)(F). In general, the high-tax kickout rule applies to recharacterize high-taxed income as general category income, foreign branch category income, section 951A category income, or income in a specified separate category, depending on how such income would have been characterized had it not otherwise been passive income.

KPMG observation

The final regulations retain the general rules regarding section 951A category and passive category income. Although acknowledging that passive category income would be included under section 951A in rare circumstances (because in the normal course passive income would be included in the U.S. tax base as FPHCI subpart F income, which is excluded from tested income), Treasury specifically rejected comments suggesting that the final regulations provide that income included in the section 951A category is never assigned to the passive category and that passive category income subject to the high-tax kickout rule is never assigned to the section 951A category.

Financial services income of financial services entities

Section 904(d)(2)(C) provides that financial services income is treated as general category income in the case of a member of a "financial services group" or a person "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" (each a "financial services entity" under existing regulations). The existing regulations define financial services income as income earned by a financial services entity that is either (1) income derived in the active conduct of a banking, insurance, financing, or similar business (referred to as "active financing income"); (2) passive income as determined before the application of the high-tax exception in section 904(d)(2)(B)(iii)(II); (3) export financing interest as defined in section 904(d)(2)(G); or (4) incidental income. Existing Reg. § 1.904-4(e)(2) provides a list of 24 categories of income that are treated as active financing income together with a "catch-all" provision which allows taxpayers to designate "[a]ny similar item of income" as financial services income on Form 1118 or 1116. The existing regulations define "incidental income" as "income that is integrally related to active financing income of a financial services entity." The existing regulations determine whether an individual or entity "is predominantly engaged in the active financing business," and thus a financial service entity, by reference to its active financing income as defined in Reg. § 1.904-4(e)(2). Specifically, an individual or entity is a financial services entity for any year if for that year at least 80% of its gross income is active financing income, or the entity is a member of an affiliated group and 80% of the group's income is active financing income.

The preamble to the 2019 proposed regulations notes that the Code makes several references to similar concepts with similar policy objectives, including the definition of "predominantly engaged in the active conduct of a banking, financing, or similar business" in section 954(h) for purposes of the subpart F rules. In the interest of promoting simplification and consistency, the 2019 proposed regulations modify the definitions of financial services income and financial services entity by cross-referencing section 954(h) (for banking and financing entities) and sections 1297 and 953 (for insurance companies).

Specifically, under the 2019 proposed regulations, a banking or financing company is a financial service entity if it is "predominantly engaged in the active conduct of a banking, financing, or similar business under section 954(h)(2)(B)," for this purpose substituting "controlled foreign corporation" with "individual or corporation." Under section 954(h)(2)(B), as cross-referenced by the 2019 proposed regulations, an individual or corporation would be a financial services entity if either (1) more than 70% of its gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with customers which are not related persons (as defined in section 954(h)(4)) ("lending or finance test"), (2) it is engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States, or (3) it is engaged in the active conduct of a securities business and is registered as a securities broker or dealer. Additionally, the 2019 proposed regulations would treat the members of an "affiliated group" as financial services entities on a group-wide basis only if the group as a whole meets the 70% lending or finance test of section 954(h)(2)(B)(i). Once a financial services entity has been identified, its income that is "derived in the active conduct of a banking, financing, or similar business under section 954(h)(3)(A)(i)" is financial services income. Neither section 954(h) nor the 2019 proposed regulations define what income is treated as "derived in the active conduct of a banking, financing, or similar business" for this purpose.

KPMG observation

As under the existing section 904 regulations, in order for the income of a corporation to be financial services income, the corporation must be a financial services entity, either on a standalone basis or as a member of a financial services group. Under the 2019 proposed regulations, by cross-reference to section 954(h)(2)(B), a corporation would be a financial services entity on a standalone basis if it is a licensed bank or a registered broker-dealer, or if more than 70% of its gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with customers which are not related persons. Section 954(h)(4) provides a restrictive list of activities that constitute a "lending or finance business" for this purpose, which list does not include many activities of a broker-dealer or other activities common to banks (e.g., investment and advisory services). However, a corporation that is not otherwise a financial services entity can nonetheless be treated as a financial services entity if the affiliated group of which it is a member meets the 70% lending or finance requirements of section 954(h)(2)(B)(i) on a group-wide basis. The disparate entity and groups tests for qualification of a corporation as a financial services entity under the 2019 proposed regulations appears to be a departure from the statutory text, which contains the same requirement ("predominantly engaged in the active conduct of a banking, insurance, financing, or similar business") for both tests. Further, because many activities common to banks are not included in the restrictive list of activities that constitute a "lending or finance" business, including broker-dealer activities, a group that derives substantial income from activities other than a lending or finance business does not appear to be able to qualify as a financial services group under the 2019 proposed regulations.

KPMG observation

As described above, the existing regulations list specific categories of income that are considered to be active financing income for purposes of determining whether income is financial services income, and also provide that such income includes incidental income "integrally related" to such income if the entity otherwise qualifies as a financial services entity. The 2019 proposed regulations would replace these rules with a cross-reference to the description in section 954(h)(3)(A)(i) of income "derived in the active conduct of a banking, financing, or similar business." The legislative history to section 954(h) also includes a list of activities that are intended to constitute "active conduct of a banking, financing, or similar business." The list in the legislative history to section 954(h)(4) appears to be based in large part on the list in existing Reg. § 1.904-4(e)(2), which predates section 954(h) (and which in turn is reflected in legislative history dating back to 1986), but is not identical to that list and also does not explicitly include "incidental income." In any case, this legislative history has not otherwise been incorporated into the Code or regulations (including the 2019 proposed regulations). Thus, in the attempt to create consistency across provisions, the 2019 proposed regulations seem to in fact introduce more uncertainty than clarity into the identification of financial services income.

KPMG observation

The consequences to taxpayers from the changes to the definition of financial services income in the 2019 proposed regulations may be broader than just foreign tax credit basketing because the financial services income definition is cross-referenced in other provisions (e.g., sections 250 and 864(f)).

Distributive share of partnership income

Prior final section 904 regulations provided, in general, that a partner's share of partnership income is treated as passive category income only to the extent that the income earned by the partnership is passive income ("partnership look-through rule"). However, under the prior regulations, if any limited partner or corporate general partner owned less than 10% of the value in the partnership, the partnership look-through rule did not apply and the partner's distributive share of partnership income was entirely characterized as passive category income.

The final regulations remove the 10% ownership threshold for corporate general partners and provide that the partnership look-through rule applies to all general partners (whether individual or corporate) regardless of ownership.

KPMG observation

The preamble to the 2018 proposed regulations noted that income from a less than 10% owned partnership would be one of the rare instances in which tested income at the CFC level, and thus a GILTI inclusion at the U.S. shareholder level, could be within the passive limitation category. As a result of this change, an inclusion of passive income under section 951A may now be an even rarer occurrence.

Look-through rules

The final regulations retain the approach taken in the 2018 proposed regulations that the look-through rules under section 904(d)(3) cannot apply to treat payments from CFCs as section 951A category income, because a CFC does not have section 951A category income. Therefore, a payment from a CFC to its U.S. shareholder will be passive category income if the look-through rules apply and otherwise will be foreign branch or general category income, based on the rules of Reg. § 1.904-4.

The final regulations clarify the application of the look-through rules in the context of disallowed business interest expense under section 163(j). As discussed below, consistent with the 2018 proposed regulations, the final regulations provide that a deduction for business interest expense that is disallowed under section 163(j) for a given tax year, but permitted in a future tax year, is apportioned as though incurred in the year in which the expense is deductible. However, the disallowance of the deduction to the payor CFC does not defer inclusion in the recipient's gross income and that income must be assigned to a separate category. Therefore, the final regulations clarify that business interest expense that is disallowed under section 163(j) for a tax year is nevertheless taken into account in such tax year in the allocation and apportionment of the expense to the payor CFC's gross income solely for purposes of determining the appropriate category of the recipient's interest income under the look-through rules.

Expense allocation and apportionment

Both the final regulations and the 2019 proposed regulations include important provisions relating to expense allocation and apportionment, especially with respect to expenses for R&E, stewardship, settlement payments, and foreign taxes. As a U.S. taxpayer must calculate its foreign tax credit separately with respect to the four categories of income, these rules are a critically important aspect of the foreign tax credit calculation. Further, after the repeal of section 902 by TCJA, a U.S. taxpayer now is deemed to pay taxes with respect to income earned by a CFC only to the extent it has an inclusion with respect to the specific grouping of income (made at the CFC level) to which the CFC has properly allocated the foreign taxes.

KPMG observation

While prior to TCJA the impact of section 861 and the accompanying regulations was primarily felt by taxpayers in calculating the foreign tax credit limitation, these rules apply to a number of operative sections. This importance of the regulations beyond the foreign tax credit limitation has been substantially magnified post-TCJA because the rules became operative with respect to a taxpayer's FDII calculation and taxpayers are generally required to use consistent methodologies for the allocation and apportionment of expenses with respect to different operative sections. Thus, where regulatory flexibility exists with respect to allocating and apportioning a particular expense, the positive impact selecting a permissible method may have on the taxpayer's foreign tax credit limitation has to be weighed against any adverse consequences on the taxpayer's FDII calculation and vice versa.

The final regulations and 2019 proposed regulations largely retain the framework for expense allocation and apportionment as set forth in the 2018 proposed regulations. The 2019 proposed regulations would, however, provide additional guidance with respect to the allocation and apportionment of particular expenses—notably, stewardship, R&E, and settlement payments.

Allocation and apportionment of expenses to GILTI

As expected and consistent with the 2018 proposed regulations, the final regulations do not wholly prevent a taxpayer's deductions from being allocated and apportioned to a taxpayer's income in the section 951A limitation category. A number of taxpayers requested relief from this aspect of the 2018 proposed regulations citing as support for such relief the language in the Conference Report suggesting that a taxpayer should not be subject to residual U.S. tax on its GILTI inclusion amounts if such income is taxed in a foreign jurisdiction at a rate of at least 13.125%. Treasury ultimately rejected these requests for relief based on the lack of statutory authority. Nevertheless, Treasury would provide relief in the 2019 proposed regulations with respect to the allocation of R&E expenses to the section 951A limitation category (discussed below). Conversely, the rules related to the allocation and apportionment of stewardship in the 2019 proposed regulations would potentially be less favorable than positions taken by taxpayers under the existing regulations (discussed below).

KPMG observation

The final GILTI regulations package included a proposed regulation that would allow a taxpayer to elect not to include in GILTI its high-taxed tested income, which may provide substantial relief to taxpayers who are subject to U.S. residual tax by reason of the allocation and apportionment of U.S. taxes to the GILTI basket. The proposed regulation is proposed to be effective only after the regulations are finalized. Even after the proposed regulations are finalized, a taxpayer that makes an election to exclude high-tax income from tested income may still benefit from considering other available options for alleviating residual U.S. tax with respect to its GILTI (e.g., engaging in affirmative subpart F planning). Whether it will be more advantageous for a taxpayer to exclude an item of income from tested income under the GILTI high-tax exception or, alternatively, to affirmatively plan into subpart F income will depend on the particular facts and attributes of the taxpayer, including whether the taxpayer has excess limitation with respect to its general category income and whether the conversion of subpart F income is feasible.

Changes to the definition of exempt income and exempt asset

The 2018 proposed regulations provided that exempt income and assets includes a portion of a domestic corporation's gross FDII and assets that produce gross income included in FDII, respectively. Under the 2018 proposed regulations, the portion of the asset that produces FDII that was treated as exempt was equal to the product of the value of the assets that produce gross income included in FDII and a fraction equal to the FDII deduction over FDII income.

In a report of initial impressions on the 2018 proposed regulations, KPMG observed that the 2018 proposed regulations did not provide a methodology for identifying the assets (or the portion of the assets) that produce FDII. Read ***TaxNewsFlash*** (November 2018). Further, it was noted that it would be reasonable to expect the allocation rule to focus more narrowly on assets that produce "foreign derived deduction eligible income ("FDDEI")" as that is the income that is intended to be benefited by the section 250 deduction. Consistent with this observation, Treasury amended this rule in the final regulations to focus on assets that produce gross FDDEI.

KPMG observation

Treating FDII assets as exempt assets generally has the effect of apportioning more of a taxpayer's interest expense to its section 951A category income and foreign branch category income (just as treating "GILTI inclusion stock" as an exempt asset causes more expenses to be apportioned to general, passive, and foreign branch category income). The final regulations' change in the methodology for determining exempt FDII assets will ameliorate (though not eliminate) this effect by diluting the fraction by which assets are determined to be exempt.

Additionally, the 2019 proposed regulations include clarification that the general exempt income and asset rules would apply to insurance companies in respect of certain income, such as certain deductible dividends received and tax-exempt interest, despite the fact that the insurance company may be subject to the "proration rules" on account of the receipt of such income.

R&E expense

In general

The 2019 proposed regulations would substantially change the rules under Reg. § 1.861-17 for the allocation and apportionment of R&E expense. Under the 2019 proposed regulations, R&E expenses (including both deductions under section 174 and amortization of amounts capitalized under section 59(e)) would be definitely related to all "gross intangible income" reasonably connected with the relevant SIC code category. "Gross intangible income" generally would include all of the taxpayer's income attributable to intangible property (e.g., direct sales, royalties), but does not include dividends, subpart F, or GILTI inclusions. "Intangible property" for this purpose is defined by reference to section 367(d)(4).

KPMG observation

The 2019 proposed regulations would specifically apply to both deductions under section 174 and amortization of amounts capitalized under section 59(e). Existing Reg. § 1.861-17, in contrast, lists only section 174 expenses as expenses subject to allocation and apportionment under the regulation. While not discussed in the preamble, it can be surmised that the broadening of the scope of the regulation to apply also to deductions that were capitalized under the section 59(e) election is predicated on section 59(e) applying only to expenditures that should generally bear the same factual relationship to the classes of income to which section 174 expenditures are related and allocable pursuant to Reg. § 1.861-17.

KPMG observation

Because existing Reg. § 1.861-17 was drafted pre-TCJA, it did not specifically address whether R&E expenses were allocable to section 951A category income. The 2019 proposed regulations would offer welcome relief, providing that no R&E expense is allocated to section 951A category income. In addition, because R&E expense is also not allocated to dividends, subpart F, or amounts included under section 1293, the class of gross income to which R&E expenses will be allocated will generally include only that income which earned directly by the U.S. person from exploitation of the intangible property, including direct sales and services and royalties from licensing the property to controlled and uncontrolled parties.

Under existing Reg. § 1.861-17, after first applying the exclusive apportionment rules, taxpayers are permitted to apportion remaining R&E expense under either the sales method or the gross income method. However, the preamble to the 2019 proposed regulations explains that the sales method provides a better method of matching the R&E expense to the anticipated income from R&E activities. As a result, the 2019 proposed regulations would eliminate the gross income method for apportioning R&E expenditures, and thus would require taxpayers to apportion based on gross receipts from sales and services.

Exclusive apportionment

Under existing Reg. § 1.861-17, under the sales method, 50% of R&E expense is exclusively apportioned to the "geographic source" when more than half of the R&E took place. The 2019 proposed regulations would retain the 50% exclusive apportionment rule, but would modify the rule's language to clarify that, for purposes of determining whether half of the R&E took place in a geographic region, taxpayers must analyze the R&E that took place in the United States compared to the R&E that took place outside the United States.

KPMG observation

Existing Reg. § 1.861-17 is unclear as to whether the exclusive apportionment rule applies to apportion expense to foreign source income only in the instance of a taxpayer that conducts more than half of its R&E in a single foreign country or whether the rule also applies if a taxpayer conducts more than half of its R&E collectively across all non-U.S. jurisdictions. Under the 2019 proposed regulations, however, it is clear that the exclusive apportionment rule would apply where more than half of the taxpayer's R&E is performed outside the United States in the aggregate. Therefore, under the 2019 proposed regulations, the exclusive apportionment rule would apply to each taxpayer, either to apportion R&E to U.S. source income (if 50% or more of R&E expense relates to activities performed within the United States) or foreign source income (if more than 50% of such activities are performed outside the United States).

Sales of controlled and uncontrolled corporations

Under section 1.861-17, taxpayers are required to take into account certain gross receipts of controlled and uncontrolled corporations if the taxpayer can reasonably be expected to license, sell, or transfer intellectual property ("IP") that would arise from the taxpayer's R&E expense to such persons. The existing regulation provides that past experience with R&E "shall be considered in determining reasonable expectations" for this purpose. Proposed section 1.861-17 retains the rule with respect to controlled and uncontrolled corporations, but converts the consideration of past experience into a presumption, providing that a taxpayer that has previously licensed, sold, or transferred IP related to a SIC code category to a controlled or uncontrolled corporation is presumed to expect to license, sell, or transfer to that corporation all future IP related to that category.

KPMG observation

An example in the 2019 proposed regulations suggests that this presumption is a per se rule that cannot be rebutted even if it is clear the taxpayer will not in fact license, sell, or transfer the IP to the controlled or uncontrolled party.

The 2019 proposed regulations would also "clarify" the treatment of cost sharing arrangements ("CSAs") in two respects—(1) R&E expense allocated under Prop. Reg. § 1.861-17 does not include amounts that are not deductible under the second sentence of Reg. § 1.482-7(j)(3)(i); and (2) the exclusion of the controlled party's gross receipts applies only for purposes of apportioning the R&E expense related to the CSA.

KPMG observation

Based on the plain language of current Reg. § 1.861-17, it appeared that if the taxpayer entered into a CSA with a controlled corporation, none of that corporation's sales were taken into account for allocating any R&E expense (i.e., whether such sales were related to the CSA or not), even if the taxpayer also separately licensed IP unrelated to the CSA to that corporation. The 2019 proposed regulations would address this ambiguity and provide that the controlled corporation's gross receipts are only excluded for purposes of allocating the taxpayer's R&E expense associated with the CSA.

Non-application of tax-exempt asset rule to R&E expense

One question taxpayers faced when applying existing Reg. § 1.861-17 was whether the tax exempt asset rule of section 864(e)(3) applied. The application of this rule when applying the gross income method appeared straightforward, but it was unclear how to apply the rule to the sales method. Instead of providing rules for how to apply section 864(e)(3) to the new proposed R&E expense allocation rules, the 2019 proposed regulations provide that section 864(e)(3) would not apply for R&E expense allocation purposes. There is no discussion in the preamble as to why this approach was adopted.

SIC code category—wholesale and retail trade

R&E expense is allocated based on income in the relevant SIC code category. The 2019 proposed regulations provide special rules for determining the relevant SIC code category, specifically related to wholesale and retail trade. In particular, if taxpayers engage in "material" non-sales activities (e.g., manufacturing or extraction) and wholesale or retail activities, the 2019 proposed regulations would require the taxpayer to use the non-wholesale or non-retail SIC code category for all activities related to the category of products. Thus, under the rule, the non-sales activities SIC code category would take precedence over the wholesale and retail activity product code.

KPMG observation

Generally, under this rule, taxpayers cannot use a wholesale or retail SIC code category unless they perform solely sales-related activities. The effect of this rule is to align the taxpayer's R&E expense with its core business and minimize the SIC code categories, arguably simplifying the allocation of R&E expense.

Other changes

Although the 2019 proposed regulations do not specifically take into account comments received in connection with the proposed regulations under section 250, they clarify that exclusive apportionment only applies for section 904 purposes. Comments received with respect to Reg. § 1.861-17 in connection with the proposed section 250 regulations will be addressed in future guidance.

The 2019 proposed regulations would also make several modifications to existing Reg. § 1.861-17 in an effort to simplify the rules. In particular, the 2019 proposed regulations would remove both the legally mandated R&E rule (under which taxpayers could directly apportion legally required R&E to the jurisdiction requiring such expenses) and increased exclusive apportionment of R&E rule (under which taxpayers were permitted to request increased exclusive apportionment if their facts justified it). The preamble explains that these rules were removed due to taxpayers generally failing to rely on them coupled with changes in the international business environment since the rules were originally drafted in 1977.

Final regulations

The 2018 proposed FTC regulations provided a one-time exception to the five-year binding election period, permitting taxpayers to change between the sales method and the gross income method in the first tax year beginning after December 31, 2017. The final regulations finalized this rule without change. In addition, in light of Prop. Reg. § 1.861-17, the final regulations permit taxpayers to change to the sales method without consent up to their last tax year that begins before January 1, 2020.

Stewardship expense

The 2019 proposed regulations provide rules for the allocation and apportionment of stewardship expenses to account for changes made by the TCJA. Under the existing regulations, stewardship expense is allocated to "dividends received, or to be received from" the corporation's subsidiaries. The 2019 proposed regulations would provide that stewardship expense is allocated to a class of gross income that includes not only dividends, but also inclusions from the related subsidiary including current income inclusions of a shareholder under section 951, section 951A, the related section 78 gross-up for foreign tax credits in respect of such inclusions, as well as similar current inclusions of a shareholder resulting from an interest in any PFIC it holds. Additionally, the 2019 proposed regulations would provide an explicit rule for the apportionment of stewardship expenses between the statutory and residual groupings based on the relative values of the stock in each grouping held by the taxpayer, as determined under the stock characterization rules provided in the interest allocation and apportionment rules (Reg. § 1.861-13).

KPMG observation

While the R&E expense allocation rules in the 2019 proposed regulations would generally increase a taxpayer's FTC limitation in its section 951A limitation category, the rules in the 2019 proposed regulations related to stewardship likely will decrease a taxpayer's FTC limitation in the section 951A limitation category. While the 2019 proposed regulations may prove unfavorable to some taxpayers, such regulations would, through their reference to the stock characterization rules, allow for the application of the tax exempt asset rule for purposes of allocating and apportioning stewardship deductions, which is generally favorable for the taxpayer's FTC limitation in its section 951A limitation category.

KPMG observation

In requiring that taxpayers apportion stewardship expense based on stock, the 2019 proposed regulations would eliminate the other reasonable methods for apportioning stewardship expense provided in existing Reg. § 1.861-8, which include apportionment based on time spent, gross receipts, gross income, or unit sales volume. Moreover, in requesting comments on whether exceptions to the general rule in the 2019 proposed regulations should be permitted "to treat stewardship expenses as definitely related to a more limited class of gross income," the preamble implies that the 2019 proposed regulation generally does not permit the allocation of stewardship with respect to less than all subsidiaries of the shareholder. However, this implication is arguably inconsistent with the regulation itself, which would provide that stewardship expense is allocated to "dividends received, or to be received, from the related corporation." Moreover, stewardship expense can be incurred with respect to U.S. affiliates, and Reg. § 1.861-14T provides that the stock of a U.S. affiliates is disregarded in apportioning expense under an asset method. Therefore, if the 2019 proposed regulations were interpreted as not permitting a taxpayer to specifically allocate stewardship expense between its subsidiaries—including between its U.S. and foreign affiliates—the result would be that all stewardship expense would be allocated and apportioned under the regulation solely based on stock of foreign affiliates owned by the taxpayer, thus potentially over-allocating the expense to section 951A category income. This does not appear to be an appropriate result, and it is hoped and expected that the rule will be clarified to properly address stewardship expenses incurred with respect to U.S. affiliates when finalized.

Treasury extended the principles applicable to the allocation and apportionment of stewardship expense as applied to a taxpayer's corporate investments to expenses incurred with respect to an interest in a partnership. Specifically, the 2019 proposed regulations would provide that any "stewardship expenses" incurred with respect to a partnership are definitely related and allocable to the partner's distributive share of partnership income and are to be apportioned among the relevant statutory and residual groupings in a manner consistent with the principles of apportionment of stewardship expenses in respect of related corporations.

Notably, Treasury requested comments on several issues related to the allocation and apportionment of stewardship expense, including whether (1) there may be instances in which stewardship expense should be directly allocable to a more limited class of gross income, (2) the definition of stewardship expenses should be modified, and (3) additional changes to the allocation and apportionment of stewardship expense are necessary to reflect changes resulting from the new law and modern business practices.

Damages and settlement payments

The 2019 proposed regulations would also provide guidance with respect to damages and settlement payments. The expense allocation rules for legal and accounting fees in the existing regulations do not provide guidance on damages and settlement payments. Because these expenses can often be significant, Treasury issued regulations to provide guidance on the allocation and apportionment of these expenses. The 2019 proposed regulations set forth three specific rules regarding the allocation and apportionment of damages and settlement payments depending on the nature of the expense. In particular, the 2019 proposed regulations would provide the following:

- Damages and settlement payments for a liability suit arising from a particular product or service are allocated to the class or classes of gross income produced by the product or service that gave rise to the income.

- Damages and settlement payments for a liability suit arising from the production of a particular product or service (e.g., an industrial accident) are allocated to the class of gross income produced by the assets involved in the event, and as necessary, apportioned based on the relative value of the assets in such groupings

- Investor claims for corporate negligence, fraud, or other malfeasance are allocated and apportioned based on the value of all of the corporation's assets.

Interest expense

Final regulations

Consistent with its overall posture in the final regulations, Treasury implemented the interest expense allocation and apportionment rules in the 2018 proposed regulations with minimal changes.

Taxpayers had requested relief in the interest expense allocation and apportionment rules to account for changes in the TCJA. For example, one comment requested that, in transitioning from the fair market value method to the tax book value method, as required by the new law, taxpayers be allowed to average the fair market value determined at the end of the 2017 tax year with the tax book value determined at the end of the 2018 tax year. Another comment requested that in the three-year period beginning on January 1, 2018, that a taxpayers be entitled to annually or retroactively choose apply the alternative tax book value method. Treasury rejected these comments as being inconsistent with the TCJA and, in the latter case, potentially subject to taxpayer abuse.

In addition, taxpayers requested modifications to the proposed changes in the 2018 proposed regulations to the rules in Reg. § 1.861-13 for characterizing CFC stock for purposes of applying an asset method of allocation and apportionment. The 2018 proposed regulations set forth rules that would have significantly revised the existing CFC stock characterization rules mainly to ensure that a portion of the stock of a CFC will be characterized as a section 951A category asset if the taxpayer has a GILTI inclusion from such CFC. In addition, the 2018 proposed regulations also characterized a portion of the stock of a CFC (or noncontrolled 10% owned foreign corporation) as stock that could give rise to a section 245A dividend for purposes of applying section 904(b)(4), which excludes expenses allocated and apportioned to such portion from the FTC limitation for each limitation category.

The 2018 proposed regulations provided that if a CFC owns stock in a noncontrolled 10% owned foreign corporation, such foreign corporation's assets or income are assigned to a gross subpart F category to the extent dividends distributed by it to the CFC would be gross subpart F income of the CFC owner. A comment requested that guidance be issued providing, instead, that stock of such a foreign corporation be assigned to the residual category (which generally includes income that does not result in a current inclusion) on account of the commenter's belief that the CFC should be entitled to a dividends-received deduction under section 245A with respect to the dividend from the foreign corporation. This comment finds its support in the language in the Conference Report that suggests that such a dividend received by a CFC would be eligible for section 245A on the basis of the rule in Reg. § 1.952-2 that treats a CFC as a domestic corporation for purposes of determining its taxable income. Treasury rejected this comment and indicated that, consistent with its comments in the preamble to the temporary section 245A regulations, it is continuing to study whether a CFC would be eligible to claim a deduction under section 245A, but in any event expects forthcoming guidance will provide that, in general, Reg. § 1.952-2 does not cause provisions explicitly applicable only to domestic corporations to become applicable to a CFC for purposes of determining its subpart F inclusion.

In addition, a comment requested that interest expense not be allocated to the stock of a CFC with a net tested loss. Treasury rejected this comment on the basis that there is no authority to suggest it would be appropriate to modify the general rule that a taxpayer allocate its interest expense to all of its assets when an asset, such as stock, produces a loss, such as a tested loss, in the current year but nonetheless remains an asset with income-producing potential. Further, Treasury observed that the tested loss is already accounted for in the 2018 proposed regulations, because the tested loss would reduce the inclusion percentage and thereby reduce the value of the stock of CFCs with tested income within the section 951A limitation category.

Nevertheless, Treasury did provide additional guidance in response to taxpayer comments with respect to two important issues. First, Treasury resolved the long-standing question as to whether a CFC using the asset method of apportionment is required to increase the value of stock in 10% owned corporations by the E&P of such lower-tier corporations for purposes of apportioning the CFC's own interest expense by providing that such E&P adjustment is indeed required.

Second, Treasury amended the rule in the 2018 proposed regulations with respect to the application of the modified gross income method to the apportionment of a CFC's deductions for interest expense. Under the existing regulations, a CFC using the modified gross income method apportions its interest expense among its various categories of income based on the gross income within each category. For this purpose, the gross income of such CFC includes its share of the gross income of lower-tier CFCs (net of interest expense) other than subpart F income (net of allocable interest expense). The 2018 regulations would have treated a lower-tier CFC's tested income in the same manner as subpart F income, and thus its gross tested income would not have tiered up to the CFC. One taxpayer commented that excluding tested income of lower-tier CFCs under the modified gross income method could lead to significantly different results for a CFC that allocates its interest expense based on the asset method versus a modified gross income method. In response to this comment, Treasury revised the rule in the final regulations to account for this potentially distortive outcome by tiering up gross tested income (net of allocable interest expense) of lower-tier CFCs for purposes of allocating interest expense of a CFC under the modified gross income method.

KPMG observation

It should be noted that the treatment of subpart F income of lower-tier CFCs for purposes of allocating interest expense of a CFC under the modified gross income method remains unchanged. In discussing the comment submitted with respect to the GILTI change, Treasury references the rationale provided by the commenter that may have led to maintaining this distinction: that is, GILTI is generally calculated on an aggregate basis with respect to all of a U.S. shareholder's CFCs, while subpart F remains a separate entity calculation. While this distinction should not be minimized, it seems that minimizing the distortive effects of using the asset method instead of the modified gross income method would provide sufficient justification for making this change with respect to subpart F income as well.

KPMG observation

This amendment in the final regulations to the modified gross income method more closely aligns the interest expense allocation results under the modified gross income method with the results under the asset method.

To illustrate, assume that CFC is a holding company whose sole asset is 100% of the stock of X, a CFC that produces only tested income. CFC has no assets and its activities include only (1) the receipt of $1 of interest income that is subpart F income, and (2) the payment of interest on a loan to a related party.

If CFC chooses to apply the asset method, its interest expense would be allocable against tested income as its sole asset is the stock of a CFC that produces only tested income, with the result that such interest expense could create a tested loss in the CFC and be treated as tested interest expense for purposes of determining a U.S. shareholder's specified interest expense. If CFC instead chose to apply the modified gross income method as it would have applied in the 2018 proposed regulations, its interest expense would instead be allocated solely against subpart F income as the tested income of X would not tier up to CFC under such regulations, and thus the interest expense could not create a tested loss nor be taken into account in determining specified interest expense. In contrast, under the final regulations as revised, if CFC chooses to apply the modified gross income method, the tested income (net of allocable interest expense) of X would tier up to CFC and the majority of its interest expense would be allocable against tested income. Such result would be consistent with the results under the asset method.

2019 proposed regulations

The 2019 proposed regulations would modify the interest expense allocation and apportionment rules in light of taxpayer comments received with respect to the 2018 proposed regulations.

First, the 2019 proposed regulations would narrow the rule in Reg. § 1.861-12T(f)(1) relating to capitalized, deferred, or disallowed interest expense. In particular, under existing regulations, if interest is capitalized, deferred, or disallowed under the Code, a taxpayer is entitled to reduce the adjusted basis or the fair market value of an asset connected to the interest by the principal amount of the interest that is disallowed. The effect of this rule is that for expenses that are allocated based on the asset method (e.g., interest expense), a lesser amount would be allocated to the asset to which the reduction was applied. In response to a comment, Treasury would narrow this rule by clarifying that an asset is connected with an indebtedness only if using the debt proceeds to acquire or produce the asset causes the interest to be so capitalized, deferred, or disallowed. Further, the 2019 proposed regulations would modify the examples on this point.

KPMG observation

As a result of this modification in the 2019 proposed regulations, a taxpayer would not be entitled to reduce the value of CFC stock acquired by a corporation in exchange for a debt instrument the interest for which is disallowed under section 163(l) because it is not the acquisition of the CFC stock, but rather the terms of the instrument, that causes the disallowance. This result is made explicit in the modified example included in the 2019 proposed regulations.

Second, the 2019 proposed regulations would add rules that parallel those in the final regulations related to the matching of interest income to interest expense in the case of downstream loans made by a U.S. partner to a partnership. Under the prior regulations, in the case of a loan from a partner to its partnership (a "downstream partnership loan"), the interest income of the partner is categorized based on the look-through rules, but the partner's distributive share of the partnership's interest expense is allocated and apportioned at the partner level under Reg. § 1.861-9(e)(2). As a result, purely internal transactions between a partner and a partnership could result in reallocations of net income from one foreign tax credit category to another. Under the final regulations, the partner's interest income is assigned to the same statutory and residual groups from which its distributive share of the partnership interest expense is deducted, thus ensuring that these amounts are directly netted against each to avoid any overall impact on the partner's foreign tax credit capacity.

Further, in response to taxpayer comments, similar rules would also apply to loans from a partnership to a partner ("upstream partnership loans"). In particular, the rules in the 2019 proposed regulations would provide that the partner's distributive share of the interest income would be matched with the related interest expense of the partner with respect to the upstream partnership loan. The 2019 proposed regulations would provide an identical result in respect of guaranteed payments, thereby preventing a taxpayer from increasing its FTC limitation by converting its existing partnership loan to an equity interest with a guaranteed payment.

Foreign income taxes

The final regulations finalized Reg. § 1.904-6 as proposed in the 2018 proposed regulations without significant changes. As highlighted in the preamble to the final regulations, there was significant uncertainty regarding the application of the 2018 proposed regulations in assigning foreign income taxes attributable to base differences, timing differences, and disregarded payments to the relevant foreign tax credit categories for purposes of applying section 904 and to the income and previously taxed earnings and profits ("PTEP") groups for purposes of section 960. Therefore, while Treasury finalized Prop. Reg. § 1.904-6 without substantive modification, Treasury also issued a revised Prop. Reg. § 1.904-6 and a new Prop. Reg. § 1.861-20 to provide taxpayers with additional guidance regarding the allocation and apportionment of foreign income taxes. Issuing such regulations in proposed form also provides taxpayers with the opportunity to comment on this new guidance. These proposed regulations would only apply to tax years beginning after December 31, 2019.

The principles of Prop. Reg. § 1.861-20 are in keeping with the general principles of Reg. § 1.904-6. The proposed regulation would generally assign a foreign income tax to a relevant grouping by relating the foreign income tax to foreign taxable income based upon how such foreign taxable income is characterized for U.S. federal income tax purposes. To do so, the proposed regulation provides the following three-step process:

- First, items of foreign gross income are assigned to the relevant groupings;

- Second, deductions allowed under foreign law are allocated and apportioned using the relevant rules or principles of foreign law or, if there are none, the principles of the U.S. expense allocation and apportionment regulations;

- Third, the foreign income tax is apportioned amongst the groupings using the ratio of foreign taxable income in the grouping to all foreign taxable income upon which the foreign income tax is imposed.

KPMG observation

Prop. Reg. § 1.861-20 would utilize the "statutory" and "residual" grouping construct used by the U.S. expense allocation and apportionment regulations rather than the 904 limitation categories in order that the same methodology of assigning foreign taxes may be applied for purposes of section 904 and "operative sections" other than section 904. For example, Prop. Reg. § 1.960-1 references Prop. Reg. § 1.861-20 for purposes of allocating and apportioning foreign income taxes to the various subpart F income groups, the tested income group, and the residual income group. In general, the statutory groupings for purposes of section 904 are the section 904 limitation categories. The statutory groupings for purposes of allocating and apportioning foreign income taxes to the section 960 income groupings are the subpart F income groups (e.g., separate items of foreign personal holding company income, foreign base company sales income, etc.), the tested income group, and the PTEP groups within each section 904 limitation category. The residual grouping consists of income that is not in a subpart F income group, tested income group, or PTEP group.

Assigning foreign gross income to the relevant statutory and residual groupings

Similar to Reg. § 1.904-6, foreign gross income is assigned to a grouping but is characterized according to U.S. federal income tax principles. Applying this concept in practice under Reg. § 1.904-6 has been difficult because the amount of the item for foreign income tax purposes may be different than the amount for U.S. federal income tax purposes which, in conjunction with the base and timing difference rules, raised significant uncertainty as to the characterization of items of foreign gross income. Prop Reg. § 1.861-20 would introduce a "corresponding U.S. item" concept and revised base and timing difference rules in an effort to provide increased certainty regarding the characterization of items of foreign gross income.

A corresponding U.S. item is the amount of gross income (or loss) arising from the same transaction or other realization event that gives rise to foreign gross income, if such amount is taken into account for U.S. tax purposes in the same tax year as the foreign tax is paid or accrued. If there is a corresponding U.S. item, even if different in amount than the foreign gross income, the foreign gross income must be basketed in the same manner as the corresponding U.S. item. This concept assists taxpayers with characterizing amounts of foreign gross income because such amount is characterized the same as the U.S. federal income tax characterization of amounts (even if different) arising from the same transaction or realization event. If the corresponding U.S. item is a loss (or zero), then the item of foreign gross income is assigned to the grouping to which a gain for U.S. federal income tax purposes would have been assigned.

KPMG observation

The definition of a corresponding U.S. item only accounts for gains or losses while the operative rule allows for gains, losses, and income that is zero. The definition of corresponding U.S. item may need to be revised to account for this discrepancy.

The 2019 proposed regulations would provide guidance for associating foreign taxes to a grouping in the event that there is no corresponding U.S. item by reason of certain "timing differences." Specifically, where a taxpayer recognizes an item of foreign gross income arising from a transaction or other foreign realization event that does not result in the recognition of gross income or loss under federal income tax law in the same U.S. tax year in which the foreign income tax is paid or accrued, except by reason of a base difference, the 2019 proposed regulations generally would assign the foreign gross income to the grouping that a corresponding U.S. item would be assigned if the event giving rise to the foreign gross income resulted in the recognition of gross income or loss under U.S. federal income tax law in the tax year in which the foreign income tax is paid or accrued. This rule would apply, for instance, in a situation where a transaction results in the realization and recognition of gain or loss for foreign tax purposes, but is treated as a nonrecognition event for U.S. tax purposes (e.g., a section 351 exchange).

The 2019 proposed regulations would significantly clarify and limit the scope of what constitutes a base difference. The 2018 proposed regulations merely noted that base differences were rare and provided as examples insurance proceeds and gifts. The 2019 proposed regulations would provide an exclusive list of base differences, while requesting comments regarding other items that may constitute base differences:

- Death benefits described in section 101;
- Gifts and inheritances described in section 102;
- Contributions to capital described in section 118;
- The receipt of money or other property in exchange for stock described in section 1032 (including by reason of a transfer described in section 351(a));
- The receipt of money or other property in exchange for a partnership interest described in section 721;
- The portion of a distribution of property by a corporation to its shareholder with respect to its stock that is described in section 301(c)(2); and
- A distribution to a partner described in section 733.

The preamble to the 2019 proposed regulations notes that foreign gross income related to a base difference is characterized for section 904 purposes as within the foreign branch limitation category and for other purposes as within the residual grouping.

KPMG observation

Although the statutory reference to the foreign branch limitation category in the statutory base difference rule in section 904(d)(2)(H)(i) appears to be an error, the preamble to the 2019 regulations reiterates that the foreign gross income is assigned to the foreign branch limitation category because of such statutory reference. Neither the final regulations (Reg. § 1.904-6) nor the proposed regulations (Prop. Reg. §§ 1.861-20 and 1.904-6), however, specifically state that such foreign gross income is assigned to the foreign branch limitation category, but rather merely assign the foreign gross income to the "separate category described in section 904(d)(2)(H)(i)." Therefore, an argument that the cross-reference in section 904(d)(2)(H)(i) to the foreign branch limitation category is properly disregarded as a scrivener's error might still support a view that the amount attributable to a base difference should be assigned to the general limitation category.

The 2019 proposed regulations would provide helpful new rules to assign foreign gross income arising from a distribution with respect to stock, including a dividend, capital gain, or both, to groupings. Foreign gross income from a distribution that is recognized for both foreign and U.S. federal income tax purposes and is treated as a dividend under foreign law is assigned in the same manner as (i) the amount of such distribution that is treated as a dividend for U.S. federal income tax and / or as a PTEP distribution to the extent of E&P giving rise to the dividend and / or PTEP distribution, (ii) then as a base difference to the extent the foreign dividend distribution is a return of capital pursuant to section 301(c)(2), and (iii) then as the capital gain recognized for U.S. federal income tax purposes. The gross income from such a distribution that is recognized as a capital gain for foreign tax purposes is assigned in the same manner as (i) the amount of the capital gain recognized for U.S. federal income tax to the extent of such capital gain, (ii) then as a base difference to the extent the foreign capital gain distribution is a return of capital pursuant to section 301(c)(2), and (iii) then as the dividend and / or PTEP distribution recognized for U.S. federal income tax purposes. Foreign gross income from a distribution that is not treated as a distribution of property (e.g., stock dividends and foreign law consent dividends) is characterized applying the rules above by treating the amount of the foreign law distribution as if it were made for U.S. federal income tax purposes in the U.S. tax year in which the foreign income tax with respect to such amount is paid or accrued.

KPMG observation

The characterization of a distribution from a foreign corporation to its shareholder would often vary for U.S. federal income tax and foreign tax purposes because of differences between how the two jurisdictions calculate the amount the earnings currently available to support a dividend and the amount of the shareholder's basis. In particular, it should be noted that differences in the amount of earnings available at any given time to support a current dividend could be purely temporary as a result of a myriad of possible differences in accounting methods employed by each jurisdiction, such as depreciation conventions. In light of this and given the narrow list of items the 2019 proposed regulations would characterize as base differences, the characterization of a section 301(c)(2) return of capital as a base difference is curious. In contrast, though equally curious, under the 2019 proposed regulations, permanent differences in U.S. and foreign tax base resulting from section 338 elections would be a timing difference by virtue of not being included in the list of base differences.

Foreign gross income related to a disregarded payment made by a foreign branch to its owner is assigned to a grouping by deeming the payment to have been made ratably out of the after-tax income of the foreign branch as computed for federal income tax purposes. For this purpose, the branch income is deemed to arise in the statutory and residual groupings in the same ratio as the tax book value of the assets, including stock, owned by the foreign branch under the rules of Reg. § 1.987-6(b)(2). If the item of foreign gross income arises from a disregarded payment to a foreign branch from its owner, then the foreign gross income is assigned to the residual grouping. [If the 2019 proposed regulations are applied for purposes of section 904, then the foreign gross income with respect to a disregarded payment from a foreign branch to its U.S. branch owner in the same manner as the U.S. branch owner's income that is reattributed under the rules in Reg. § 1.904-4(f). Further, the foreign gross income related to a disregarded payment from a U.S. branch owner to its foreign branch that results in general basket income of the owner to be reattributed to its foreign branch would be treated as foreign branch income.] Foreign gross income from the sale of a disregarded entity is assigned to groupings based upon treating the gross income recognized for U.S. federal income tax purposes from the sale of the assets as foreign gross income recognized from the disposition of assets for foreign tax law purposes.

KPMG observation

A disregarded entity or true branch may be treated as a foreign branch for purposes of the disregarded payment rules even if it is owned by a person other than a U.S. person (e.g., a CFC). *See,* e.g., Reg. § 1.904-4(f)(3); Prop. Reg. § 1.861-20(d)(3)(ii)(D) ("A foreign branch owner can include a foreign corporation."). The owner of the foreign branch could not have income within the branch limitation category, however, unless it is a U.S. person.

KPMG observation

The 2019 proposed regulations would assign to the residual grouping any foreign gross income arising from disregarded payments from a branch owner that is a CFC to its foreign branch. As a result, foreign income taxes attributable to such income would be disallowed as a foreign tax credit pursuant to Reg. § 1.960-1(d)(3)(ii)(A) and (e). This appears to be an odd result given that foreign gross income with respect to a disregarded payment from the foreign branch to its CFC owner would be treated as a deemed distribution from the income of the foreign branch and the related tax could be related to income other than the residual grouping. The preamble to the 2019 proposed regulations does not explain the reasoning behind this rule, but a Treasury official has publicly expressed a view that disregarded "downstream" payments from a CFC to its foreign branch are analogous to tax-free contributions described in sections 118 and 1032, the foreign gross income from which would be attributable to a base difference under the 2019 proposed regulations. However, this does not properly account for the fact that many payments from a shareholder to its subsidiary are not in the nature of a contribution. Further, there seems little policy justification for basketing a tax paid or accrued with respect to, for example, a disregarded royalty from a CFC to its disregarded subsidiary differently than a disregarded royalty from the disregarded entity to its CFC parent.

The foreign gross income that a taxpayer recognizes from a reverse hybrid (an entity treated as a flow-through entity for purposes of its jurisdiction and as a corporation for purposes of the owner's jurisdiction) is assigned to groupings by treating such income as the income of the reverse hybrid and applying the general rules in the 2019 proposed regulations for assigning foreign gross income to groupings. For purposes of applying section 904 when a reverse hybrid is owned directly by a U.S. shareholder, the 2019 proposed regulations (Prop. Reg. § 1.904-6(f)) would assign such foreign gross income to the section 951A income category to the extent such foreign gross income would be tested income of the reverse hybrid and to the extent of the owner's inclusion percentage.

KPMG observation

Under the 2019 proposed regulations, the foreign income taxes attributable to the foreign income of a reverse hybrid that are treated as paid or accrued by a U.S. shareholder owner of a reverse hybrid entity under the technical taxpayer rule would be assigned to the section 951A income category (assuming the taxes relate to gross income earned by the reverse hybrid that results in a section 951A inclusion) rather than the general income category. The preamble requests comments with respect to the interaction of Prop. Reg. § 1.904-6(f) with sections 245A(g) and 909 (pertaining to split taxes, of which foreign taxes imposed on reverse hybrids is one category). It is not clear if there are specific types of interactions the request had in mind, such as whether all split taxes should similarly be basketed with respect to the split income.

KPMG observation

Foreign income taxes assigned to the section 951A income category are not haircut under the proposed regulations, even though taxes attributable to GILTI inclusions are subject to a 20% reduction.

Determining foreign taxable income in a statutory grouping and apportioning foreign income taxes

Foreign income taxes are apportioned between the relevant statutory and residual groupings based upon the ratio of foreign taxable income in a grouping to all of the taxpayer's foreign taxable income to which the tax relates (Step 3 noted above—the foreign income tax is apportioned amongst the groupings using the ratio of foreign taxable income in the grouping to all foreign taxable income upon which the foreign income tax is imposed.).

To determine foreign taxable income in a statutory grouping, the taxpayer's foreign deductions must be allocated and apportioned to the relevant groupings pursuant to the rules of Prop. Reg. § 1.861-20(e). In general, this proposed regulation provides that, for purposes of allocating and apportioning foreign deductions in determining foreign taxable income, the foreign law of the jurisdiction imposing the tax on the foreign taxable income controls. However, if the relevant foreign law does not provide rules for the allocation and apportionment of deductions, then the principles of the U.S. expense allocation and apportionment regulations would apply for such purpose. The proposed regulation would provides that such principles are not required to be applied other than on a company by company basis but that such principles should be applied consistently with how the taxpayer applies the U.S. expense allocation and apportionment regulations for purposes of determining the income and earnings and profits of such entity. As an example, the regulations note that a taxpayer must use the modified gross income method under Reg. § 1.861-9T for purposes of allocating and apportioning interest in determining foreign taxable income if the taxpayer applies the modified gross income method in determining the income and earnings and profits of a controlled foreign corporation for U.S. federal income tax purposes.

KPMG observation

The methodology for allocating and apportioning foreign deductions in Prop. Reg. § 1.861-20 is consistent with the methodology in existing Reg. § 1.904-6. Such methodology can be burdensome given that a taxpayer would need to understand the allocation and apportionment methodology in each foreign jurisdiction in which it operates and pays or accrues foreign income tax.

Provisions related to insurance companies

The 2019 proposed regulations would provide guidance as to how certain expenses of insurance companies are to be apportioned. In particular, certain deductions of life insurance companies such as reserve adjustments and certain other deductions ("section 818(f) expenses") are treated as items which cannot definitely be allocated to an item or class of gross income and thus are apportioned ratably between U.S. source and foreign source income. A common question with respect to section 818(f) expenses is how to allocate such expenses when a life insurance company is part of an affiliated group that also includes non-life insurance companies.

Several approaches were suggested and are discussed in the preamble to the 2019 proposed regulations for purposes of this apportionment, including a separate entity method, a limited single entity method, a single entity method, a life subgroup method, or a facts and circumstances method. The 2019 proposed regulations ultimately would adopt a separate entity approach, but request comments as to whether a life subgroup would be more appropriate.

Further, the 2019 proposed regulations would provide guidance with respect to the application of the exempt asset and income rule of Reg. § 1.861-8 to certain dividends and interest income earned by insurance companies.

Deemed paid credits under section 960

This section focuses on important changes and clarifications to section 960 under the final regulations and the 2019 proposed regulations. Significant portions of the section 960 regulations were finalized unchanged from the 2018 proposed regulations, which were discussed extensively in ***TaxNewsFlash*** (November 2018).

After the repeal of section 902 in the TCJA, section 960 is now the only provision which allows foreign income taxes accrued by a CFC to be deemed paid by its corporate U.S. shareholder. Section 960 applies mechanics at the CFC level by which a U.S. taxpayer determines which taxes paid by the foreign corporation, if any, will be deemed paid by it. Under these rules, such CFC-level taxes are only deemed paid by a U.S. taxpayer to the extent they are allocated to an income group of the CFC that generates an inclusion by a U.S. taxpayer with respect to that CFC or are allocated to a distribution of PTEP. As was the case before the new law, non-corporate U.S. shareholders are not deemed to have paid foreign income taxes accrued by a CFC (subject to the application of other sections, such as section 962). Section 960(a) provides that a corporate U.S. shareholder of a CFC is deemed to have paid the CFC's taxes "properly attributable" to the shareholder's subpart F inclusion. Section 960(d) provides that a corporate U.S. shareholder is deemed to have paid 80% of the product of the shareholder's inclusion percentage and the aggregate foreign income taxes accrued by CFCs that are "properly attributable" to tested income ("tested taxes") taken into account by the shareholder in determining its GILTI inclusion. Section 960(b) also provides that a corporate U.S. shareholder of a CFC is deemed to have paid the CFC's foreign taxes that are "properly attributable" to a distribution of PTEP.

The final regulations generally follow the 2018 proposed regulations in providing computational rules for associating foreign income taxes to subpart F income, tested income, and PTEP groups for purposes of section 960. The six-step computational process for computing taxes deemed paid under section 960(a), (b), and (d) begins with segregating a CFC's current year income into tested income, the various subcategories of subpart F income, and residual income (which is neither subpart F income nor tested income), referred to below as "income groups." Next, deductions (other than current year taxes) must be allocated and apportioned to such income groups and the CFC's current year foreign income taxes then must be allocated and apportioned to the income groups and E&P associated with the CFC's PTEP categories. The process continues to calculate taxes deemed paid by a U.S. shareholder under section 960(a) and section 960(d). In its last step, taxes deemed paid by a U.S. shareholder under section 960(b) in connection with a PTEP distribution are calculated. Following immediately below is a more detailed discussion of certain computational steps.

Grouping of income

The rules for grouping income in the final regulations are generally unchanged from the 2018 proposed regulations. Under the final regulations, a CFC's income for its current U.S. tax year (other than gross income relating to a PTEP distribution (discussed below)) and foreign income taxes accrued in its current U.S. tax year are assigned to a section 904 category (for CFCs, generally either the general limitation or the passive limitation category). Income and taxes are then further assigned to an "income group" within a section 904 category or to a "PTEP group" (discussed below). "Income groups" consist of the subpart F income groups, the tested income group, and the residual income group. The subpart F income groups comprise several separate income groups including, most significantly, separate groups for each separate "item" of foreign base company income identified under Reg. § 1.954-1(c)(1)(iii).

KPMG observation

Treasury received comments requesting that all subpart F income items in a separate category be treated as a single item for purposes of determining what taxes are properly attributable to a subpart F inclusion. The government indicated that the comment was not adopted because the grouping rules under the 2018 proposed regulations are necessary to properly coordinate the rules for deemed paid foreign income taxes with the subpart F high-tax exception and the section 904 high-tax kickout. These rules ensure the same amount of foreign tax is treated as attributable to a particular item of a CFC's foreign base company income for all three provisions. The preamble did not discuss the possibility of simplifying the grouping rules for all three purposes.

KPMG observation

An example of a subpart F income group is foreign base company sales income, which could include income earned from sales by separate QBUs, located in various foreign jurisdictions, of a single CFC. Under these rules, sales by separate QBUs are aggregated into a single group, rather than segregating such income into multiple income groups based on the location of the sale or identity of the QBU conducting such sale. In contrast, the proposed GILTI high-tax exception would apply separately to the tested income earned by each QBU.

KPMG observation

These grouping rules will be of much more significance going forward than they have been in the past. In particular, grouping was of very limited relevance in determining if an item of subpart F income qualified for the high-tax exception of section 954(b)(4) because the determination was ultimately driven by the pooling regime of former section 902. In contrast, under the section 960 regulations, the association of taxes with a particular group of subpart F income will directly determine whether that income group qualifies for the high-tax exception.

Allocation and apportionment of expenses and foreign taxes to income groups

Consistent with the 2018 proposed regulations, the final regulations require a CFC to allocate and apportion its deductions to the current year gross income that has been assigned to the various income groups described above under the U.S. expense allocation and apportionment rules (Reg. § 1.861-8, *et seq.*) for purposes of determining the net income (or loss) of the CFC within each income group. The CFC follows the general expense allocation and apportionment rules of the regulations enacted under section 861 in allocating deductions and foreign taxes to an income group by treating the income groups enumerated in Reg. § 1.960-1 as the relevant statutory groupings. Reg. § 1.904-6, as finalized, applies to tax years that begin after December 31, 2017, and end on or after December 4, 2018. However, as discussed above, Prop. Reg. §§ 1.861-20 and 1.904-6 would replace Reg. § 1.904-6 for tax years beginning after December 31, 2019.

Under the final regulations, current year taxes are allocated to the income groups under the principles of Reg. § 1.904-6. Current year taxes are limited to the taxes paid or accrued by the CFC during its current U.S. tax year, even if a portion of the CFC's foreign tax year to which the taxes relate does not overlap with its U.S. tax year. As a result, when a CFC has different tax years for U.S. and foreign purposes, the CFC's "current year" taxes for a particular U.S. tax year could be based in part on foreign taxes imposed on income earned by the CFC in a different U.S. tax year. The final regulations provide that current year taxes for these purposes include subsequently redetermined foreign income taxes that "relate back" to the current year under section 905(c). Only current year taxes allocated to a specific income group are deemed paid with respect to an income inclusion (for example, under sections 951(a) or 951A(a)) that is sourced from the income group. Current year taxes that are assigned to the residual group are not deemed paid, and thus, are lost.

The final regulations revise the 2018 proposed regulations to eliminate any inference that the timing difference rule assigns tax on the basis of the separate categories that existed in the year in which an item was included. Therefore, a tax imposed in a post-TCJA year with respect to pre-TCJA income is assigned to a tested income group if the pre-TCJA income, if recognized in the year the tax was imposed, would be tested income. Additional changes clarify that, in order to allocate and apportion a current year tax to the section 904 categories and income groups within those categories, all of the foreign taxable income for the period with respect to which the tax is imposed under foreign law is characterized using U.S. federal income tax principles and assigned to the categories or groups as though that foreign taxable income were recognized for U.S. federal income tax purposes in the year in which the tax is paid or accrued.

KPMG observation

The final regulations under section 960 assign current year taxes that are attributable to a "base difference" (as determined under Reg. § 1.904-6(a)(1)(iv)) to the residual income group. The effect of this assignment is that any taxes incurred by a CFC as a result of a base difference are not eligible to be claimed as a deemed paid credit under section 960. The regulations state that base differences arise only in the limited circumstance of a foreign tax imposed on a **type** of item that does not constitute income under U.S. federal income tax principles, such as a gift or insurance proceeds.

KPMG observation

Despite numerous comments suggesting changes to the proposed rule, the final regulations maintain the definition of current year taxes as foreign income taxes that a CFC pays or accrues in its tax year (i.e., the U.S. tax year of a CFC that either is an inclusion year or during which the CFC receives or makes a distribution described in sections 959(a) or (b)). Thus, taxes could be stranded when a CFC has a different U.S. and foreign tax year, or when there is a timing difference under foreign law. Treasury received comments requesting that, in such circumstances, the current year tax be treated as properly attributable to PTEP and thus to be deemed paid under section 960 (e.g., under section 960(b) upon a subsequent distribution of the PTEP) despite that there is otherwise no current year income inclusion in the same income group. Treasury did not adopt these comments, reasoning that associating current year taxes with PTEP rather than current year items of income would be inconsistent with Congress's intent to eliminate pooling and calculate deemed paid FTCs on a current year basis.

KPMG observation

Treasury received comments requesting adjustments to the computation of deemed paid taxes if a domestic corporation's subpart F inclusion is reduced by a qualified deficit described in section 952(c)(1)(B). The final regulations retain the rule that reduces the amount of foreign income taxes deemed paid to the extent the U.S. shareholder reduces its subpart F inclusion by reason of a qualified deficit. Otherwise, taxpayers could be allowed a deemed paid credit in excess of the amount of foreign income taxes the CFC paid with respect to the income that was included. A similar issue arises where a CFC's subpart F income in a tax year is limited by its E&P for the tax year under section 952(c)(1)(A). In this situation, the final regulations afford relief by providing that the amount of foreign income taxes deemed paid are not reduced by reason of the limitation. This rule is appropriate, because the E&P limitation of section 952(c)(1)(A) only provides a timing benefit to a U.S. shareholder—any subpart F income not taken into account in a tax year by reason of the limitation is recaptured in a subsequent year—whereas a reduction to foreign income taxes deemed paid by the shareholder under section 960(a) would be a permanent loss. In contrast, the reduction to a subpart F inclusion under the qualified deficit rule of section 952(c)(1)(B) is a permanent benefit to a U.S. shareholder, because there is no recapture of the reduction to the shareholder's inclusion by reason of the rule.

Previously taxed earnings and profits

The section 960 regulations set forth a separate set of mechanical rules that apply to CFC taxes attributable to PTEP. These rules determine the amount of deemed paid taxes that a U.S. shareholder takes into account when it receives a PTEP distribution, based on foreign income taxes paid or accrued by either the distributing CFC or a lower-tier CFC in a current or prior year that are properly attributable to the PTEP. The creditability of taxes paid or accrued on PTEP distributed through tiers of CFCs is an area that previously lacked specific guidance prior to the change in law, and requires rules distinct from those applicable to subpart F and GILTI inclusions, which only give rise to credits for current year taxes.

The final regulations track PTEP on an annual basis based on the separate limitation category assigned to the inclusion that generated the PTEP. The 2018 proposed regulations identified 10 "PTEP groups," and subsequently Notice 2019-01, 2019-2 I.R.B. 275, expanded the number of PTEP groups to 16. The final regulations consolidate certain of the PTEP groups that were listed in Notice 2019-01, and accordingly the final regulations contain 10 PTEP groups.

Within each annual layer for each separate limitation category, PTEP is further assigned to one of these 10 PTEP groups based on the underlying subpart F, GILTI, or section 956 inclusion that generated the PTEP (taking into account reclassifications of PTEP from section 959(c)(2) to section 959(c)(1)). For example, PTEP attributable to GILTI inclusions are assigned to a PTEP group separate from PTEP attributable to subpart F inclusions, which would be tracked in three distinct PTEP groups (with two separate PTEP groups related to section 965 mandatory repatriation inclusions).

The final regulations modify the transition rule for foreign income taxes deemed paid with respect to PTEP groups by eliminating a condition that could be read to provide that taxes imposed after 2017 on a distribution from a PTEP group from an inclusion year before 2018 are not treated as PTEP group taxes.

Treasury and the IRS intend to issue more comprehensive regulations addressing the maintenance of annual PTEP accounts and the PTEP groups in a separate notice of proposed rulemaking under section 959. It is anticipated that, as part of that guidance, further changes may be made to Reg. § 1.960-3 in order to coordinate both sets of regulations.

KPMG observation

Prior to the change in law, PTEP generally has been classified in only two categories—previously taxed income resulting from section 956 inclusions and previously taxed income resulting from subpart F inclusions. After the change in law, additional subgroups are necessary, due in part to different substantive rules that can apply to distributions of the various PTEP groups for foreign tax credit purposes, including reductions in creditable taxes attributable to PTEP groups related to mandatory repatriation inclusions, as well as different foreign currency gain or loss calculations that apply to distribution of mandatory repatriation associated PTEP versus other PTEP groups under section 986(c).

KPMG observation

Section 78 provides that the amount of foreign income taxes deemed paid pursuant to section 960(b) is treated as a dividend. The purpose of section 78 is to disallow a CFC's deduction for foreign income taxes when a U.S. shareholder elects to claim a foreign tax credit for the year. Although foreign income taxes properly attributable to a PTEP group reduce the amount of the PTEP in such group, such amounts should not be considered deducted because the amount reduced is an amount that has already been subjected to U.S. federal income tax. However, Treasury did not provide any relief given the clear statutory text of section 78.

KPMG observation

Consistent with the statute and proposed regulations, the final regulations do not haircut creditable taxes on GILTI PTEP distributions, even though taxes attributable to GILTI inclusions are subject to a 20% reduction.

Section 956

The final regulations maintain the rule in the 2018 proposed regulations providing that no foreign income taxes are deemed paid under section 960(a) with respect to a section 956 inclusion. According to Treasury and the IRS, an inclusion under section 956 is not an item of income of the CFC (instead, it is an income item of the U.S. shareholder), and, therefore, the taxes of the CFC could not be properly attributable to such inclusion. Further, Treasury and the IRS have asserted that a deemed paid credit would be contrary to legislative intent to eliminate tax pooling and move to a FTC system based solely on current year taxes and income.

Section 960 regulations apply to other provisions

The final regulations clarify that these regulations apply to any provision where a taxpayer is treated as a domestic corporation that is deemed to pay foreign taxes or treats a foreign corporation as a CFC (e.g., section 962(a)(2), section 1293(f)).

Section 960(c)

If certain conditions are met, section 960(c)(1) and Reg. § 1.960-4 allow a taxpayer to increase its section 904 limitation in the year of the receipt of PTEP. The increase in section 904 limitation under section 960(c)(1) is reduced by the amount which would have been section 904 limitation in the inclusion year if the amounts had not been included in gross income under sections 951(a) or 951A(a).

Coordination rule for section 965(g) and section 960(b)

The final regulations finalize the rule to disallow credits for the applicable percentage of foreign income taxes deemed paid under section 960(b) with respect to distributions to the domestic corporation of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits, and provide a coordination rule with Prop. Reg. § 1.960-3, which provides rules for section 960(b).

Treatment of section 78 dividend as foreign oil related income

A comment requested clarification that a section 78 dividend associated with an inclusion under section 951A can be included in foreign oil related income under section 907(c)(3)(B). In the preamble, Treasury and the IRS agreed that a section 78 dividend with respect to an inclusion under section 951A can be included in foreign oil related income, and that section 907(c)(3)(B), as amended by the TCJA, provides for this result notwithstanding the existence of outdated regulations. However, the final regulations do not contain this clarification, because rules relating to section 907 were out of scope.

OFL, SLL, and carryover rules

OFL recapture rules

Reg. § 1.904(g)-3 sets forth a seven-step calculation pursuant to which a taxpayer ultimately determines its OFL recapture, SLL recapture, and overall domestic loss ("ODL") recapture amounts for the tax year. In particular, a taxpayer determines its OFL recapture amount in Step 5 of the calculation by determining the amount of income and gain recognized by the taxpayer during the tax year that is required to be recaptured. However, in addition to the requirement to recapture gain recognized during the tax year, section 904(f)(3) requires a taxpayer that disposes of certain property used or held for use predominantly without the United States in a trade or business, to recapture as foreign source income gain recognized on that disposition, regardless of whether the gain would otherwise be recognized, to the extent of any overall foreign loss account.

The seven-step process in Reg. § 1.904(g)-3 does not address the calculation of OFL recapture for property dispositions pursuant to section 904(f)(3) in which no gain is recognized. To fill this void, Treasury issued proposed regulations on June 25, 2012 (the "2012 proposed regulations"), that would add a Step 8 to the seven-step calculation. Under this new Step 8, the taxpayer would calculate the amount of the OFL account that should be recaptured as a result of a non-recognition transaction. Treasury finalized the 2012 proposed regulations in the final regulations.

In addition, Treasury also responded to taxpayer comments to the 2012 proposed regulations regarding the interaction of the OFL rules and the branch loss recapture rules in prior section 367(a)(3) and the dual consolidated loss recapture rules. In particular, a comment observed that, as a result of the ordering rules for OFL recapture, branch loss recapture, and dual consolidated loss recapture, after a taxpayer calculates its OFL recapture amount in Steps 1 through 8, additional foreign source income could be recognized pursuant to the branch loss recapture or dual consolidated loss recapture rules. The question raised by the comment was whether a taxpayer should again apply the OFL recapture rules in Step 5 to the additional foreign source income. The 2019 proposed regulations would answer this question in the affirmative by adding a new Step 9 at which point the taxpayer would calculate its additional OFL recapture amount resulting from the additional foreign source income recognized as a result of the dual consolidated loss recapture (as following the TCJA branch loss recapture income can no longer be treated as foreign source income).

Transition rules

As described above, the TJCA added two new additional section 904 limitation categories for foreign branch income and GILTI income. The new law did not, however, provide explicit transition rules to address carryovers of FTC attributes from pre- to post-reform years, and vice versa. Such attributes include foreign tax credit carryovers under section 904(c), as well as OFL, ODL, and SLL accounts that were created and "basketed" based upon the pre-reform categories.

Transition rules for carryover of FTC attributes

The 2018 proposed regulations provide a relatively narrow set of transition rules for purposes of categorizing pre-2018 general category FTC carryforwards. Specifically, under the 2018 proposed regulations, taxpayers could elect, but were not required, to treat a portion of their pre-2018 general category FTC carryforwards as foreign branch category taxes to the extent the taxes would have been so allocated if they had arisen in a post-reform year. The 2018 proposed regulations contemplate that taxpayers who make this election must "roll back" to pre-reform years (i.e., reconstruct) the complex computation and reallocation methods for determining the amount of foreign branch income and taxes in order to characterize the taxes, but the preamble requested comments on whether a simplified alternative method would be appropriate. If such election is made, other pre-2018 general category tax attributes such as OFLs and ODLs would be re-basketed to the foreign branch category in the same proportion as carryover FTCs are. In addition, taxpayers that generate excess foreign branch credits in their first post-reform year are entitled to carry those taxes back to their last pre-reform year, and upon doing so the taxes are re-basketed as general category.

In response to comments about the complexity involved in doing a wholesale recomputation, the final regulations provide a simplified safe harbor option that allows taxpayers to allocate unused foreign taxes from a particular pre-reform year to the post-reform separate category for foreign branch category income based on a ratio equal to the amount of foreign income taxes that were paid or accrued by the taxpayer's foreign branches in a tax year divided by the amount of foreign income taxes assigned to the general category that were paid or accrued, or deemed paid by the taxpayer with respect to such tax year. Taxpayers who do not choose to apply the safe harbor method generally must determine unused foreign taxes with respect to the foreign branch category as if the separate category had applied in the year the taxes were paid or accrued—that is, a complete recomputation of its attributes as if the branch category rules were effective in the relevant pre-reform years.

SLL, OFL and ODL accounts

Prop. Reg. § 1.904(f)-12(j) generally provided that any SLL or OFL account in a pre-2018 separate category remained in the same post-2017 separate category. However, to the extent there were any unused foreign taxes with respect to the pre-2018 separate category for general category income for which the taxpayer elected to make an allocation of such taxes between the general and foreign branch separate categories, any general category losses were allocated in the same proportion. As such, under this proposed regulation, if a taxpayer did not have any unused foreign taxes in the general category (and therefore could not make such an election in respect of unused foreign taxes), such taxpayer would be ineligible to make a transition election with respect to its loss accounts.

Treasury received comments requesting flexibility in this regard. Treasury agreed with these comments and accordingly finalized Reg. § 1.904(f)-12 to allow taxpayers to elect to transition their loss accounts in the absence of a taxpayer having unused foreign taxes in the general category to transition. Further, rather than requiring a full recomputation with respect to these loss accounts, safe harbors can be elected in certain instances. The foregoing changes are subject to the consistency requirements described below.

Consistency requirements

The final regulation provides that when a taxpayer makes an election to transition one or more of its unused general category foreign tax credits or relevant loss accounts, it must make such election consistently with respect to all of such attributes. However, a taxpayer that has made such an election may freely elect to apply the safe harbor method with respect to certain attributes, while opting to perform a full recomputation with respect to other attributes. Nevertheless, because the safe harbor for the ODL transition election follows the results the application of the safe harbor for the transition of unused foreign taxes in the general income category, a taxpayer that does not have unused foreign taxes in the general category appears unable to apply the safe harbor provided for the transitioning of ODLs and is therefore required to perform a complete recomputation.

KPMG observation

The final regulations retain the election to re-basket attributes between general and foreign branch categories and provide even more flexibility by introducing safe harbors with respect to each attribute. In requiring taxpayers to apply the default rule (i.e., the attribute remains in the general basket) or elect to transition such attributes between the general income category and foreign branch category consistently, significant modeling may be required for a taxpayer to determine whether the election is beneficial. Further, once a taxpayer has chosen to make a transition election with respect to such attributes, the ability to apply the safe harbor methods provided with respect to some attributes and not others introduces an additional layer of complexity (albeit taxpayer-favorable) that further complicates the taxpayer's modeling exercise.

Translation of foreign income taxes and foreign tax redeterminations

This final section discusses widespread changes enacted with respect to sections 905, 986, and 6689. These rules potentially require the foreign tax credit calculation with respect to a given year to be revisited for many years beyond such year, requiring recalculation of the foreign tax credit and general U.S. federal income tax consequences each time a foreign tax redetermination (as defined below) arises.

On November 7, 2007, the Federal Register published new temporary regulations (T.D. 9362) (the "2007 temporary regulations") at 72 FR 62771. Proposed regulations under sections 905(c) and 986(a) (the "2007 proposed regulations" and together with the 2007 temporary regulations, the "2007 regulations") were published in connection with the 2007 temporary regulations. The 2007 temporary regulations expired in 2010 and the 2007 proposed regulations, while outstanding, did not take into account the revisions to section 905(c) made by the TCJA and the repeal of section 902 foreign tax credit pooling. Treasury has adopted certain portions of the 2007 regulations under sections 905(c) and 986(a) in the final regulations and 2019 proposed regulations. The final regulations and the 2019 proposed regulations provide rules applicable to redeterminations of U.S. tax liability ("U.S. tax redeterminations") that occur because of changes to a U.S. taxpayer's foreign income tax liability or certain other changes that do not involve a change in the foreign income tax liability of the taxpayer but that may nonetheless affect a taxpayer's foreign tax credit ("foreign tax redeterminations"). Specifically, the following portions of the 2007 regulations are finalized: (1) the currency translation rules (which are moved from Reg. § 1.905-3T(b) to Reg. § 1.986(a)-1), (2) the definition of foreign tax redetermination in Reg. § 1.905-3T(c), (3) the rules under Reg. § 1.905-3T(d)(1) requiring a U.S. tax redetermination with respect to foreign income taxes other than those that are deemed paid under section 960, and (4) the rules in Reg. § 1.905-3T(e) relating to foreign income taxes imposed on foreign income tax refunds. Treasury acknowledged that the number of instances in which a U.S. tax redetermination will be required is likely to increase significantly as a result of the TCJA's amendment of section 905(c) necessitated by the repeal of the pooling method prescribed by former section 902. Therefore, several aspects of the 2007 regulations were not finalized, and instead the 2019 proposed regulations include new proposed regulations on these topics. Specifically, the 2019 proposed regulations include: (1) rules requiring a U.S. tax redetermination with respect to foreign income taxes deemed paid under section 960, (2) procedural aspects of the required notification of the IRS in the case of a foreign tax redetermination, and (3) the related penalty imposed under section 6689 for failing to comply with these notification requirements.

Regulations under section 905

Regulations implementing the operative provisions

The 2007 regulations defined the term “foreign tax redetermination” and provided rules for when a foreign tax redetermination would result in a U.S. tax redetermination. Under those regulations and despite the definition, there was uncertainty regarding whether certain events would constitute a foreign tax redetermination.

Under the final regulations, as described above, a foreign tax redetermination includes a change in the liability for a foreign income tax and other changes described in the regulation that may affect a taxpayer’s foreign tax credit. For cash method taxpayers, a foreign tax redetermination therefore occurs when a foreign income tax claimed as a foreign tax credit is refunded. For accrual method taxpayers, a foreign tax redetermination occurs if taxes that when paid or later adjusted differ from amounts accrued by the taxpayer and claimed as a credit or added to PTEP group taxes (as defined in Reg. § 1.960-3(d)(1)). Importantly, these adjustments include corrections or adjustments to accruals to reflect the final foreign income tax liability inclusive of additional foreign income taxes that accrue after the close of the tax year to which the tax relates.

KPMG observation

By including revisions to accruals within the scope of “foreign tax redeterminations,” foreign tax redeterminations are not limited to additional assessments and refunds from audits or the resolution of tax disputes.

KPMG observation

CFCs are accrual method taxpayers and foreign income tax returns are not filed until after the close of the U.S. tax year in which the foreign income taxes reported on such return are accrued for U.S. federal income tax purposes. Additionally, such foreign returns will, in most cases, report a foreign tax liability that differs (even if insignificantly) from the amount of foreign income taxes accrued for U.S. federal income tax purposes. This situation would constitute a foreign tax redetermination under the final regulation’s definition of that term and, under the 2019 proposed regulations, as discussed below, would relate to the U.S. tax year in which such accrual was made, would generally constitute a U.S. tax redetermination, and would generally necessitate the filing of an amended return for such year.

The final regulations include several additional clarifications with respect to the 2007 regulations. First, a foreign tax redetermination includes the failure to pay accrued taxes on or before the date that is 24 months after the close of the tax year of the section 901 taxpayer to which such taxes relate (the “24-month period”) and the subsequent payment of any such accrued but unpaid taxes. The 2007 temporary regulations described the applicable time period as “two years” rather than 24 months. This caused confusion as to whether “two years” meant two full calendar years or instead two tax years, in which case any short tax year could significantly shorten the time period. Because any accrued tax that is not paid within the 24-month period must be translated on the date of payment, the change from “two years” to “24 months” is also relevant for currency translation (discussed below in the discussion on regulations under section 986). The 2019 final regulations also clarified that in the case of a foreign income tax liability imposed on a partnership or trust, the reference to “taxable year” in determining the 24-month period is to the tax year of such partnership or trust, and not of a partner or beneficiary (aligning with the “technical taxpayer rule” contained in Reg. § 1.901-2(f)). When this rule applies, any accrued taxes which remain unpaid upon expiration of the 24-month period are treated as refunded at the expiration of such period. Additionally, the final regulations clarify that foreign income taxes that first accrue after the 24-month period may not be claimed as a credit or added to PTEP group taxes until they are paid.

The final regulations also provide that, if a foreign tax redetermination occurs with respect to a foreign tax claimed as a direct credit, then a redetermination of U.S. tax liability is required for the tax year in which the credit was claimed, as well as any year to which unused foreign taxes from such year were carried under section 904(c).

As described above, in conjunction with the final regulations, the 2019 proposed regulations provide additional essential guidance under section 905(c) addressing foreign tax redeterminations with respect to foreign corporations necessitated by the TCJA’s repeal of section 902 foreign tax credit pooling. The 2019 proposed regulations would add to the first sentence of final Reg. § 1.905-3(a) and provide specifically that a foreign tax redetermination would also include a change in the liability for foreign income taxes, as defined in Reg. § 1.960-1(b)(5), that may affect a taxpayer's U.S. tax liability, including by reason of a change in the amount of its foreign tax credit, the amount of its distributions or inclusions under sections 951, 951A, or 1293, the application of the high-tax exception described in section 954(b)(4)—including for purposes of determining tested income under section 951A(c)(2)(A)(i)(III)—or the amount of tax determined under sections 1291(c)(2) and 1291(g)(1)(C)(ii).

If a foreign tax redetermination occurs, then the 2019 proposed regulations would require an adjustment to the amount of foreign taxes deemed paid, the related section 78 gross-up, and an adjustment in the taxable income, as well as E&P, of the foreign corporation for the year to which such foreign tax redetermination relates. A U.S. tax redetermination would be required whenever a foreign tax redetermination affects U.S. tax liability (such as through changing an inclusion amount under the subpart F or GILTI regimes) even if there is no change to the amount of foreign tax credits originally claimed and apparently regardless of whether a U.S. shareholder even elects to claim a foreign tax credit.

KPMG observation

The 2019 proposed regulations’ addition of additional types of events that could constitute a foreign tax redetermination in addition to those that directly affect the amount of the taxpayer’s foreign tax credit was, according to the preamble to the 2019 proposed regulations, necessitated by the interaction of foreign tax redeterminations and the high-tax exceptions under GILTI and subpart F. This is because foreign tax redeterminations would be accounted for by making adjustments to the amount of foreign income taxes paid by a CFC in the tax year to which such adjustment relates and, thus, could change a taxpayer’s eligibility for those high-tax exceptions.

The 2019 proposed regulations provide a transition rule that applies to post-TCJA foreign tax redeterminations of a foreign corporation that relate to pre-TCJA foreign income taxes. In the case of such a foreign tax redetermination, a U.S. tax redetermination must be made for the relevant pre-TCJA year; as well, adjustments must be made to the foreign corporation’s E&P and foreign tax pools and a U.S. tax redetermination must also be made for any other pre-TCJA year in which a deemed-paid credit would arise with respect to the foreign corporation and any year to which unused foreign taxes from any such year were carried. It should be noted that all of these adjustments require extensive notifications to the IRS in specified form. Treasury invites comments as to whether any simplified method may be appropriate.

KPMG observation

In its request for comments, Treasury suggested as a possibility making all pre-TCJA foreign income tax related adjustments of a CFC to its pools in the foreign corporation's mandatory repatriation transition tax year. This simplification comes with the attendant cost of suffering the applicable section 965(g) haircut on these taxes. It is possible that taxpayers in certain foreign tax credit positions (such as those with an abundance of excess general limitation credits that they do not anticipate they could utilize before expiration of the relevant carryforwards) might find this haircut a small price to pay in exchange for relief from the compliance burden.

The 2019 proposed regulations include a "successor rule" that may frequently apply in the case of disregarded entities ("DREs") whose regarded owner changes before a foreign tax redetermination of an earlier tax year occurs and in the case of reorganizations and liquidations. Pursuant to this rule, when the person bearing legal liability with respect to a foreign tax redetermination is not the same person that had legal liability for the tax in the relation-back year (determined under U.S. tax principles, such that in the case of legal liability imposed with respect to a disregarded entity, the relevant person is its regarded owner), the required U.S. tax redetermination is made as if the redetermination occurred in the hands of the original taxpayer. It will often be the case that the difference in foreign tax is paid by, or received as a refund by, the successor. However, this rule provides that for U.S. tax purposes it is the original taxpayer that is the party with the liability for, or a right to a refund of, this redetermined foreign tax. As such, general U.S. tax principles apply to determine the U.S. federal income tax consequences of this mismatch (such as constructive distributions or contributions). The preamble provides an example involving a foreign legal entity that was a DRE in a tax year in which it paid an incorrectly lower amount of foreign tax and then later converted to a corporation before the year the foreign tax redetermination occurs. Given that the 2019 proposed regulations suppose the foreign tax redetermination had happened with respect to the entity which was the regarded owner (for U.S. tax purposes) of the DRE in the year to which the redetermined tax relates, the 2019 proposed regulations treat the former owner (and shareholder of the foreign legal entity now treated as a corporation (for U.S. tax purposes)) as having the liability for such redetermined tax. Therefore, if the foreign legal entity (now, a regarded subsidiary of the entity which the U.S. characterizes as the liable party) pays the redetermined foreign tax, such entity will be treated for U.S. tax purposes as having made a distribution to the former owner, consistent with general U.S. federal income tax principles that when a subsidiary assumes a liability of its parent, it is treated as making a distribution to the parent.

KPMG observation

If instead the regarded owner of a foreign legal entity treated as a DRE for U.S. federal income tax purposes distributes the DRE to its parent and subsequently a foreign tax redetermination occurs relating to a year of the DRE in which it was owned by the distributing subsidiary, when the DRE satisfies the obligation in relation to the foreign tax redetermination, such may be characterized for U.S. federal income tax purposes as a capital contribution by the parent to the subsidiary and have impacts on various attributes, such as basis in the subsidiary stock. Reverse consequences occur when a foreign tax redetermination results in a refund; when a parent receives a refund in the immediately preceding fact pattern, such may be characterized as a distribution for U.S. federal income tax purposes since the 2019 proposed regulations view the right to the refund as property of the subsidiary. When negative consequences could result (for example, a constructive distribution resulting in an undesirable movement of PTEP in a certain category from a subsidiary to its parent), taxpayers should consider whether appropriate planning can be implemented to avoid these consequences. For example, under appropriate circumstances, it is possible that a binding commitment by the parent to contribute the refund to the subsidiary may avoid the dividend characterization otherwise suggested above.

As referenced above, the final regulations include a rule that when a foreign income tax is incurred with respect to the receipt of a refund of a foreign income tax previously paid, such new foreign income tax is accounted for as a reduction of the amount of the refund and no other credit or deduction may be taken in respect of such foreign income tax. This rule applies to any section 901 taxpayer, which includes for this purpose a specified 10%-owned foreign corporation.

Finally, the final regulations restore a rule that Treasury believes had been inadvertently deleted in prior packages that requires a certified translation of a foreign tax receipt or tax return.

Regulations pertaining to the notification requirement

The 2019 proposed regulations contain a number of procedural rules relating to the requirement for taxpayers to notify the IRS of a foreign tax redetermination. When multiple foreign tax redeterminations occurring within the same or two consecutive tax years require a U.S. tax redetermination of a particular year, one amended return and accompanying statement can be filed for all of the redeterminations.

An exception originally contained in the 2007 temporary regulations is expanded in the 2019 proposed regulations to provide that in certain instances when a foreign tax redetermination does not lead to a change in the U.S. tax due for the related year (either on its own or considered, when permitted by the regulation, with certain other foreign tax redeterminations) an amended return is not related for the related year provided an statement is attached to the timely filed original return for the tax year in which the foreign tax redetermination occurs. This exception may apply when increased U.S. tax liability resulting from a refund of foreign taxes related to an earlier year may be offset by a foreign tax credit carryback or carryover, the statement required with the original and timely return for the year in which the foreign tax redetermination occurs is filed and the additional carryover or carryback used on account of the redetermination is appropriately adjusted.

Further, the 2019 proposed regulations would allow for an exception from the amended return requirement if the taxpayer satisfies alternative notification requirements that may be prescribed in the future. Treasury invites comments on possible alternative methods to satisfy section 905(c) notification requirements.

Specific rules are provided for pass-through entities that report foreign taxes paid to their owners, such as partnerships reporting foreign taxes paid on Schedule K-1s.

Additionally, special rules would be provided for entities subject to the jurisdiction of the IRS Large Business & International (LB&I) division ("LB&I taxpayers"). Generally, LB&I taxpayers can avoid filing an amended return in limited instances when they provide their examiner with notice of a foreign tax redetermination that requires a U.S. tax redetermination within a prescribed time period. Such time period generally runs for 120 days starting from the latest of three dates. However, this alternative cannot be utilized when the time period would start after the due date of the return for the tax year in which the foreign tax redetermination occurs. The 2019 proposed regulations provide a list of conditions, all of which must be satisfied to apply this special rule. Notably, certain detailed information signed under penalties of perjury must be provided by the LB&I taxpayer during the course of the relevant exam.

Regulations under section 986

Several rules included in the 2007 temporary regulations were in included in the final regulations under section 986.

Unless certain elections are made or one of several exceptions applies, foreign taxes paid in foreign currency are generally translated using the weighted average exchange rate for the tax year to which the taxes relate. The relevant tax year to which taxes relate for purposes of determining the applicable exchange rate is the relevant tax year of the person, including a partnership or trust, that has legal liability for such taxes (commonly referred to as "the technical taxpayer"). This is consistent with measuring the 24-month period with respect to the close of the tax year of the technical taxpayer and results in greater consistency with the translation convention for the associated income inclusions which are also determined with respect to the tax year of the technical taxpayer.

Exceptions to the general rule apply. Any tax that is not paid within the 24-month period must be translated at the spot rate on the date of payment. In an example contained in the final regulations, a contested tax relating to Year 1 is finally settled in Year 6 resulting in an increased liability over the amount actually paid and accrued in Year 1. Even though that contested tax must be taken into account in Year 1, the amount of the tax is translated at the spot rate on the date of actual payment in Year 6 because this tax first accrues after the 24-month period. In addition, any tax paid before the beginning of the section 901 taxpayer's U.S. tax year to which such tax relates must be translated into U.S. dollars using the spot rate on the date of payment. The final regulations clarify that the spot rate on the date of payment applies if the currency is inflationary in the accrual year or any subsequent year until the foreign tax is paid.

In certain instances, an election may be made to translate foreign taxes on the date of payment rather than at the weighted average exchange rate for the tax year provided that the liability is denominated in nonfunctional currency. Whether a foreign tax attributable to a QBU is denominated in nonfunctional currency is determined with respect to the functional currency of the QBU owner and not the QBU. When such an election is made, accrued but unpaid taxes at year end are provisionally translated at the spot rate on the last day of the year (or, on the date of payment, if such taxes are paid before the due date (including extensions) of a timely filed return with respect to such tax year). Under the final regulations, a corporate taxpayer can now make this election with respect to less than all of its foreign income taxes denominated in nonfunctional currency by making the election for only those taxes denominated in nonfunctional currency that are attributable to QBUs (including the corporate taxpayer) with U.S. dollar functional currencies. Note that this election may now also be made on behalf of a foreign corporation.

When there is a change in functional currency between the time a tax is paid or accrued and when it is refunded, the final regulations provide that the QBU uses the exchange rate used when the QBU's functional currency changed to determine its basis in the nonfunctional currency and recognize section 988 gain or loss that would have been recognized if the refund had been received immediately before the change in functional currency.

Regulation under section 6689

Section 6689 provides that a taxpayer may be subject to a penalty if the taxpayer fails to notify the Secretary of a foreign tax redetermination on or before the date prescribed by regulations. Prop. Reg. § 301.6689-1 would clarify that a taxpayer also must provide notice in the manner prescribed in Reg. § 1.905-4 to avoid the penalty. The penalty generally is computed by reference to the deficiency resulting from a foreign tax redetermination. Prop. Reg. § 301.6689-1 would clarify that in the case of a partnership, which generally does not have a deficiency, the amount of the penalty is determined by reference to the imputed underpayment, as described in section 6225. Prop. Reg. § 301.6689-1 also would eliminate the statement in existing Reg. § 301.6689-1T(b) that if the penalty under section 6689 applies, the penalty under section 6653(a) does not apply, because section 6653(a) is the predecessor to section 6662, and the penalty under section 6662 can apply even if the penalty under section 6689 applies.

Updates to consolidated foreign tax credit rules

Prop. Reg. § 1.1502-4 would amend the regulations under section 1502 relating to the computation of the consolidated foreign tax credit. For purposes of determining the foreign tax credit limitation, the 2019 proposed regulations would provide that the amount of foreign source income in each separate category is the consolidated taxable income of the group (determined under Reg. § 1.1502-11) in that category, with certain adjustments. Existing Reg. § 1.1502-4 determines the foreign tax credit limitation by reference to the aggregate separate taxable incomes from foreign sources of the members of the group.

The 2019 proposed regulations also would add new rules for purposes of determining the source and separate category of a consolidated net operating loss ("CNOL"), which generally would be determined based on the excess SLLs and U.S. source loss for the tax year. The 2019 proposed regulations also would provide rules for determining the source and separate category of the portion of a CNOL that is apportioned to a separate return year of a member. The 2019 proposed regulations generally are intended to categorize a CNOL that is apportioned to a separate return year in a way that is linked to the source and separate category of income that is produced by the member's assets. The 2019 proposed regulations would achieve this result by apportioning a proportionate amount of the CNOL in each grouping based on a comparison of the value of the member's assets in that grouping to the value of the group's total assets in the grouping, using the methodology in existing Reg. § 1.1502-9(c)(2), then by making adjustments to ensure that the amount of the CNOL apportioned to the separate return year of the member is equal to the amount of CNOL attributable to the member. The principles applicable to CNOLs also would apply to consolidated net capital losses.

The 2019 proposed regulations also would update the regulations to remove references to obsolete provisions, such as the per-country limitation.

The rules in Prop. Reg. § 1.1502-4 apply to tax years for which the original consolidated federal income tax return is due (without extensions) after the date the proposed rules are published in the Federal Register.

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