DEPARTMENT OF THE TREASURY

Internal Revenue Service

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Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance relating to the determination of the foreign tax credit under the Internal Revenue Code (the ''Code''). The guidance relates to changes made to the applicable law by the Tax Cuts and Jobs Act (the ''Act''), which was enacted on December 22, 2017. Guidance on other foreign tax credit issues, including in relation to pre-Act statutory amendments, is also included in this document. The proposed regulations provide guidance needed to comply with statutory changes and affect individuals and corporations claiming foreign tax credits.

DATES: Written or electronic comments and requests for a public hearing must be received by February 5, 2019.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–105600–18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20224. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–105600–18), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20044, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–105600–18).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under §§ 1.861–8 through 1.861–13, 1.861–17, and 1.904(b)–3, Jeffrey P. Cowan, (202) 317–4924; concerning the proposed regulations under §§ 1.901(j)–1, 1.904–1 through 1.904–6, 1.904(f)–12, and 1.954–1, Jeffrey L. Parry, (202) 317–4916, and Larry R. Pounders, (202) 317–5465; concerning §§ 1.78–1 and 1.960–1 through 1.960–7, Suzanne M. Walsh, (202) 317–4908; concerning §§ 1.965–5 and 1.965–7, Karen J. Cate, (202) 317–4667; concerning submissions of comments and requests for a public hearing, Regina Johnson, (202) 317–6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

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 In particular, the Act repealed the fair market value method of asset valuation for purposes of allocating and apportioning interest expense under section 864(e)(2), added section 904(b)(4),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

This document contains proposed regulations (the ''proposed regulations'') addressing (1) the allocation and apportionment of deductions under sections 861 through 865 and adjustments to the foreign tax credit limitation under section 904(b)(4); (2) transition rules for overall foreign loss, separate limitation loss, and overall domestic loss accounts under section 904(f) and (g), and for the carryover and carryback of unused foreign taxes under section 904(c); (3) the addition of separate categories under section 904(d) and other necessary updates to the regulations under section 904, including revisions to the look-through rules and other updates to reflect pre-Act statutory amendments; (4) the calculation of the exception from subpart F income for high-taxed income under section 954(b)(4); (5) the determination of deemed paid credits under section 960 and the gross up under section 78; and (6) the application of the election under section 965(n).

Explanation of Provisions

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

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

The Department of the Treasury (''Treasury Department'') and the Internal Revenue Service (''IRS'') have received comments suggesting that section 951A, in combination with section 904(d)(1)(A) (the ''section 951A category''), was intended to provide that the income of a United States shareholder derived through the CFC would be subject to additional U.S. tax if the foreign effective tax rate is below a particular rate, and should be effectively exempt from U.S. tax if the foreign effective tax rate is at or above that rate. These comments generally cite language in H.R. Rep. 115–466 (2017) (the ''Conference Report'') illustrating that no U.S. ''residual tax'' applies to foreign earnings subject to a foreign effective tax rate of 13.125 percent or more.

Allocated expenses may reduce the amount of section 951A category income included in U.S. taxable income below the amount of the foreign base on which the CFC paid at least a 13.125 percent foreign effective tax rate, with the effect that the United States shareholder's foreign taxes deemed paid may exceed the pre-credit U.S. tax on its section 951A category income, resulting in excess credits that may not offset U.S. tax on other income. This result flows from the fact that the foreign tax credit limitation under section 904 is calculated with respect to the pre-credit U.S. tax on the shareholder's net foreign source taxable income in each separate category. The comments nevertheless suggest that taxpayers' inability to reduce U.S. tax on non-section 951A category income (such as U.S. source income) with the excess credits is tantamount to imposing U.S. ''residual tax'' on section 951A category income, even though the actual U.S. tax liability on that income, as reduced by foreign tax credits, is zero. The comments suggest that in order to assure full utilization of foreign tax credits associated with section 951A category income that is subject to a foreign effective tax rate of 13.125 percent or greater, no expenses should be allocated and apportioned to the section 951A category income.

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

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

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

Many of the existing expense allocation rules have not been significantly modified since 1988. Furthermore, for taxable years beginning after December 31, 2020, a worldwide affiliated group will be able to elect to allocate and apportion interest expense on a worldwide basis. *See* section 864(f). The Treasury Department and the IRS expect the implementation of section 864(f) will have a significant impact on the effect of interest expense apportionment and will necessitate a reexamination of the existing expense allocation rules.

Therefore, the Treasury Department and the IRS expect to reexamine the existing approaches for allocating and apportioning expenses, including in particular the apportionment of interest, research and experimentation (''R&E''), stewardship, and general & administrative expenses, as well as to reexamine the ''CFC netting rule'' in § 1.861–10(e). The Treasury Department and the IRS request comments with respect to specific revisions to the regulations that should be made in connection with this review.

Part I.A of this Explanation of Provisions describes proposed changes to the rules addressing exempt income and assets, including the application of those rules in the context of the deduction under section 250. Part I.B of this Explanation of Provisions describes rules to address the allocation and apportionment of the deduction under section 250 and clarifying changes to the allocation and apportionment of certain other deductions. Part I.C of this Explanation of Provisions describes a new rule addressing loans to partnerships by certain partners and their affiliates. Part I.D of this Explanation of Provisions describes a revision to the CFC netting rule. Part I.E of this Explanation of Provisions describes rules for the valuation of assets, including stock, for purposes of allocating and apportioning deductions. Part I.F of this Explanation of Provisions describes rules for characterizing the stock of certain foreign corporations for purposes of allocating and apportioning deductions. Part I.G of this Explanation of Provisions describes rules for certain elections relating to the allocation and apportionment of R&E expenditures. Part I.H of this Explanation of Provisions describes rules for applying section 904(b)(4).

A. Changes and Clarifications to Definitions of Exempt Income and Exempt Asset

Section 864(e)(3) provides that, for purposes of allocating and apportioning any deductible expense, any tax-exempt asset (and any income from the asset) is not taken into account. Section 864(e)(3) also provides that a similar rule applies for the portion of any dividend equal to the deduction allowable under section 243 or 245(a) with respect to the dividend and the like portion of any stock the dividends on which would be so deductible. Section 864(e)(3) was not modified by the Act.

The Treasury Department and the IRS are aware that some taxpayers have taken the position that under § 1.861–8T(d)(2)(ii) assets or income that are partially exempt, excluded, or eliminated may be treated as entirely exempt. This interpretation is inconsistent with section 864(e)(3). The proposed regulations revise the definitions of exempt income and exempt asset to clarify that income or assets are treated as exempt (or partially exempt) under section 864(e)(3) only to the extent that the income or the income from the assets are, or are treated as, exempt, excluded, or eliminated. Proposed § 1.861–8(d)(2)(ii)(A).

New section 250(a)(1) allows a domestic corporate shareholder a deduction (the ''section 250 deduction'') equal to portions of its foreign-derived intangible income (''FDII''), GILTI inclusion, and the amount treated as a dividend under section 78 that is attributable to its GILTI inclusion. Because the section 250 deduction effectively exempts a portion of certain income, the proposed regulations provide that for purposes of applying the expense allocation and apportionment rules, the gross income offset by the section 250 deduction is treated as exempt income, and the stock or other asset giving rise to that income is treated as a partially exempt asset. *See* Senate Committee on Finance, Explanation of the Bill, S. Prt. 115–20, at 376 n.1210 (November 22, 2017) (''The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax.''). This rule does not apply for purposes of determining the amount of the foreign derived intangible income in applying section 250 as the operative section. No inference is intended regarding whether the section 250 deduction is treated as giving rise to exempt income or assets for any other purpose of the Code other than for purposes of the allocation and apportionment of deductions under §§ 1.861–8 through 1.861–17.

Under proposed § 1.861–8(d)(2)(ii)(C)(*1*), a portion of a domestic corporation's gross income that is FDII or results from a GILTI inclusion (and the corresponding section 78 gross up) is treated as exempt income based on the amount of the section 250 deduction allowed to the United States shareholder under section 250(a)(1). Similarly, the value of a domestic corporation's assets that produce FDII or GILTI is reduced to reflect the fact that the income from the assets is treated in part as exempt. Proposed § 1.861–8(d)(2)(ii)(C)(*2*).

The amount of the section 250 deduction used to determine the amount of gross income that is exempt is reduced to the extent section 250(a)(2)(B) requires a reduction to the amount of the deduction. Therefore, proposed § 1.861–8(d)(2)(ii)(C) does not apply to treat income or assets as exempt if the domestic corporation is not allowed a deduction under section 250(a)(2), even though the domestic corporation may have FDII or a GILTI inclusion.

A special rule is provided in proposed § 1.861–8(d)(2)(ii)(C)(*2*)(*ii*) to determine the portion of CFC stock that gives rise to a GILTI inclusion that is treated as exempt. The rule provides that a portion of CFC stock owned by a domestic corporation that is a United States shareholder of the CFC is treated as exempt based on a fraction equal to the amount of the section 250 deduction allowed to the domestic corporation under section 250(a)(1)(B)(i) (taking into account the reduction, if any, required under section 250(a)(2)(B)(ii)), divided by the domestic corporation's GILTI inclusion. In general, the fraction is applied to the portion of the CFC stock that is treated as giving rise to a GILTI inclusion and that is not assigned to a section 245A subgroup, as determined under the rules in proposed § 1.861–13. *See* Part I.F.1 and I.H of this Explanation of Provisions. To the extent the domestic corporation is allowed a section 250 deduction for an amount under section 250(a)(1)(B) (because the domestic corporation has a GILTI inclusion), the proposed regulations treat a portion of the stock of a CFC with respect to which the domestic corporation is a United States shareholder as exempt even if the CFC has a tested loss for the taxable year.

Section 245A(a) allows domestic corporate shareholders a deduction equal to the foreign-source portion of dividends received from certain foreign corporations (the ''section 245A deduction''), subject to certain limitations described in section 246. Although section 864(e)(3) contemplates that dividends described in sections 243 and 245(a) are treated similarly to exempt income to the extent of the deductions allowed under those sections, section 864(e)(3) does not apply to the dividend income reduced by the section 245A deduction. Instead, section 904(b)(4) provides for alternative adjustments. *See* Part I.H.2 of this Explanation of Provisions for a discussion of the different approaches under section 864(e)(3) and 904(b)(4). Proposed § 1.861–8(d)(2)(iii)(C) clarifies that the section 245A deduction does not give rise to exempt income. Similarly, no asset is treated as an exempt asset by reason of the section 245A deduction. Different treatment is provided under § 1.861–8T(d)(2)(ii)(B) for dividends received deductions under sections 243 and 245 because section 864(e)(3) specifically provides that similar rules to the exempt asset and income rules apply to those deductions.

Finally, the proposed regulations confirm in proposed § 1.861–8(d)(2)(iv) that earnings and profits excluded from income under section 959 (''previously taxed earnings and profits'') do not result in any portion of the stock in a CFC being treated as an exempt asset. Under §§ 1.861–12 and 1.861–12T, stock in a CFC is characterized by reference to the income generated each year by the CFC's assets. Previously taxed earnings and profits are not a type of income that is generated during the taxable year by a CFC's assets; rather, the CFC's assets, whether acquired with previously taxed or non-previously taxed earnings and profits or with another source of funds, generate income used to characterize the stock. For the avoidance of doubt, proposed § 1.861–8(d)(2)(iv) confirms that the fact that a CFC has previously taxed earnings and profits does not result in any portion of the CFC's stock being treated as an exempt asset under section 864(e)(3).

B. Allocation and Apportionment of Foreign Income Taxes, the Section 250 Deduction, and a Distributive Share of Partnership Deductions

Section 1.861–8(e) provides rules for allocating and apportioning certain deductions. Section 1.861–8(e)(6) provides rules for the allocation and apportionment of deductions for state, local, and foreign income, war profits and excess profits taxes. In the case of deductions for foreign income, war profits and excess profits taxes, the allocation and apportionment rules under § 1.861–8(e) are intended to be consistent with the principles of § 1.904–6. The proposed regulations clarify this result by expressly incorporating the principles of § 1.904–6(a)(1)(i), (ii), and (iv) in allocating and apportioning taxes to the relevant statutory and residual groupings (and not just to separate categories of income for purposes of determining the foreign tax credit limitation).

The proposed regulations include rules for allocating and apportioning the section 250 deduction. For these purposes, although the section 250 deduction is a single deduction that equals the sum of the amounts specified in section 250(a)(1)(A) and (B), the proposed regulations provide separate rules with respect to (i) the portion of the section 250 deduction for FDII and (ii) the portion of the section 250 deduction for the GILTI inclusion and the amount of the section 78 gross up attributable to foreign taxes deemed paid with respect to the GILTI inclusion. The amount of each portion of the section 250 deduction to be allocated and apportioned takes into account any reductions required under section 250(a)(2)(B).

Under proposed § 1.861–8(e)(13), the portion of the section 250 deduction for FDII is treated as definitely related and allocable to the specific class of gross income that is included in the taxpayer's foreign-derived deduction eligible income (as defined in section 250(b)(4)). Although foreign-derived deduction eligible income is an amount net of expenses, the class is determined based solely on the gross income that is used to calculate foreign-derived deduction eligible income. In cases where the income is allocated to a class that contains multiple categories under section 904(d) or U.S. source income, the deduction is apportioned ratably based on the relative amounts of gross income in the different income groupings.

Proposed § 1.861–8(e)(14) provides a similar rule for the portion of the section 250 deduction allowed for the GILTI inclusion and the corresponding section 78 gross up. In certain cases, gross income from the GILTI inclusion could be in a grouping other than the grouping for section 951A category income (for example, because it is U.S. source or passive category income). In such cases, the deduction for the GILTI inclusion and the section 78 gross up is apportioned ratably based on the relative amounts of gross income in the different income groupings.

The proposed regulations also clarify the general rule for allocating and apportioning a taxpayer's distributive share of partnership deductions. Proposed § 1.861–8(e)(15) provides that if a taxpayer is a partner in a partnership, the taxpayer's deductions that are allocated and apportioned include the taxpayer's distributive share of the partnership's deductions.

C. Special Rule for Specified Partnership Loans

The Treasury Department and the IRS are aware that certain loans made to a partnership by a United States person, or a member of its affiliated group, that owns an interest (directly or indirectly) in the partnership can result in a distortion in the determination of the foreign tax credit limitation under section 904 when the same person takes into account both a distributive share of the interest expense and the interest income with respect to the same loan. This result occurs due to differences in the rules that govern the source and separate category of the interest income and those that govern the allocation and apportionment of interest expense. To prevent the distortive effect of these differences, proposed § 1.861–9(e)(8)(ii) generally provides that, to the extent the lender in a specified partnership loan transaction takes into account both interest expense and interest income with respect to the same loan, the interest income is assigned to the same statutory and residual groupings as those groupings from which the interest expense is deducted, as determined under the allocation and apportionment rules in §§ 1.861–9 through 1.861–13. Additionally, proposed § 1.861–9(e)(8)(i) provides that, for purposes of applying the allocation and apportionment rules, a portion of the loan is not taken into account as an asset of the lender based on the ratio of the portion of the interest income included by the lender that is subject to this matching rule to the total amount of interest income included by the lender with respect to the loan in the taxable year. The proposed regulations include anti-avoidance rules to extend these provisions to certain back-to-back loans or loans made through CFCs. *See* proposed § 1.861–9(e)(8)(iii) and (iv). The proposed regulations also apply the specified partnership loan rules to transactions that are not loans but that give rise to deductions that are allocated and apportioned in the same manner as interest expense under § 1.861–9T(b). Proposed § 1.861–9(e)(8)(v).

D. Revision to CFC Netting Rule Relating to Hybrid Debt

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

E. Valuation of Assets for Purposes of Apportioning Interest Expense and Other Deductions

1. Repeal of Fair Market Value Method and Transition Relief

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

For purposes of determining asset values, an average of values within each statutory grouping is computed for the year on the basis of the values of assets at the beginning and end of the year. *See* § 1.861–9T(g)(2)(i)(A). The Treasury Department and the IRS understand that taxpayers previously using the fair market value method may not have had an independent reason to calculate the adjusted tax basis of their assets as of the beginning of their first post-2017 taxable year as required by the tax book value and alternative tax book value methods. To provide transitional relief, the proposed regulations provide in § 1.861–9(g)(2)(i) that for the first taxable year beginning after December 31, 2017, a taxpayer that had been using the fair market value method may choose to determine asset values using an average of the end of the first quarter and the year-end values of its assets, provided that all the members of an affiliated group (as defined in § 1.861–11T(d)) make the same choice and no substantial distortion would result.

The amendments made to section 864(e)(2) by the Act repealed the fair market value method only for purposes of allocating and apportioning interest expense. Accordingly, the fair market value method and the rules in § 1.861–9(h) remain applicable for non-interest expenses that are properly apportioned on the basis of the relative fair market values of assets.

2. Clarification of Rules for Adjusting Stock Basis in Nonaffiliated 10 Percent Owned Corporations for Earnings and Profits

Under section 864(e)(4)(A) and § 1.861–12(c)(2)(i)(A), for purposes of apportioning expenses on the basis of the tax book value of assets, certain adjustments are made to the adjusted basis of stock in a 10 percent owned corporation based on the earnings and profits (or deficits in earnings and profits) of the corporation attributable to the stock. The Treasury Department and the IRS are aware that some taxpayers have taken the position that the adjustment to basis for earnings and profits under § 1.861–12T(c)(2) does not include previously taxed earnings and profits. This interpretation is inconsistent with the text and purpose of section 864(e)(4) and § 1.861–12(c)(2). The adjustment under section 864(e)(4) is intended to better approximate the value of stock. *See* Joint Committee on Tax'n, General Explanation of the Tax Reform Act of 1986 (Pub. L. 99–514) (May 4, 1987), JCS–10–87, at p.87. Whether or not certain earnings and profits are reclassified from earnings described in section 959(c)(3) to previously taxed earnings and profits has no bearing on the value of the stock. Therefore, the proposed regulations confirm that previously taxed earnings and profits are taken into account for purposes of the adjustment described in § 1.861–12(c)(2). In addition, the proposed regulations clarify that the reference to the ''rules of section 1248'' in § 1.861–12T(c)(2)(i)(B) is intended to provide rules for determining the pro rata share of earnings and profits attributable to the taxpayer's shares, and is not relevant to determining the amount of the foreign corporation's earnings and profits subject to the adjustment, which is governed by the rules in sections 964(a) and 986. Proposed § 1.861–12(c)(2)(i)(B)(*2*).

The Treasury Department and the IRS are also aware that taxpayers have expressed uncertainty as to which values are used for averaging beginning and year-end values in the case of 10 percent owned corporations whose stock basis is adjusted under § 1.861–12(c)(2) (including rules described in § 1.861–12T(c)(2)), which, in general, first eliminates any additions to basis on account of previously taxed earnings and profits made under sections 961 and 1293(d), and then increases or decreases adjusted basis by the shareholder's pro rata share of total earnings and profits. The proposed regulations clarify in proposed § 1.861–9(g)(2)(i)(B) that the beginning and end-of-year values of stock are determined without regard to any adjustments under section 961(a) or 1293(d), and before making the adjustment for earnings and profits provided in § 1.861–12(c)(1)(i)(A). The adjustment for total earnings and profits provided in § 1.861–12(c)(1)(i)(A) is only made after the average of the beginning and end of year values has been determined.

3. Determination of Stock Basis in Connection With Section 965(b)

In Part VII.D of the Explanation of Provisions of the notice of proposed rulemaking for the regulations under section 965, *see* 83 FR 39,531, the Treasury Department and the IRS acknowledged that the application of section 965(b)(4)(A) and (B) may warrant the issuance of special rules for the determination of adjusted basis. For example, if the increase in earnings and profits under section 965(b)(4)(B) and § 1.965–2(d)(2) is taken into account for purposes of determining the increase to adjusted basis under § 1.861–12(c)(2)(i)(A), and there is no corresponding reduction to the adjusted basis in the stock of the foreign corporation, the tax book value of the stock would be overstated by the amount of the increase.

If a shareholder elects to make the basis adjustments under proposed § 1.965–2(f)(2)(i), the tax book value of the stock of its foreign corporations that were specified foreign corporations (as defined in § 1.965–1(f)(45)) will generally reflect the proper adjusted basis amounts as long as any amounts included in basis under proposed § 1.965–2(f)(2)(ii)(A) are treated similarly to adjustments under section 961 and not included in the taxpayer's basis in stock under § 1.861–12T(c)(2)(i)(B). Accordingly, proposed § 1.861–12(c)(2)(i)(B)(*1*)(*ii*) provides that, for purposes of § 1.861–12(c)(2), a taxpayer determines the basis in the stock of a specified foreign corporation as if it had made the election under § 1.965–2(f)(2)(i), even if the taxpayer did not in fact make the election, but does not include the amount included in basis under § 1.965–2(f)(2)(ii)(A) (because the amount of that increase would not be included if the increase was by operation of section 961). For this purpose, the amount included in basis under proposed § 1.965–2(f)(2)(ii)(A) is determined without regard to whether any portion of the amount is netted against other basis adjustments under proposed § 1.965–2(h)(2). Proposed § 1.861–12(c)(2)(i)(B)(*1*)(*ii*) applies to the taxable year of the inclusion under section 965 as well as to future taxable years.

The Treasury Department and the IRS request comments on alternative ways to account for section 965(b) that minimize taxpayer burdens without distorting the measurement of a CFC's tax book value.

F. Characterization of Stock of Certain Foreign Corporations Under § 1.861–12

1. Characterization of CFC Stock To Account for Section 951A Category, Treaty Categories, and Section 904(b)(4)

Section 1.861–12 provides special rules for applying the asset method in order to apportion expenses to the separate categories in computing the foreign tax credit limitation. The proposed regulations clarify in § 1.861–12(a) that § 1.861–12 also applies in apportioning expenses among statutory and residual groupings for operative sections other than section 904.

Special rules are provided in § 1.861–12T(c) regarding the treatment of stock, including stock in 10 percent owned corporations (as defined in § 1.861–12T(c)(2)(ii)) and stock in CFCs. The purpose of the stock characterization rules of § 1.861–12T(c) is to characterize the stock by reference to the income which the stock generates to its owner. With respect to CFCs, the rules generally look through to the income generated by the assets of the CFC for purposes of characterizing the stock of the CFC. Before the Act, the income earned by the CFC was generally assigned to the same separate category to which that income would be assigned if earned directly by the United States shareholder because the categories of income of a CFC and U.S. person were the same, and the look-through rules under section 904(d)(3) generally applied to ensure that once income was assigned to a separate category, the category of the income was maintained when the income was paid or distributed by the CFC to its owner or taken into account as an inclusion by the owner.

As described in Part II.B.3 of this Explanation of Provisions, the new separate category for section 951A category income applies only to an inclusion by a United States person of gross income under section 951A(a). Accordingly, gross tested income of a CFC is generally assigned to the general category, even though the stock of the CFC may give rise to a GILTI inclusion that is section 951A category income in the hands of a United States shareholder. Therefore, § 1.861–12T(c) would not result in characterizing any of the stock of the CFC as a section 951A category asset because the tested income of the CFC is assigned to the general category, even though the related income included by the United States shareholder is assigned to the section 951A category. Accordingly, the proposed regulations in § 1.861–13 provide special rules to account for the fact that, with respect to the section 951A category, the application of § 1.861–12T(c) to determine the income of the CFC or the income generated by the assets of the CFC does not, on its own, reflect the separate category of the income generated by the stock of the CFC to the United States shareholder. The proposed regulations also address a similar issue that arises when a CFC earns U.S. source income that is included under section 951(a) or 951A(a) in gross income of a United States shareholder who elects under an income tax treaty to treat the inclusion as foreign source income, resulting in separate category treatment for income resourced under a tax treaty (a ''treaty category''). *See* section 904(h). Proposed § 1.861–13 applies solely for purposes of characterizing stock when section 904 is the operative section.

Under proposed § 1.861–13, a taxpayer first determines the amount of the stock of a CFC that is characterized in each of the statutory groupings described in § 1.861–13(a)(1) under the asset method or the modified gross income method. Under the modified gross income method, stock of a CFC may be characterized as producing general category gross tested income even though the CFC has a tested loss. *See* proposed § 1.861–13(a)(1)(ii).

Next, a portion of the stock characterized as producing general category gross tested income is assigned to the section 951A category. Only a portion of the stock so characterized is assigned to the section 951A category because the amount of the GILTI inclusion by the United States shareholder may be less than the aggregate tested income of its CFCs because of offsets from another CFC's tested loss or because of a reduction for net deemed tangible income return described in section 951A(b)(2). The inclusion percentage, as defined in section 960(d)(2), takes into account the percentage of net CFC tested income that is not included under section 951A(a) due to tested losses or the net deemed tangible income return. Accordingly, proposed § 1.861–13(a)(2) assigns a United States shareholder's stock in a CFC generating gross tested income to the section 951A category based on the United States shareholder's inclusion percentage as determined under § 1.960–2(c)(2). In general, earnings and profits related to the gross tested income that is not included under section 951A(a), when distributed, result in dividend income that is assigned to the general category.

The use of the inclusion percentage to assign stock to the section 951A category applies regardless of whether the stock of the CFC produces tested income or a tested loss for the year, in order to reflect the aggregate nature of the calculation of a United States shareholder's GILTI inclusion. Stock of a CFC is generally assigned to the statutory grouping for gross tested income, under either the asset or modified gross income methods described in proposed § 1.861–12(c)(3), if the CFC's assets generate gross tested income or if the CFC earns gross tested income, even if the CFC ultimately produces a tested loss for the taxable year. However, a United States shareholder with no GILTI inclusion for a taxable year has an inclusion percentage of zero, and therefore none of the stock of its CFCs is assigned to the section 951A category in that year.

Under proposed § 1.861–13(a)(3), a similar rule applies for characterizing stock as a treaty category asset if stock of a CFC is assigned to the statutory grouping for gross tested income that was resourced under a treaty. The portion of the stock of the CFC that is assigned to a treaty category is based on the United States shareholder's inclusion percentage. In the case of stock of a CFC initially assigned to the statutory groupings for gross subpart F income that is resourced under a treaty, all of that stock is assigned to a treaty category.

Finally, in the case of stock of a CFC assigned to the general and passive categories or the residual grouping for U.S. source income, proposed § 1.861–13(a)(5) provides rules for subdividing the categories or groupings into a section 245A subgroup and non-section 245A subgroup for purposes of applying section 904(b)(4). See Part I.H of this Explanation of Provisions for a description of the regulations under section 904(b)(4). In general, these rules provide that the portion of stock that does not generate income that is included under section 951A(a) or 951(a)(1) and does not represent income described in section 245(a)(5) (which gives rise to a dividends received deduction under section 245 instead of section 245A) is assigned to the section 245A subgroup.

2. Treatment of Gross Tested Income for Tiers of CFCs

Both the asset method and modified gross income method described in § 1.861–12T(c)(3) provide rules to characterize stock in a CFC when there are tiers of CFCs. Under the modified gross income method in § 1.861–12T(c)(3)(iii), a taxpayer characterizes the value of the first-tier CFC based on the gross income net of interest expense of the CFC within each relevant separate category. In the case of vertically-owned CFCs, gross income of any higher-tier CFC includes the gross income net of interest expense of any lower-tier CFC, but does not include subpart F income of any lower-tier CFC. *See* § 1.861–9T(j)(2). However, § 1.861–12T(c)(3)(iii) provides that for purposes of applying the modified gross income method to characterize CFC stock, the gross income of the first-tier CFC includes the total amount of subpart F income (net of interest expense apportioned at the level of the CFC that earned the income) of any lower-tier CFC.

The proposed regulations add similar rules for GILTI inclusions. In particular, the proposed regulations provide in §§ 1.861–9(j)(2)(ii)(C) and 1.861–12(c)(3)(iii) that for purposes of characterizing CFC stock under the modified gross income method, the gross tested income of lower-tier CFCs, net of interest expense apportioned to the tested income, is excluded from the gross income of intermediate-tier CFCs but is included in the gross income of the first-tier CFC. The Treasury Department and the IRS request comments on whether additional rules are required to account for gross tested income earned in lower-tier CFCs, including gross tested income of lower-tier CFCs that produce tested losses.

3. Characterization of Stock of a Noncontrolled 10-Percent Owned Foreign Corporation

To reflect the repeal of section 902, the Act modifies section 904(d)(2)(E) to provide a new definition for a noncontrolled 10-percent owned foreign corporation. The proposed regulations modify § 1.861–12(c)(4) to provide that stock in a noncontrolled 10-percent owned foreign corporation is generally characterized under the same rules previously used for noncontrolled section 902 corporations.

G. Allocation and Apportionment of Research and Experimental Expenditures

In general, R&E expenditures are apportioned between groupings within product categories according to either a sales or gross income method of apportionment at the taxpayer's election. § 1.861–17(c) and (d). Under § 1.861–17(e)(1), a taxpayer may choose to use either the sales method or gross income method for its original return for its first taxable year. The taxpayer's use of either method constitutes a binding election to use the method chosen for that year and for the subsequent four years. Within this five-year period, the election can only be revoked with the Commissioner's consent. A taxpayer may change the election at any time after five years, but the new election is binding for a new five-year period. § 1.861–17(e)(2).

In light of the numerous amendments to the foreign tax credit rules made by the Act, the proposed regulations provide a one-time exception to the five-year binding election period. Accordingly, under proposed § 1.861–17(e)(3), even if a taxpayer is subject to the binding election period, for the taxpayer's first taxable year beginning after December 31, 2017, the taxpayer may change its apportionment method without obtaining the Commissioner's consent. This one-time change of method constitutes a binding election to use the method chosen for that year and for the next four taxable years.

The Treasury Department and the IRS request comments on whether other aspects of § 1.861–17 should be revised in light of the changes to section 904(d), in particular the addition of the section 951A category. For example, because the look-through rules in section 904(d)(3)(C) do not assign interest, rents, or royalties that reduce tested income to the section 951A category, royalties paid by a CFC to a United States shareholder are generally general category income even though the sales by the CFC to which the royalties relate may generate income in the section 951A category to the United States shareholder. This could result in R&E expenditures being apportioned under the sales method solely to the section 951A category, even though the royalty income is assigned to the general category. However, under the gross income method, R&E expenditures would be apportioned to both the general and section 951A category. Comments are requested on whether and how the regulations governing either or both methods should be revised to account for the addition of the section 951A category.

H. Section 904(b)(4)

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

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

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

2. Income Other Than Amounts Includible Under Section 951(a)(1) or 951A(a)

Section 904(b)(4)(B) requires determining what income with respect to stock of a specified 10-percent owned foreign corporation is income ''other than amounts includible under section 951(a)(1) or 951A(a).'' The terms used in section 904(b)(4) are defined by reference to definitions provided in section 245A.

As discussed in Part I.A of this Explanation of Provisions, with respect to other dividends received deductions, section 864(e)(3) provides that rules similar to the exempt income and exempt asset rules apply to the dividends and stock on which the dividends are paid. The Act did not extend this treatment to the section 245A deduction but instead added section 904(b)(4). In contrast to section 864(e)(3), which removes the exempt income and assets from the determination before deductions are allocated and apportioned under the rules of §§ 1.861–8 through 1.861–17, section 904(b)(4) provides that the deductions are disregarded after they have been allocated and apportioned. Disregarding the deductions after they have been allocated and apportioned is consistent with a policy that the deductions are properly allocable and apportioned to income eligible for a section 245A deduction and, therefore, should not be apportioned to income in other separate categories or U.S. source income. By disregarding these deductions, section 904(b)(4) has the effect of computing the foreign tax credit limitation fraction in section 904(a) (but not the pre-credit U.S. tax) as if the deductions had not been allowed.

The proposed regulations provide that income ''other than amounts includible under section 951(a)(1) or 951A(a)'' refers to income for which a section 245A deduction is allowed. Thus, in the case of section 904(b)(4)(B)(i), proposed § 1.904(b)–3(c)(1) provides that income for which a section 245A deduction is allowed means dividends for which a section 245A deduction is allowed. In the case of section 904(b)(4)(B)(ii), proposed § 1.904(b)–3(c)(1) and (2) provide rules for determining what amount of stock of the foreign corporation corresponds to income that, if distributed, is generally eligible for a section 245A deduction, by subdividing a portion of the stock into a section 245A subgroup and a non-section 245A subgroup within each separate category.

3. Expenses Properly Allocable to Dividend Income

Proposed § 1.904(b)–3(a)(1)(ii) provides that deductions ''properly allocable'' to dividends for which a section 245A deduction is allowed are disregarded. The amount of properly allocable deductions is determined by treating each section 245A subgroup for each separate category as a statutory grouping under § 1.861–8(a)(4) for purposes of allocating and apportioning deductions. Only dividend income for which a section 245A deduction is allowed is included in a section 245A subgroup. *See* § 1.904(b)–3(b) and (c)(1). Because hybrid dividends described in section 245A(e)(4), and dividends on stock with respect to which the holding period requirements of section 246(c) are not met, are ineligible for a deduction under section 245A, the dividends and the deductions allocable or apportioned to them are not disregarded under section 904(b)(4).

The deductions allocated and apportioned to the section 245A subgroup within each separate category are disregarded for purposes of determining the foreign source taxable income in the separate category and the entire taxable income included in the fraction under section 904(a) for all separate categories. Deductions allocated and apportioned to the section 245A subgroup within the residual grouping for U.S. source income are disregarded solely for purposes of determining the denominator of the limitation fraction (worldwide taxable income) in the separate categories that have foreign source taxable income. Proposed § 1.904(b)–3(a)(2). Dividends in the residual grouping for which a section 245A deduction is allowed could include, for example, dividends from a United States-owned foreign corporation (as defined in section 904(h)(6)) paid out of U.S. source income that is neither effectively connected income nor dividend income received from a domestic corporation. *See* sections 245A(c)(3) and 245(a)(5).

Proposed § 1.904(b)–3(b) also provides that the section 245A deduction is always allocated solely to a section 245A subgroup and therefore is always disregarded under section 904(b)(4).

4. Expenses Properly Allocable to Stock

In order to determine the deductions ''properly allocable'' to stock of a specified 10-percent owned foreign corporation that is in the section 245A subgroup, the stock is first characterized for purposes of allocating and apportioning expenses under § 1.861–12 and, if applicable, § 1.861–13. In the case of a specified 10-percent owned foreign corporation that is not a CFC, all of the value of its stock is generally in a section 245A subgroup because the stock cannot generate an inclusion under section 951(a)(1) or 951A(a). Proposed § 1.904(b)–3(c)(2). If the specified 10-percent owned foreign corporation is a CFC, a portion of the value of stock in each separate category and in the residual grouping for U.S. source income is subdivided between a section 245A and non-section 245A subgroup under the rules described in § 1.861–13(a)(5). *See* Part I.F.1 of this Explanation of Provisions. The amount of properly allocable deductions is determined by treating the section 245A subgroup for each separate category as a statutory grouping under § 1.861–8(a)(4) for purposes of allocating and apportioning deductions on the basis of assets, which include the stock.

Previously taxed earnings and profits do not affect the amount of expenses that are disregarded under section 904(b)(4). The characterization of stock in a specified 10-percent owned foreign corporation for purposes of section 904(b)(4)(B)(ii) is determined on an annual basis by applying the rules in § 1.861–12(c), which generally requires applying either the asset method or the modified gross income method. Whether or not the CFC has previously taxed earnings and profits, including from prior years or due to section 965, has no bearing on how either method is applied to characterize stock. *See also* proposed § 1.861–12(c)(2)(i)(B)(*2*).

5. Coordination With OFL/ODL Rules

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

II. Foreign Tax Credit Limitation Under Section 904

The proposed regulations update §§ 1.904–1 through 1.904–6 (the ''section 904 regulations'') to eliminate deadwood and reflect statutory amendments made to section 904 before the Act. For example, proposed §§ 1.904–1 through 1.904–3 reflect the repeal of the overall limitation and per-country limitation. Proposed § 1.904–4 reflects statutory amendments made before the Act eliminating various separate categories described in section 904(d)(1).

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

A. Transition Rules in Proposed §§ 1.904–2(j) and 1.904(f)–12(j) Accounting for the Increase in Section 904(d)(1) Separate Categories

1. Carryovers and Carrybacks of Unused Foreign Taxes Under Section 904(c)

The Act does not provide any transition rules for assigning carryforwards of unused foreign taxes earned in pre-2018 taxable years to a different separate category, including the new post-2017 separate categories for section 951A category income and foreign branch category income. Therefore, proposed § 1.904–2(j)(1)(ii) provides that if unused foreign taxes paid or accrued or deemed paid with respect to a separate category of income are carried forward to a taxable year beginning after December 31, 2017, those taxes are allocated to the same post-2017 separate category as the pre-2018 separate category from which the unused foreign taxes are carried.

However, double taxation may result if unused foreign taxes paid, accrued, or deemed paid in a pre-2018 taxable year are not assigned to the separate category to which the taxes would have been assigned if the new post-2017 separate categories had existed in the pre-2018 taxable year. This could arise, for example, if unused foreign taxes imposed on income derived through foreign branches in a pre-2018 taxable year are not associated with foreign branch category income. Matching the unused foreign taxes to the separate category that includes income of the same type as the income on which the taxes were imposed furthers the purpose of the section 904(c) foreign tax credit carryover rules to mitigate the effect of timing differences in the recognition of income for U.S. and foreign tax purposes that could otherwise result in double taxation. *See* H.R. Rep. No. 85–775, at 27 (1957).

Therefore, proposed § 1.904–2(j)(1)(iii) provides an exception that permits taxpayers to assign unused foreign taxes in the pre-2018 separate category for general category income to the post-2017 separate category for foreign branch category income to the extent they would have been assigned to that separate category if the taxes had been paid or accrued in a post-2017 taxable year. Any remaining unused taxes are assigned to the post-2017 separate category for general category income. The exception applies only to unused taxes that were paid or accrued, and not taxes that were deemed paid with respect to dividends or inclusions from foreign corporations, because income derived through foreign corporations cannot be foreign branch category income. *See* Part II.B.2 of this Explanation of Provisions.

Because the new post-2017 separate category for foreign branch category income does not include income that would have been passive category income or income in a separate category described in proposed § 1.904–4(m) that is not listed in section 904(d)(1) (a ''specified separate category'') if earned in a pre-2018 taxable year, the exception in proposed § 1.904–2(j)(1)(iii) applies only to unused foreign taxes that were paid or accrued with respect to income in the pre-2018 separate category for general category income. Furthermore, because the determination of taxable income in the section 951A category is intertwined with numerous other new provisions in the Code outside of section 904 that contain novel elements (such as the section 250 deduction and the new inclusion rules in section 951A that permit the sharing of tested losses among CFCs) that did not exist under prior law, it is not possible to reconstruct the amount of unused foreign taxes in a pre-2018 taxable year that would have been assigned to section 951A category income. Therefore, the reallocation exception in the proposed regulations does not require or allow taxpayers to assign any unused foreign taxes to the post-2017 separate category for section 951A category income, which is not eligible to be sheltered from U.S. tax by foreign tax credit carryovers. *See* section 904(c).

The proposed regulations require taxpayers applying the exception in § 1.904–2(j)(1)(iii) to analyze general category income earned in prior years in order to determine the extent to which the income would have been foreign branch category income under the rules described in proposed § 1.904–4(f). Unused foreign taxes in the general category arising in those prior years are then allocated and apportioned under § 1.904–6 between the general category and the foreign branch category. This analysis does not require applying any other post-Act provisions to prior years (for example, the new expense allocation rules described in the proposed regulations would not be relevant to the analysis).

The Treasury Department and the IRS recognize that taxpayers may face difficulties in reconstructing the allocation of unused foreign taxes. Therefore, the Treasury Department and the IRS request comments on whether the final regulations should include a simplified rule for taxpayers that choose to reconstruct the allocation of general category unused foreign taxes (for example, by looking to the relative amounts of foreign branch category and general category income or assets in the first post-2017 taxable year to which the unused foreign taxes are carried), what form such a rule should take, and whether there are any special concerns regarding members that have left a consolidated group. See, for example, § 1.904–7(f)(4)(ii).

All income included in the post-2017 separate category for foreign branch category income would have been general category income if earned in a pre-2018 taxable year. All income included in the post-2017 separate categories for general category income, passive category income, or income in a specified separate category would have been treated as general category income, passive category income, or income in a specified separate category, respectively, if earned in a pre-2018 taxable year. Accordingly, proposed § 1.904–2(j)(2)(ii) and (iii) provides that any unused foreign taxes with respect to general category income or foreign branch category income in a post-2017 taxable year that are carried back to a pre-2018 taxable year are allocated to the pre-2018 separate category for general category income, and any excess foreign taxes with respect to passive category income or income in a specified separate category in a post-2017 taxable year that are carried back to a pre-2018 taxable year are allocated to the same pre-2018 separate category. No rule is included with respect to the post-2017 separate category for section 951A category income (including a separate category for a GILTI inclusion that is resourced under a tax treaty), because carrybacks are not allowed for unused foreign taxes in that separate category.

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

Similar to the transition rules for carryovers and carrybacks of unused foreign taxes, the proposed regulations provide transition rules for recapture in a post-2017 taxable year of an overall foreign loss (OFL) or separate limitation loss (SLL) in a pre-2018 separate category that offset U.S. source income or income in another pre-2018 separate category, respectively, in a pre-2018 taxable year, as well as for recapture of an overall domestic loss (ODL) that offset income in a pre-2018 separate category in a pre-2018 taxable year.

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

B. Separate Categories of Income

1. Treatment of Export Financing Interest, High-Taxed Income, and Financial Services Income

Under section 904(d)(2)(B)(iii), passive income does not include export financing interest and high-taxed income. Before the Act, the only separate category described in section 904(d)(1) aside from passive category income was general category income, and therefore §§ 1.904–4(c) and (h)(2) treated export financing interest and high-taxed income as general category income.

Given the expansion of categories under section 904(d)(1) to include foreign branch category and section 951A category income, and the fact that section 904(d)(2)(B)(iii) only provides that export financing interest and high-taxed income are not passive income, the proposed regulations provide that export financing interest and high-taxed income should be categorized based on whether the income otherwise meets the definition of foreign branch category income, section 951A category income, or general category income. Therefore, the proposed regulations revise § 1.904–4(c) and (h)(2) to provide that export financing interest and high-taxed income are assigned to separate categories other than passive category income based on the general rules in § 1.904–4.

To coordinate the high-taxed income rules of section 904(d)(2)(F) with the new rules for computing foreign income taxes deemed paid under section 960 described in Part IV of this Explanation of Provisions, the proposed regulations revise the grouping rules of § 1.904–4(c)(4) to group passive category income from dividends, subpart F and GILTI inclusions from each foreign corporation, and passive category income derived from each foreign qualified business unit (QBU), under the grouping rules in § 1.904–4(c)(3) rather than by reference to the source of the corporation's or QBU's income. The Treasury Department and the IRS request comments on whether additional changes should be made to the high-taxed income rules in § 1.904–4(c) in light of changes to section 904(d) made by the Act.

Both before and after the Act, section 904(d)(2)(C)(i) provides that certain financial services income is treated as general category income. However, the Act's addition of foreign branch category and section 951A category income, which are new and more specific categories, take precedence over the treatment of financial services income as general category income. Therefore, the proposed regulations provide that any financial services income not treated as foreign branch category income or section 951A category income is generally treated as general category income. *See* proposed § 1.904–4(e).

The proposed regulations do not include any substantive changes to the definition of financial services entity in § 1.904–4(e)(3). It is intended that the current classification of an entity as a financial services entity is generally unaffected by the changes made by the proposed regulations to the look-through rules in § 1.904–5. However, the Treasury Department and the IRS are considering modifications to the gross income-based test for determining financial services entity status and request comments in this regard, particularly with respect to the appropriate treatment of related party payments.

2. Foreign Branch Category Income

i. Gross Income in the Category

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

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

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

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

First, the proposed regulations provide that gross income attributable to a foreign branch does not include items arising from activities carried out in the United States. Proposed § 1.904–4(f)(2)(ii).

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

Third, the proposed regulations provide that foreign branch category income does not include gain realized by a foreign branch owner on the disposition of an interest in a disregarded entity or an interest in a partnership or other pass-through entity. Proposed § 1.904–4(f)(2)(iv)(A). However, an exception is provided for the sale of a partnership interest if the gain is reflected on the books and records of a foreign branch and the interest is held in the ordinary course of the foreign branch owner's trade or business. Proposed § 1.904–4(f)(2)(iv)(B).

Fourth, the proposed regulations provide anti-abuse rules relating to the reflection of income on the books and records of a branch. The Treasury Department and the IRS are concerned that in certain cases gross income items could be inappropriately recorded on the books and records of a foreign branch or a foreign branch owner. Therefore, the proposed regulations include an anti-abuse rule providing for the reattribution of gross income if a principal purpose of recording, or failing to record, an item on the books and records of a foreign branch is the avoidance of Federal income tax or avoiding the purposes of section 904 or section 250. Proposed § 1.904–4(f)(2)(v). The rule further provides a presumption that interest income received by a foreign branch from a related party is not gross income attributable to the foreign branch unless the interest income meets the definition of financial services income.

Finally, in order to accurately reflect the gross income attributable to a foreign branch, a determination that affects not only the application of section 904(a) but also the determination of deduction eligible income under section 250(b)(3)(A), the proposed regulations provide that gross income attributable to a foreign branch that is not passive category income must be adjusted to reflect certain transactions that are disregarded for Federal income tax purposes. Proposed § 1.904–4(f)(2)(vi). This rule applies to transactions between a foreign branch and its foreign branch owner, as well as transactions between or among foreign branches, involving payments that would be deductible or capitalized if the payment were regarded for Federal income tax purposes. For example, a payment made by a foreign branch to its foreign branch owner may, to the extent allocable to non-passive category income, result in a downward adjustment to the gross income attributable to the foreign branch and an increase in the general category gross income of the United States person. Each payment in a series of disregarded back-to-back payments, for example, a payment from one foreign branch to another foreign branch followed by a payment to the foreign branch owner, must be accounted for separately under these rules. Comments are requested on whether special rules are required in the case of a true branch (generally, a branch that is taxable solely on profits from a business conducted in the country and not taxable as a resident of that country) with respect to amounts that are deemed to be made to or from the home office of the branch under the foreign jurisdiction's rules for attributing profits to the branch.

In general, the proposed regulations do not treat disregarded transactions as ''regarded'' for Federal income tax purposes; rather, they provide that certain disregarded transactions result in a redetermination of whether gross income of the United States person is attributable to its foreign branch or to the foreign branch owner. Thus, while disregarded transactions may allocate income between the foreign branch category and the general category, those transactions have no effect on the amount, character, or source of a United States person's gross income. U.S. source gross income that is reallocated from the general category to the foreign branch category and that is properly subject to foreign tax may be eligible to be treated as foreign source income under the terms of an income tax treaty, in which case the resourced income would be subject to a separate foreign tax credit limitation for income resourced under a tax treaty. *See* section 904(d)(6).

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

The Treasury Department and the IRS request comments on how adjustments relating to these transactions could be limited or simplified to reduce administrative and compliance burdens while still providing for an accurate categorization of gross income, consistent with the purpose of both sections 904 and 250(b)(3)(A). For example, comments are requested on whether these rules should be narrowed to cover a more limited set of transactions or whether disregarded payments should be netted before determining the amount of reallocation.

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

ii. Definition of a Foreign Branch

The proposed regulations define a foreign branch by reference to the regulations under section 989 (''section 989 regulations'') by providing that a foreign branch is a QBU described in § 1.989(a)–1(b)(2)(ii) and (b)(3) that carries on a trade or business outside the United States. Proposed § 1.904–

4(f)(3)(iii). In general, § 1.989(a)–1(b)(2)(ii) provides rules for treating activities of a branch of a taxpayer as a QBU. Specifically, it provides that the activities of a corporation, partnership, trust, estate, or individual qualify as a separate QBU if the activities constitute a trade or business, and a separate set of books and records is maintained with respect to the activities. Section 1.989(a)–1(b)(3) includes a special rule treating activities generating income effectively connected with the conduct of a trade or business as a separate QBU.

The section 989 regulations treat partnerships and trusts as *per se* QBUs. *See* § 1.989(a)–1(b)(2)(i). As a result, they do not include a rule treating the activities of a partnership or trust that constitute a trade or business, but for which a separate set of books and records is not maintained, as a QBU. For example, § 1.989(a)–1(b)(2)(ii) would not treat the activities of a partnership QBU as a QBU if no separate set of books is maintained with respect to the activities.

In order to ensure that foreign branch category income does not include income reflected on the books and records of a QBU unless the QBU conducts a trade or business, the proposed regulations' definition of foreign branch does not incorporate the section 989 regulations' *per se* QBU rules, and instead requires that a foreign branch carry on a trade or business. In addition, the proposed regulations include a special rule, as illustrated by an example, providing that a foreign branch may consist of activities conducted through a partnership or trust that constitute a trade or business conducted outside the United States, but for which no separate set of books and records is maintained. *See* § 1.904–4(f)(4)(i), *Example 1.*

The proposed regulations also modify the trade or business requirements in the section 989 regulations for purposes of the foreign branch definition. Specifically, to constitute a foreign branch, a QBU must carry on a trade or business outside the United States. For this purpose, activities that constitute a permanent establishment in a foreign country under a bilateral U.S. tax treaty, whether or not the activities also rise to the level of a separate trade or business, are presumed to constitute a trade or business. *See* proposed § 1.904–4(f)(3)(iii)(B).

Under § 1.989(a)–1(c), for activities to constitute a trade or business, they must ordinarily include the collection of income and the payment of expenses. The proposed regulations provide that, for purposes of determining whether a set of activities satisfy the trade or business requirement of § 1.989(a)–1(c) in the context of the definition of a foreign branch, activities that relate to disregarded transactions are taken into account and may give rise to a trade or business for this purpose. *See* proposed § 1.904–4(f)(3)(iii)(B).

3. Section 951A Category Income

Section 904(d)(1)(A) defines a new separate category as ''any amount includible in gross income under section 951A (other than passive category income).'' Consistent with that language, proposed § 1.904–4(g) provides that the gross income included in the section 951A category is generally the gross income of a United States shareholder from a GILTI inclusion. However, a GILTI inclusion that is allocable to passive category income under the look-through rules in § 1.904–5(c)(6) is excluded from section 951A category income. A passive category GILTI inclusion could arise, for example, from a CFC's distributive share of partnership income in which the CFC owns less than 10 percent of the value in the partnership. *See* proposed § 1.904–4(n)(1)(ii). Comments are requested on whether the rules treating a less than 10 percent partner's distributive share of partnership income as passive category income should be modified.

In addition, the proposed regulations amend § 1.904–2(a) to reflect the exclusion of foreign tax credit carryovers under section 904(c) for foreign taxes paid or accrued with respect to section 951A category income or with respect to section 951A category income that is treated as income in a separate category for income resourced under a tax treaty.

4. Items Resourced Under a Treaty

Legislation commonly referred to as the Education Jobs and Medicaid Assistance Act (EJMAA), enacted on August 10, 2010, added section 904(d)(6), which, as amended by the Tax Cuts and Jobs Act, provides that if, without regard to any treaty obligation of the United States, any item of income would be treated as derived from sources within the United States, under a treaty obligation of the United States the item of income would be treated as arising from sources outside the United States, and the taxpayer chooses the benefits of the treaty obligation to treat the income as arising from sources outside the United States, then subsections 904(a), (b), and (c) and sections 907 and 960 shall be applied separately with respect to each item. Thus, section 904(d)(6)(A) applies a separate foreign tax credit limitation to each item of resourced income, without regard to the separate category to which the item would otherwise be assigned.

i. Grouping Methodology

Proposed § 1.904–4(k)(2) adopts a grouping methodology similar to that employed in § 1.904–5(m)(7) with respect to income treated as in a separate category under the separate treaty resourcing rules of section 904(h)(10). Under the proposed regulations, the taxpayer must segregate income treated as foreign source under each treaty and then compute a separate foreign tax credit limitation for income in each separate category that is resourced under that treaty.

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

ii. Coordination With Certain Treaty and Code Provisions

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

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

In addition, under the mutual agreement procedures of U.S. income tax treaties, U.S. taxpayers may request assistance from the U.S. competent authority, such as for the relief of double taxation in cases not provided for in the treaty. Where the U.S. competent authority agrees to grant relief to a taxpayer that involves resourcing, the taxpayer has effectively chosen the benefit of a treaty obligation of the United States to treat the item of income as foreign source. Accordingly, proposed § 1.904–4(k)(4)(ii) clarifies that section 904(d)(6) separate category treatment applies to items of income resourced pursuant to a competent authority agreement.

5. Section 78 Gross Up and Section 986(c) Gain or Loss

Numerous comments were received requesting guidance on the appropriate separate category to which the gross up described in section 78 attributable to foreign taxes deemed paid under section 960(d) should be assigned. Proposed § 1.904–4(o) provides a rule consistent with existing § 1.904–6(b)(3) that assigns the gross up to the same separate category as the deemed paid taxes. See Part II.E.3 of this Explanation of Provisions for a description of rules for allocating and apportioning deemed paid taxes to separate categories.

Proposed § 1.904–4(p) also provides a rule assigning gain or loss under section 986(c) with respect to a distribution of previously taxed earnings and profits to the separate category from which the distribution was made.

C. Noncontrolled 10-Percent Foreign Corporation

Under section 904(d)(2)(E) as amended by the Act, the term ‘‘noncontrolled section 902 corporation’’ has been revised to ‘‘noncontrolled 10-percent owned foreign corporation.’’ The definition has also been amended to reflect the repeal of section 902, but maintains pre-Act rules for when a taxpayer meets the requisite stock ownership with respect to a passive foreign investment company (‘‘PFIC’’). The proposed regulations update the references in the section 904 regulations to noncontrolled section 902 corporations to reflect the revised statutory term and definition.

The ownership requirement for PFICs differs from the United States shareholder requirement that generally applies to a noncontrolled 10-percent owned foreign corporation described in section 904(d)(2)(E)(i)(I). The proposed regulations in § 1.904–5(a)(4)(vi) provide that for purposes of the regulations under section 904, any reference to a United States shareholder in the context of a noncontrolled 10-percent owned foreign corporation also includes a taxpayer that meets the stock ownership requirements described in section 904(d)(2)(E)(i)(II), even if the taxpayer is not a United States shareholder within the meaning of section 951(b).

D. Look-Through Rules

Before amendments made by the American Jobs Creation Act of 2004 (AJCA), section 904(d)(3) generally provided that dividends, interest, rents, and royalties (‘‘look-through payments’’) received or accrued by a taxpayer from a CFC in which the taxpayer is a United States shareholder were treated as income in the separate category to which the payment was allocable. Section 904(d)(4) provided similar look-through rules for dividends from noncontrolled section 902 corporations. The AJCA reduced the number of separate categories from nine to two, and revised section 904(d)(3). Under section 904(d)(3)(A) as amended by the AJCA, except as otherwise provided by section 904(d)(3), dividends, interest, rents, and royalties received or accrued by a taxpayer from a CFC in which the taxpayer is a United States shareholder are not treated as passive category income. Exceptions are provided, generally, when the payment is allocable to passive category income. However, the existing regulations under § 1.904–5 were largely unchanged after the AJCA amendments and retained the pre-AJCA approach to assigning dividends, interest, rents, and royalties based on the separate category of the income to which the payment was allocable, rather than excluding the income from the passive category to the extent not allocable to the passive category. In practice, because there were generally only two separate categories after the AJCA and because the general category was a residual category, the approach under the existing regulations of assigning payments to a separate category based on the separate category to which they were allocable resulted in payments that were not allocable to passive category income being assigned to the general category.

The Act added two new separate categories to section 904(d)(1) but made no changes to the look-through rules in section 904(d)(3) and (4). In addition, the legislative history does not provide any indication of how the look-through rules were intended to operate with the addition of the new separate categories.

The proposed regulations provide that the look-through rules under section 904(d)(3) provide look-through treatment solely for payments allocable to the passive category. Any other payments described in section 904(d)(3) are assigned to a separate category other than the passive category based on the general rules in § 1.904–4. Therefore, proposed § 1.904–5 revises the various look-through rules to reflect the application of look-through rules solely with respect to payments allocable to passive category income. Dividends, interest, rents, or royalties paid from a CFC to a United States shareholder thus are not assigned to a separate category (other than the passive category) under the look-through rules, but are assigned to the foreign branch category, a specified separate category described in proposed § 1.904–4(m), or the general category under the rules of proposed § 1.904–4(d).

Consistent with the general rule for look-through payments, section 904(d)(3)(B) assigns amounts included under section 951(a)(1)(A) (‘‘subpart F inclusions’’) to the passive category to the extent the inclusion is attributable to passive category income. Under the authority of section 951A(f)(1)(B), the proposed regulations treat GILTI inclusions in the same manner as subpart F inclusions for purposes of section 904(d)(3)(B). Therefore, proposed § 1.904–5(c)(6) provides that GILTI inclusions are treated as passive category income to the extent the amount so included is attributable to income received or accrued by the CFC that is passive category income.

Under the proposed regulations, the look-through rules also do not apply to treat deductible payments made by a foreign branch that are allocable to foreign branch category income (for example, payments made by a foreign disregarded entity that constitutes a foreign branch to a related look-through entity) as foreign branch category income. Instead, the rules of § 1.904–4 apply to characterize the income in the hands of the recipient.

Finally, as a result of the proposed revisions to § 1.904–5 that limit the look-through rules generally to passive category income, the proposed regulations include a rule addressing income subject to the separate category required under section 901(j)(1)(B). These rules ensure that income from sources within countries described in section 901(j)(2) that is paid or accrued through one or more entities retains its source and therefore continues to be subject to the separate category described in section 901(j)(1)(B). *See* proposed § 1.901(j)–1(a).

E. Allocation and Apportionment of Foreign Taxes

1. Special Rule for Base and Timing Differences

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

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

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

2. Taxes Imposed in Connection With Foreign Branches

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

The proposed regulations are consistent with the general principles and purpose of § 1.904–6(a)(1) and are intended to provide clarity where the application of these principles would be difficult or uncertain. The Treasury Department and the IRS recognize that there may be additional circumstances where the application of these rules may be ambiguous and request comments on whether further guidance is needed to clarify how foreign taxes should be allocated and apportioned between the foreign branch category and other separate categories.

3. Taxes Deemed Paid Under Section 960

The proposed regulations propose modifications to § 1.904–6(b) to reflect the Act's repeal of section 902 and revisions to section 960. In general, the proposed regulations provide that foreign income taxes deemed paid under section 960(a) or (d) are allocated to the same separate category to which the related section 951(a)(1) or 951A(a) inclusion is assigned. Similarly, in the case of a distribution of previously taxed earnings and profits described in section 960(b)(1) or (2), any foreign tax deemed paid with respect to the distribution under section 960(b) is allocated to the separate category to which the distribution is attributable.

4. Creditable Foreign Tax Expenditures

As discussed in Part II.B.2 of this Explanation of Provisions, a U.S. or foreign partnership does not characterize any of its income as foreign branch category income. Instead, a distributive share of a partnership's income may be characterized as foreign branch category income in the hands of certain U.S. partners. In order to ensure that creditable foreign tax expenditures (CFTEs) that are allocated to a partner that has a distributive share of income that is assigned to the foreign branch category are appropriately assigned, proposed § 1.904–6(b)(4) provides rules for allocating and apportioning CFTEs to the foreign branch category.

III. Treatment of Subsequent Reductions in Tax in Applying Section 954(b)(4)

The Treasury Department and the IRS are aware that certain taxpayers have formed CFCs in certain jurisdictions that purport to have a type of integration regime whereby all or substantially all of the corporate income tax paid by the CFC on its earnings is refunded to its shareholder when the earnings are distributed, even though the shareholder is not subject to any foreign tax on the distribution. These taxpayers rely on the rules in § 1.954–1(d)(3), which provide that a subsequent reduction in corporate foreign income taxes when earnings are later distributed to a shareholder does not affect the amount of foreign income taxes used to compute the effective tax rate on an item of income unless the reduction requires a redetermination of the United States shareholder's U.S. tax under section 905(c). These taxpayers claim that the high-tax exception from foreign base company income under section 954(b)(4) allows them to exclude the CFC's income from current taxation under subpart F, despite the fact that all or substantially all of the foreign corporate income tax is later refunded to the shareholder.

The proposed regulations modify § 1.954–1(d)(3) to provide that to the extent the foreign income taxes paid or accrued by a CFC are reasonably certain to be returned to a shareholder upon a subsequent distribution to the shareholder, the foreign income taxes are not treated as paid or accrued for purposes of the high-tax exception under section 954(b)(4). The IRS may also challenge these arrangements under existing law, for example, on the ground that the payment to the shareholder constitutes a refund under § 1.901–2(e)(2) or a subsidy under section 901(i) and § 1.901–2(e)(3) that reduces the amount of tax the CFC is considered to have paid.

Comments are requested on what special rules under § 1.954–1(d)(3), § 1.901–2, and section 905(c) should be considered to account for genuine integration regimes that do not have the effect of exempting resident corporations and their shareholders from all or substantially all tax.

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

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

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

Finally, § 1.960–7 includes updated applicability dates for §§ 1.960–1 through 1.960–6, which are consistent with the effective dates of the Act.

The Act also amended section 78 to, among other things, reflect the addition of deemed paid credits under section 960(d) and to provide that any amount of taxes deemed paid under section 960 that is treated as a dividend under section 78 (a ''section 78 dividend'') is not eligible for a section 245A deduction. The proposed regulations revise § 1.78–1 to reflect changes made to section 78.

Part IV.A of this Explanation of Provisions describes computational and grouping rules relating to the calculation of deemed paid taxes under section 960(a), (b), and (d). Part IV.B of this Explanation of Provisions describes specific rules for the calculation of deemed paid taxes under section 960(a) and (d). Part IV.C of this Explanation of Provisions describes specific rules for the calculation of deemed paid taxes under section 960(b). Part IV.D of this Explanation of Provisions describes the application of the rules under section 960(a), (b), and (d) when the domestic corporation owns the CFC through a domestic partnership. Part IV.E of this Explanation of Provisions describes revisions to § 1.78–1.

A. Computational and Grouping Rules for Purposes of Calculating Taxes Deemed Paid Under Section 960

1. Current Year Taxes

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

Proposed § 1.960–1 provides definitions as well as computational and grouping rules that associate the current year foreign income taxes (''current year taxes'') of the CFC with current year income of the CFC or a distribution of previously taxed earnings and profits received by the CFC. These taxes, in turn, may be deemed paid by the United States shareholder or upper-tier CFC under section 960. Foreign income taxes generally include income, war profits, and excess profits taxes that are imposed by a foreign country or a possession of the United States. *See* proposed § 1.960–1(b)(5). The term ''possession of the United States'' means American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands. Current year taxes of a CFC are foreign income taxes paid or accrued by the CFC in its current taxable year, and the rules of section 461 and the ''relation-back'' doctrine apply to determine the timing of the accrual of foreign income taxes and the year for which they are taken into account. *See* proposed § 1.960–1(b)(4). Thus, for example, foreign income taxes calculated on the basis of net income accrue in the U.S. taxable year of the CFC with or within which its foreign taxable year ends, and are eligible to be deemed paid in the taxable year of the United States shareholder with or within which the U.S. taxable year of the CFC ends, even if a portion of the foreign taxable year of the CFC falls within an earlier or later U.S. taxable year of the CFC or its United States shareholder. Current year taxes of a CFC that are imposed on an amount under foreign law that would be income under U.S. law in a different taxable year are eligible to be deemed paid in the year in which the foreign tax accrues, and not in the earlier or later year when the related income is recognized for U.S. tax purposes. The current taxable year of the CFC is its U.S. taxable year for which a domestic corporation that is a United States shareholder of the CFC has a subpart F or GILTI inclusion with respect to the CFC, or during which the CFC receives a section 959(b) distribution or makes a section 959(a) distribution or a section 959(b) distribution.

2. Computational Rules

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

Under these computational rules, a United States shareholder first applies the grouping rules described in Part IV.A.3 of this Explanation of Provisions to assign the income of the CFC to separate categories of income described in proposed § 1.904–5(a)(4)(v) (each a ''section 904 category'') and then to groups that correspond to certain types of income (each, an ''income group'') in a section 904 category. If the CFC receives a distribution of previously taxed earnings and profits (''PTEP''), it increases the group or groups (each, a ''PTEP group'') within an annual PTEP account that corresponds both to the taxable year for which a CFC took into account the income from which the previously taxed earnings and profits arose, and to the separate category of the United States shareholder to which the amount of the resulting inclusion under sections 951(a)(1)(A) or 951A was assigned. The rules for grouping previously taxed earnings and profits within an annual PTEP account are described in Part IV.C.1 of this Explanation of Provisions. The income and PTEP groups, which are discussed in more detail below, are the mechanism for computing taxes deemed paid under section 960.

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

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

3. Associating Current Year Taxes With Income Groups

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

i. Income Group Definitions

Proposed § 1.960–1(d)(2)(ii) defines several separate income groups with respect to the subpart F income of the CFC (''subpart F income groups'') within each applicable section 904 category. Each single item of foreign base company income as defined in § 1.954–1(c)(1)(iii) is a separate subpart F income group. For example, with respect to a CFC, § 1.954–1(c)(1)(iii)(A)(*2*) identifies as a single item of income all foreign base company income (other than foreign personal holding company income) that falls within both a single separate category (typically, general category income) and a single category of foreign base company income described in each of § 1.954–1(c)(1)(iii)(A)(*2*)(*i*) through (*v*). Therefore, there is a single subpart F income group within the general category that consists of all of a CFC's foreign base company sales income. Section 1.954–1(c)(1)(iii)(B) provides grouping rules for items of passive category foreign personal holding company income, each of which is also treated as a separate subpart F income group under § 1.960–1. Proposed § 1.960–1(d)(2)(ii)(B)(*2*) also defines a separate subpart F income group for the CFC's insurance income described in section 952(a)(1), for its international boycott income described in section 952(a)(3), for the sum of its illegal bribes and kickbacks described in section 952(a)(4), and for income included in a section 901(j) separate category described in section 952(a)(5).

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

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

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

In order to determine its net income in each income group, a CFC first assigns its items of gross income to a section 904 category and to the appropriate income group within the category, and then allocates and apportions its deductions and expenses, including current year taxes, to the categories and to the income groups within the categories under the rules of sections 861 through 865 and 904(d) and the regulations under those sections.

Current year taxes are allocated and apportioned to income groups for two purposes. The first purpose is to deduct current year taxes (in functional currency) from gross income in the income group in computing the net income in the income group. The second purpose is to associate an amount of current year taxes (in U.S. dollars) with an income group. These current year taxes associated with an income group are eligible to be deemed paid by a United States shareholder that has a subpart F or GILTI inclusion that is attributable to that income group. The rules for allocating and apportioning current year taxes are the same for both purposes. *See also* proposed § 1.861–8(e)(6) (clarifying that the rules for allocating and apportioning deductions for foreign income tax expense are the same as the rules for allocating and apportioning foreign income taxes to separate categories under § 1.904–6).

Proposed § 1.960–1(d)(3)(ii) applies the rules of § 1.904–6 to allocate and apportion current year taxes to and among the section 904 categories based upon the amount of taxable income, as calculated under foreign law, of the CFC that is in each section 904 category. Proposed § 1.960–1(d)(3)(ii) then applies the principles of § 1.904–6 to allocate and apportion current year taxes to and among the income groups. If a PTEP group of the CFC is increased as a result of a section 959(b) distribution that it receives in the current taxable year, then for purposes of allocating and apportioning current year taxes that are imposed solely by reason of the section 959(b) distribution, the PTEP group is treated as an income group within the section 904 category. Part IV.C of this Explanation of Provisions discusses the rules for tracking amounts in PTEP groups and for computing deemed paid credits with respect to distributions of previously taxed earnings and profits from a PTEP group. Current year taxes that are not allocated and apportioned to a subpart F or tested income group, or to a PTEP group that is treated as an income group, are allocated and apportioned to a residual income group. Current year taxes allocated and apportioned to a residual income group cannot be deemed paid under section 960 for any taxable year. Proposed § 1.960–1(e).

Under § 1.904–6, Federal income tax principles apply to determine the separate category, income group, or PTEP group of the CFC's gross items of income and expense, the amounts of which are computed under foreign law, that are included in the foreign tax base. For example, if the United States treats a distribution as resulting in capital gain that is passive category income, but foreign law treats the item as a dividend that would be general category income, the item is assigned to the passive category for purposes of allocating and apportioning current year taxes of the CFC to the item. *See also* proposed § 1.904–6(a)(1)(i). The amount of the item, however, is determined under foreign law, and expenses (also determined under foreign law) are allocated and apportioned to the income under foreign law principles or as otherwise provided in § 1.904–6(a)(1)(ii).

Proposed § 1.960–1(d)(3)(ii)(B) also provides a rule for addressing base and timing differences (within the meaning of proposed § 1.904–6(a)(1)(iv)) for purposes of allocating and apportioning current year taxes of a CFC to income groups and PTEP groups. Current year taxes that are attributable to a base difference are allocated to the residual income group, and therefore are ineligible to be deemed paid. Current year taxes that are attributable to a timing difference—namely, current year tax imposed on an amount that is income of the CFC in a different taxable year under Federal income tax law—are allocated and apportioned to a section 904 category and income group as though the income that foreign law recognizes in the CFC's current taxable year were also recognized for Federal income tax purposes in that year. Proposed § 1.960–1(d)(3)(ii)(B) includes a special rule, which is discussed in Part IV.C.2 of this Explanation of Provisions, for current year taxes that are attributable to a timing difference resulting from a section 959(b) distribution.

B. Taxes Deemed Paid Under Section 960(a) and (d) for Subpart F Inclusions and GILTI Inclusion Amounts

Section 960(a) provides that a domestic corporation that is a United States shareholder of a CFC is deemed to have paid the CFC's foreign income taxes that are properly attributable to the item of income of the CFC that the United States shareholder includes in gross income under section 951(a)(1) as a subpart F inclusion.

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

1. Subpart F Inclusions

Under proposed § 1.960–2(b), the amount of the foreign income taxes of a CFC that its United States shareholder that is a domestic corporation is deemed to pay under section 960(a) is computed with respect to the income of the CFC, determined under Federal income tax principles in each subpart F income group within a section 904 category. A domestic corporate shareholder that has a subpart F inclusion with respect to its CFC is deemed to pay the CFC's foreign income taxes that are properly attributable to the items of income of the CFC that give rise to the subpart F inclusion of that shareholder. The amount of taxes that are properly attributable to an item of income for this purpose is equal to the domestic corporate shareholder's proportionate share of the current year taxes of the CFC that are allocated and apportioned to the subpart F income group within a section 904 category of the CFC to which the item of income is attributable. The proportionate share for each subpart F income group is equal to the current year taxes that are allocated and apportioned to a subpart F income group within a section 904 category multiplied by a fraction equal to the portion of the subpart F inclusion that is attributable to that subpart F income group to the total income in that subpart F income group. Therefore, no tax is deemed paid by a corporate United States shareholder of a CFC with respect to a subpart F income group to which current year taxes of the CFC are allocated and apportioned (including by reason of the rule for timing differences) but with respect to which no portion of a subpart F inclusion is attributable.

The denominator of the fraction, the net income in the subpart F income group, is not reduced to reflect any prior year deficits because those deficits do not reduce the subpart F income of the CFC in the current year. A pro rata share of a prior year qualified deficit reduces the amount of a United States shareholder's subpart F inclusion, and therefore by its own account reduces the numerator of the fraction. Proposed § 1.960–2(b)(3)(ii). The denominator of the fraction is, however, reduced to reflect the limitation in section 952(c)(1)(A) of the subpart F income of the CFC to its current year earnings and profits. The denominator is also reduced to reflect any reduction in the subpart F income of a CFC under section 952(c)(1)(C), which allows a CFC to reduce certain of its subpart F income by an amount of certain current year deficits of certain CFCs in the same chain of ownership. Proposed § 1.960–2(b)(3)(iii).

Section 960(a) treats foreign income taxes of a CFC as deemed paid by a United States shareholder only with respect to an item of income of a CFC that is included in the gross income of the United States shareholder under section 951(a)(1). Proposed § 1.960–2(b)(1) treats taxes as deemed paid under section 960(a) specifically with respect to subpart F inclusions because the inclusions are with respect to items of income of the CFC. In contrast, an inclusion under section 951(a)(1)(B) is not an inclusion of an ''item of income'' of the CFC but instead is an inclusion equal to an amount that is determined under the formula in section 956(a). Therefore, proposed § 1.960–2(b)(1) provides that no foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B).

2. GILTI Inclusion Amounts

Proposed § 1.960–2(c) provides that the amount of the tested foreign income taxes that a United States shareholder is deemed to pay under section 960(d) is computed with respect to the income of the CFC in each tested income group within a section 904 category. For purposes of determining a United States shareholder's tested foreign income taxes, the CFC's current year taxes are first allocated and apportioned to the tested income group within a section 904 category in order to determine the foreign income taxes ''properly attributable'' to the tested income group. The United States shareholder's tested foreign income taxes for a tested income group within a section 904 category is equal to its proportionate share of the CFC's current year taxes, determined by multiplying the CFC's current year taxes that are allocated and apportioned to a tested income group within a section 904 category by a fraction that is equal to the tested income of the CFC in the tested income group that is included in computing the domestic corporation's aggregate amount described in section 951A(c)(1)(A) and proposed § 1.951A–1(c)(2)(i), divided by the total income in the tested income group.

The United States shareholder's inclusion percentage is required to determine the amount of taxes deemed paid by the United States shareholder. In general, current year taxes allocated and apportioned to a tested income group will be in the general category at the level of the CFC, although in limited cases involving passive category tested income, current year taxes may be allocated and apportioned to the passive category. However, the domestic corporation computes only a single inclusion percentage with respect to all of its tested income, regardless of the section 904 category to which the tested income is assigned.

In the case of a United States shareholder that is a member of a consolidated group, the numerator of the inclusion percentage is computed using the GILTI inclusion amount of a United States shareholder as determined under § 1.1502–51. *See* § 1.951A–1(c)(4).

C. Taxes Deemed Paid Under Section 960(b) With Respect to Section 959 Distributions

Section 960(b)(1) provides that a United States shareholder of a CFC is deemed to have paid the CFC's foreign income taxes that the United States shareholder has not been previously deemed to pay and that are properly attributable to a distribution from the CFC that the United States shareholder excludes from its income under section 959(a) (a ''section 959(a) distribution''). Section 960(b)(2) provides that a CFC is deemed to have paid the foreign income taxes of another CFC that have not previously been deemed paid by a United States shareholder and that are properly attributable to a distribution from the other CFC to which section 959(b) applies (a ''section 959(b) distribution,'' and together with a section 959(a) distribution, a ''section 959 distribution'').

1. PTEP Groups in Annual PTEP Accounts and Associated Taxes

Proposed § 1.960–3(c)(1) requires a CFC to establish a separate, annual account (''annual PTEP account'') for its earnings and profits for its current taxable year to which subpart F or GILTI inclusions of United States shareholders of the CFC are attributable. Each account must correspond to the inclusion year of the previously taxed earnings and profits and to the section 904 category of the inclusions at the United States shareholder level. Accordingly, a CFC may have an annual PTEP account in the section 951A category or a treaty category (as defined in § 1.861–13(b)(6)), even though income of the controlled foreign corporation cannot initially be assigned to the section 951A category or a treaty category. The previously taxed earnings and profits in each annual account are then assigned to one of ten possible groups of previously taxed earnings and profits described in proposed § 1.960–3(c)(2) (each, a ''PTEP group''). The PTEP groups serve a similar function to the subpart F income groups and tested income groups—they are the mechanism for associating foreign taxes paid or accrued, or deemed paid, by a CFC with section 959 distributions of previously taxed earnings and profits. If, following the issuance of new guidance under section 959 (which will be addressed in a separate guidance project), it is determined that maintaining all ten of the PTEP groups is unnecessary, or that grouping of annual accounts into multi-year accounts is permissible, the Treasury Department and the IRS will consider consolidating PTEP groups as part of finalizing the proposed regulations.

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

2. Associating Foreign Income Taxes With PTEP Groups

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

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

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

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

3. Computational Rules

Proposed § 1.960–3(b) provides rules for determining the amount of taxes deemed paid with respect to a section 959(a) distribution. A domestic corporation that receives a section 959(a) distribution is deemed to have paid the foreign income taxes that are properly attributable to the section 959(a) distribution from the PTEP group of the distributing CFC, to the extent the PTEP group taxes have not already been deemed to have been paid in the current taxable year or any prior taxable year. Proposed § 1.960–3(b)(1). The amount of foreign income taxes that are properly attributable to a domestic corporation's receipt of a section 959(a) distribution from a PTEP group within a section 904 category are its proportionate share of PTEP group taxes associated with the PTEP group. The domestic corporation's proportionate share of foreign income taxes associated with a section 959(a) distribution from a PTEP group is determined by a fraction equal to the amount of the section 959(a) distribution attributable to the PTEP group over the total amount of previously taxed earnings and profits in the PTEP group.

A single section 959(a) distribution could be attributable to multiple PTEP groups, with respect to multiple different inclusion years, of the distributing CFC. The proposed regulations, including the order of the list of PTEP groups in § 1.960–3(c)(2), do not provide rules for the allocation of distributions among different kinds of previously taxed earnings and profits under section 959(c). The Treasury Department and the IRS anticipate that future regulations under section 959 will provide ordering rules for determining the annual PTEP account and PTEP group to which a section 959 distribution is attributable.

Proposed § 1.960–3(b)(2) provides similar rules to those in proposed § 1.960–3(b)(1) for taxes deemed paid under section 960(b)(2) with respect to a CFC's receipt of a section 959(b) distribution.

Proposed § 1.960–3(d)(3) provides a rule relating to foreign income taxes paid or accrued in a taxable year of a CFC that began before January 1, 2018, with respect to an annual PTEP account, and a PTEP group within such account, that was established for an inclusion year of a CFC that began before January 1, 2018. Specifically, in certain cases, the foreign income taxes may be deemed paid under section 960(b) with respect to a section 959 distribution in a year of the CFC that begins after December 31, 2017.

However, the Treasury Department and the IRS recognize that with respect to CFC taxable years beginning before January 1, 2018, the application of section 960(a)(3) was uncertain and some taxpayers may have added taxes paid or accrued with respect to a section 959 distribution to post-1986 foreign income taxes described in section 902(c)(2) (as in effect on December 21, 2017). In that case, those foreign income taxes could have been included in computing foreign taxes deemed paid under section 902 with respect to a distribution or inclusion of post-1986 undistributed earnings (including by reason of sections 960 and 965) in taxable years of CFCs beginning before January 1, 2018, in which case the taxes are not available to be deemed paid under section 960(b).

The proposed regulations under section 965, see 83 FR 39,514, reserved on the application of section 965(g) to taxes deemed paid under new section 960(b). The preamble to the regulations under section 965 indicated that future regulations would provide rules for new section 960(b) similar to the rules that apply for section 960(a)(3) (as in effect on December 21, 2017).

The proposed regulations in this document provide a rule in proposed § 1.965–5(c)(1)(iii) similar to the rule that applies to taxes deemed paid under section 960(a)(3) that is in proposed § 1.965–5(c)(1)(i) and (ii). In particular, no credit is allowed for the applicable percentage of taxes deemed paid under section 960(b) that are attributable to the PTEP groups described in § 1.960–3(c)(2) that relate to section 965.

In order to ensure that the disallowance under section 965(g) only applies once, the rule in proposed § 1.965–5(c)(1)(iii) does not apply to taxes deemed paid under section 960(b)(2) with respect to a section 959(b) distribution, but only applies when previously taxed earnings and profits are distributed to a domestic corporate shareholder.

D. Domestic Partnerships

If a domestic corporation owns an interest in a CFC through a domestic partnership, to the extent the domestic corporation is a United States shareholder with respect to the CFC, the proposed regulations provide that the domestic corporation is deemed to have paid foreign income taxes as if the domestic corporation had included the income from the CFC directly rather than as a distributive share of the partnership's income. Proposed § 1.960–2(b)(4) provides that a domestic corporation that has a distributive share of a domestic partnership's subpart F inclusion and is also a United States shareholder with respect to the CFC that gives rise to a subpart F inclusion is treated as a subpart F inclusion of the domestic corporation for purposes of section 960(a). Similarly, the domestic corporation's distributive share of a domestic partnership's receipt of a section 959(a) distribution is treated as a receipt by the domestic corporation directly for purposes of proposed § 1.960–3(b)(1). *See* proposed § 1.960–3(b)(5). In the case of section 960(d), the GILTI inclusion amount of a domestic corporation that is also a United States shareholder of a CFC through its interest in a domestic partnership is generally determined at the partner level and therefore the rules in proposed § 1.960–2(c) apply in the same manner as if the domestic corporation included the GILTI inclusion amount directly. *See* proposed § 1.951A–5(c).

E. Section 78 Dividend

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

V. Effect of Section 965(n) Election

Section 965(n) allows a taxpayer to exclude section 965(a) inclusions (reduced by section 965(c) deductions) and associated section 78 gross ups in determining the amount of the net operating loss carryover or carryback that is absorbed in the taxable year of the inclusions. Proposed § 1.965–7(e)(1), as proposed to be added at 83 FR 39,514 (August 9, 2018), provides that the election also applies to the determination of the amount of the net operating loss for the taxable year.

These proposed regulations at § 1.965–7(e)(1)(i) clarify that if the section 965(n) election creates or increases a net operating loss under section 172 for the taxable year, then the taxable income of the person for the taxable year cannot be less than the amount described in proposed § 1.965–7(e)(1)(ii). This rule is necessary to prevent the same deduction from being taken into account in the taxable year and also used again to create a net operating loss that is deducted in a different taxable year. The amount of the deductions that create or increase a net operating loss for the taxable year in each separate category and the U.S. source residual category by reason of the section 965(n) election is determined under proposed § 1.965–7(e)(1)(iv), and those amounts are not also taken into account in computing taxable income or the foreign tax credit limitations under section 904 for that year.

Proposed § 1.965–7(e)(1)(iv)(A) clarifies that the election under section 965(n) applies solely for purposes of determining the amount of the net operating loss for the election year and the amount of net operating loss carryover or carryback to that year. The proposed regulations provide ordering rules to coordinate the election's effect on section 172 with the computation of the foreign tax credit limitations under section 904.

First, deductions that would have been allowed for the taxable year but for the section 965(n) election, other than the amount of any net operating loss carryover or carryback to the election year that is not allowed by reason of the election, are allocated and apportioned under §§ 1.861–8 through 1.861–17 in the taxable year for which the section 965(n) election is made. The section 965(a) inclusions and associated section 78 gross ups are taken into account for this purpose, and also in applying the rules under § 1.904(g)–3(b)(3) to determine the source components of a partial net operating loss carryover to the taxable year for which the section 965(n) election is made, if any, including when the amount deducted under section 172 in that year is reduced by reason of the section 965(n) election. Proposed § 1.965–7(e)(1)(iv)(B)(*1*).

Second, the proposed regulations provide that the amount by which a net operating loss is created or increased by reason of the section 965(n) election, if any, is considered to comprise a ratable portion of all of the taxpayer's deductions (other than the section 965(c) deduction) that are allocated and apportioned to each statutory and residual grouping for the taxable year under the rules in proposed § 1.965–7(e)(1)(iv)(B)(*1*). Proposed § 1.965–7(e)(1)(iv)(B)(*2*).

Third, deductions allocated and apportioned to the statutory and residual groupings, to the extent deducted in the election year rather than deferred to create or increase a net operating loss, are combined with income in those groupings to determine the foreign tax credit limitations for the year. Deductions allocated and apportioned to the section 965(a) inclusions and associated section 78 gross ups therefore reduce income in the separate category or categories (or U.S. source residual category) to which those section 965 amounts are assigned, and are not re-allocated to reduce other income, other than by operation of the separate limitation loss and overall domestic loss allocation rules of section 904(f) and (g). *See* proposed § 1.965–7(e)(1)(iv)(B)(*3*). Accordingly, the section 965(a) inclusions and associated section 78 gross ups may both attract and absorb deductions in the election year in calculating the separate foreign tax credit limitations under section 904.

VI. Applicability Dates

In general, the portions of the proposed regulations that relate to statutory amendments made by the Act apply to taxable years beginning after December 22, 2017. *See* section 7805(b)(2). Other portions of the proposed regulations that do not relate to the Act apply for taxable years ending on or after December 4, 2018. Certain portions of the proposed regulations contain rules that relate to the Act as well as rules that do not relate to the Act. These regulations generally apply to taxable years that satisfy both of the following two conditions: (1) The taxable year begins after December 22, 2017, and (2) ends on or after December 4, 2018. *See* section 7805(b)(1)(B).

A special applicability date is provided is provided in § 1.861–12(k) in order to apply § 1.861–12(c)(2)(i)(*B*)(*1*)(*ii*) to the last taxable year of a foreign corporation beginning before January 1, 2018, since there may be an inclusion under section 965 for that taxable year. A special applicability date is also provided in § 1.904(b)–3(f) with respect to that section because section 904(b)(4) applies to deductions with respect to taxable years ending after December 31, 2017. Finally, a special applicability date is provided in § 1.78–1(c) in order to apply the second sentence of § 1.78–1(a) to section 78 dividends received after December 31, 2017, with respect to a taxable year of a foreign corporation beginning before January 1, 2018. *See* Part IV.E of this Explanation of Provisions.

Proposed §§ 1.965–5(c)(1)(iii) and 1.965–7(e)(1)(i) and (iv) have the applicability dates provided in proposed § 1.965–9 (contained in 83 FR 39,514).

VII. Conforming Amendments

Sections 1.902–0 through 1.902–4 will be withdrawn as part of finalizing the proposed regulations. With respect to portions of the temporary regulations under sections 861 through 865 that are being reproposed under the proposed regulations, the Treasury Department and the IRS will remove the corresponding temporary regulations upon finalization of the proposed regulations. In addition, the Treasury Department and the IRS intend to make conforming amendments to the examples throughout the foreign tax credit regulations upon finalization of the proposed regulations. In light of the numerous changes made under the Act to various defined terms and statutory cross references, the Treasury Department and the IRS also request comments on other regulations that require updating to conform to changes made by the Act.

Special Analyses

I. Regulatory Planning and Review

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

The proposed regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. OIRA has designated this rule as a significant regulatory action, under Executive Order 12866, and as economically significant under E.O. 12866 and section 1(c) of the MOA. Accordingly, the proposed regulations have been reviewed by the Office of Information and Regulatory Affairs. For more detail on the economic analysis, please refer to the following analysis.

A. Background

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

Under the Code, the FTC calculation is applied separately to different categories of income (a ''separate category''). For example, suppose a domestic corporate taxpayer has $100 of active foreign source income in the ''general category,'' $100 of passive foreign source income in the ''passive category,'' $50 of foreign taxes associated with the ''general category'' income, and $0 of foreign taxes associated with the ''passive category'' income. The allowable FTC is determined separately for the different categories of income (general and passive). Therefore, none of the $50 of ''general category'' FTCs can be used to offset U.S. tax on the ''passive category'' income. This taxpayer has a pre-FTC U.S. tax liability of $42 (21 percent of $200) but can claim a FTC for only $21 (21 percent of $100) of this liability, which is with respect to active foreign source income in the general category. The taxpayer carries over the remaining $29 of foreign taxes ($50 minus $21) and can generally apply the taxes as a credit in the prior taxable year or over the next 10 years against U.S. tax on general category foreign source income, subject to certain restrictions.

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

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

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

[1] Although there are several other separate categories that may apply, such as under sections 901(j) and 904(h)(10), these separate categories generally arise only in rare circumstances.

discussion of alternative policy choices that were considered.

B. The Need for Proposed Regulations

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

C. Baseline

The economic analysis that follows compares the proposed regulations to a no-action baseline reflecting anticipated federal income tax-related behavior in the absence of these proposed regulations. A no-action baseline reflects the current environment including the existing FTC regulations, prior to any amendment by the proposed regulations.

D. Overview of the Proposed Regulations

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

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

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

Further, as described in section IV.E of the Explanation of Provisions, the proposed regulations include an updated applicability date for the new section 78 provisions. In particular, the proposed regulations provide that section 78 dividends relating to taxable years of foreign corporations beginning before January 1, 2018, are not treated as dividends for purposes of the section 245A deduction. As further noted in section IV.E of the Explanation of Provisions, absent this rule, taxpayers that have calendar year CFCs instead of fiscal year CFCs would be treated differently with respect to their section 78 dividends solely on the basis of this difference in tax year status; and taxpayers with fiscal year CFCs could receive the double benefit of a section 245A deduction and a FTC under section 960 with respect to the same foreign taxes. Allowing a double benefit for a single expense erodes the U.S. tax base and treats otherwise similar taxpayers (those who have different CFC tax years) inequitably. Based on these equity considerations, the Treasury Department and the IRS expect that the proposed regulation will provide greater net benefits than the alternative of not issuing a regulation on this issue.

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

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

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

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

E. Economic Analysis

1. Anticipated Benefits and Costs of the Proposed Regulations

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations against a no-action baseline—which, as explained above, is the *status quo* in the absence of the proposed regulations. The Treasury Department and IRS expect that the certainty and clarity provided by these proposed regulations, relative to the no-action baseline, will improve U.S. economic efficiency. For example, because separate categories for GILTI and foreign branch income did not previously exist, taxpayers can benefit from the enhanced specificity regarding how income, expenses, and carryover foreign tax credits should be allocated across these separate categories. In the absence of this enhanced clarity, similarly situated taxpayers might interpret the statute differently, potentially resulting in inequitable outcomes. For example, some taxpayers may forego specific investments that other taxpayers deem worthwhile based on different interpretations of the tax consequences alone. The guidance provided in these regulations helps to ensure that taxpayers face more uniform incentives when making economic decisions, which will generally improve economic efficiency. In order to give a rough sense of the population potentially affected by these regulations, a table reporting the number of affected filers is provided in Part II of this Special Analyses.

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

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

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

However, the reduced expense allocation to the section 951A category resulting from these proposed regulations has the potential to reduce Federal tax revenue relative to the statute and in consideration of proposed though not yet final regulations related to section 951A. In addition, it could also provide some taxpayers with the incentive to locate more of their worldwide expenses in the United States, because U.S. expenses will have the potential to reduce U.S. taxable income, and also increase allowable foreign tax credits relative to the no-action baseline. However, the post-Act U.S. interest expense limitation rules under section 163(j) make it more difficult to use excessive interest expense to reduce U.S. taxable income, and the significantly lower U.S. statutory corporate rate reduces the (previously strong) incentive to locate ''fungible'' deductions such as interest expense in the United States. Therefore, any increase in the incentive to report interest expense in the United States resulting from the reduced expense allocation to the section 951A category is likely to be relatively minor. The Treasury Department and the IRS welcome comments on this estimated impact of the reduced expense allocation.

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

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

2. Alternatives Considered

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

The Act created two new separate categories with respect to FTCs, splitting the existing general category into general, section 951A, and foreign branch categories. The Act did not, however, specify how FTC carryovers were to be treated. The Treasury Department and the IRS considered alternative methods of allocating FTC carryovers originally associated with the general category to the new section 951A and foreign branch categories. One option that was considered would have required taxpayers to reassign existing general category FTC carryovers to the section 951A category as if that category existed prior to the adoption of the statute. Allocating carryovers to the section 951A category was deemed infeasible because it would be extraordinarily burdensome on taxpayers to attempt to recreate historical GILTI and would present numerous technical challenges. Such an approach would also result in eliminating the ability of taxpayers to credit those FTC carryovers since no carryovers are allowed for FTCs attributable to the section 951A category. This outcome would negatively impact taxpayers that had potentially structured their prior decisions on their presumed ability to use these FTC carryovers against U.S. tax on general category income and could result in costly and undesirable financial statement adjustments for some companies without providing any corresponding economic efficiency gains.

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

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

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

The Treasury Department and the IRS also faced the question of how to align interest income and interest expenses related to loans to a partnership from a U.S. partner. The Treasury Department and the IRS chose to match interest income allocation to interest expense allocation, rather than the reverse, because this minimizes distortions that could arise in the apportionment of other types of expenses. Under the matching rule in the proposed regulations, the gross interest income is apportioned between U.S. and foreign sources in each separate category based on a taxpayer's interest expense apportionment ratios. The Treasury Department and the IRS considered an alternative approach of tracing expenses to gross income under which the gross interest income would, under the general rules for sourcing interest income, be 100 percent foreign source income if paid by a foreign partnership not engaged in a U.S. trade or business. Some deductions, such as general and administrative expenses, can be apportioned on the basis of gross income to foreign sources. A rule that did not alter the source of the gross interest income would affect the allocation and apportionment of these other expenses, such as general and administrative expenses, that can be allocated on the basis of gross income to foreign sources. The matching rule limits these distortions because it minimizes the artificial increase in gross foreign source income based solely on a related party loan to a partnership. Accordingly, the proposed matching rule achieves a more neutral foreign tax credit limitation result and better minimizes the impact of related party loans on a taxpayer's foreign tax credit limitation.

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

II. Paperwork Reduction Act

The rules relating to foreign tax credits that were modified by the Act are reflected in several revised and new schedules added to existing forms. For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (''PRA''), the reporting burden associated with the revised and new schedules will be reflected in the IRS Forms 14029, Paperwork Reduction Act Submission, associated with the forms described in this Part II.

Form 1118, Foreign Tax Credit—Corporations, has been revised to add new Schedule C (Tax Deemed Paid With Respect to Section 951(a)(1) Inclusions by Domestic Corporation Filing Return (Section 960(a)), Schedule D (Tax Deemed Paid With Respect to Section 951A Income by Domestic Corporation Filing the Return (Section 960(d)), and Schedule E (Tax Deemed Paid With Respect to Previously Taxed Income by Domestic Corporation Filing the Return (Section 960(b)). In addition, the existing schedules of Form 1118 have been modified to account for the two new separate categories of income under section 904(d); the repeal of section 902 indirect credits for foreign taxes deemed paid with respect to dividends from foreign corporations; modified indirect credits under section 960 for inclusions under sections 951(a)(1) and 951A; modified section 78 gross up with respect to inclusions under sections 951(a)(1) and 951A; the revised sourcing rule for certain income from the sale of inventory under section 863(b); the repeal of the fair market value method for apportioning interest expense under 864(e); new adjustments for purposes of section 904 with respect to expenses allocable to certain stock or dividends for which a dividends received deduction is allowed under section 245A; the election to increase pre-2018 section 904(g) Overall Domestic Loss (ODL) recapture; and limited foreign tax credits with respect to inclusions under section 965. For purposes of the PRA, the reporting burden associated with these changes is reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Form 1118 (OMB control number 1545–0123, which represents a total estimated burden time, including all other related forms and schedules, of 3.157 billion hours and total estimated monetized costs of $58.148 billion).

Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, has also been revised to add Schedule E–1 (Taxes Paid, Accrued, or Deemed Paid on Accumulated Earnings and Profits (E&P) of Foreign Corporation) and Schedule P (Previously Taxed Earnings and Profits of U.S. Shareholder of Certain Foreign Corporations) and to amend Schedule E (Income, War Profits, and Excess Profits Taxes Paid or Accrued) and Schedule J (Accumulated Earnings & Profits (E&P) of Controlled Foreign Corporations). These changes to the Form 5471 reflect the two new separate categories of income under section 904(d); the repeal of section 902 indirect credits for foreign taxes deemed paid with respect to dividends from foreign corporations; modified indirect credits under section 960 for inclusions under sections 951(a)(1) and 951A; and limited foreign tax credits with respect to inclusions under section 965. For purposes of the PRA, the reporting burden associated with these changes is reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Schedules E, E–1, J, and P of Form 5471 (OMB control number 1545–0123).

Schedule B (Specifically Attributable Taxes and Income (Section 999(c)(2)) of the Form 5713, International Boycott Report, has also been revised to reflect the repeal of section 902. Schedule C (Tax Effect of the International Boycott Provisions) of the Form 5713 has been revised to account for the new section

904(d) categories of income. For purposes of the PRA, the reporting burden associated with these changes is reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Schedules B and C of Form 5713 (OMB control number 1545–0216, which represents a total estimated burden time, including all other related forms and schedules, of 143,498 hours).

Schedules K and K–1 of the following forms have been revised to account for the new section 904(d) categories of income: Form 1065, U.S. Return of Partnership Income, Form 1120–S, U.S. Income Tax Return for an S Corporation, and Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships. Form 1116, Foreign Tax Credit (Individual, Estate, or Trust), has also been revised to account for the new section 904(d) categories of income. For purposes of the PRA, the reporting burden associated with these changes is reflected in the IRS Form 14029, Paperwork Reduction Act Submission, associated with Forms 1065 and 1120S (OMB control number 1545–0123), associated with Form 8865 (OMB control number 1545–1668, which represents a total estimated burden time, including all other related forms and schedules, of 289,354 hours), and associated with Form 1116 (OMB control numbers 1545–0121, which represents a total estimated burden time, including all other related forms and schedules, of 25,066,693 hours; and 1545–0074, which represents a total estimated burden time, including all other related forms and schedules, of 1.784 billion hours and total estimated monetized costs of $31.764 billion).

The IRS estimates the number of affected filers for the aforementioned forms to be the following:

Form	Number of respondents * (estimated)
Form 1116	8,000,000
Form 1118	15,000
Form 1065	4,000,000
Form 1065 Schedule K–1	24,750,000
Form 1120–S	4,750,000
Form 1120–S Schedule K–1	7,500,000
Form 5471	28,000
Form 5471 Schedule E	10,000
Form 5471 Schedule J	25,500
Form 5713 Schedule B	<1,000
Form 5713 Schedule C	<1,000
Form 8865	14,500

Data tabulated from 2015 and 2016 Business Return Transaction File and E-file data.

* Except for K–1 filings, which count the total number of K–1s received; same issuer K–1s are aggregated at the recipient level.

The current status of the Paperwork Reduction Act submissions related to foreign tax credits is provided in the following table. The burden estimates provided in the above narrative are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and include but do not isolate the estimated burden of only the foreign tax credit-related forms that are included in the tables in this Part II. The Treasury Department and the IRS have assumed that any burden estimates and forms, including new information collections, related to foreign tax credits capture changes made by the Act and that no additional information collection burdens arise out of discretionary authority exercised in these regulations. The Treasury Department and the IRS welcome comments on all aspects of information collection burdens related to the foreign tax credit. In addition, the IRS forms will be posted and available for comment at *https://apps.irs.gov/app/picklist/list/draftTaxForms.html.*

Form	Type of filer	OMB No.(s)	Status
Form 1116	All other Filers (mainly trusts and estates) (Legacy system).	1545–0121	Approved by OMB through 10/30/2020.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201704-1545-023*		
	Business (NEW Model)	1545–0123	Published in the **Federal Register** Notice (FRN) on 10/8/18. Public Comment period closes on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd*.		
	Individual (NEW Model)	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission (all forms) scheduled in 3–2019. 60 Day FRN not published yet for full collection.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031*.		
Form 1118	Business (NEW Model)	1545–0123	Published in the FRN on 10/8/18. Public Comment period closes on 12/10/18.
	Link *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd*.		
Form 1065 (including Schedule K–1)	Same as above	Same as above	Same as above.
	Link: Same as above.		
Form 1120–S (including Schedule K–1)	Same as above	Same as above	Same as above.
	Link: Same as above.		
Form 5471 (including Schedules E, J)	Business (NEW Model)	1545–0123	Published in the FRN on 10/8/18. Public Comment period closes on 12/10/18.

Form	Type of filer	OMB No.(s)	Status
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
	Individual (NEW Model)	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3–2019. 60 Day FRN not published yet for full collection.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031.*		
Form 5713 Schedules B, C	All other Filers (mainly trusts and estates) (Legacy system).	1545–0216	Published in the FRN on 3/28/18. Public Comment period closed 5/29/18. Renewal submitted on 10/11/18 for review to OIRA. New 2018 Forms not included in renewal to OIRA due to timing of submission.
	Link: *https://www.federalregister.gov/documents/2018/10/29/2018-23515/agency-information-collection-activities-submission-for-omb-review-comment-request-multiple-internal, https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201807-1545-001.*		
	Business (NEW Model)	1545–0123	Published in the FRN on 10/11/18. Public Comment period closes on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
	Individual (NEW Model)	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3–2019. 60 Day FRN not published yet for full collection.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031.*		
Form 8865	All other Filers (mainly trusts and estates) (Legacy system).	1545–1668	Published in the FRN on 10/1/18. Public Comment period closes on 11/30/18. ICR in process by Treasury as of 10/17/18.
	Link: *https://www.federalregister.gov/documents/2018/10/01/2018-21288/proposed-collection-comment-request-for-regulation-project.*		
	Business (NEW Model)	1545–0123	Published in the FRN on 10/8/18. Public Comment period closes on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
	Individual (NEW Model)	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3–2019. 60 Day FRN not published yet for full collection.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031.*		

III. Regulatory Flexibility Act

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

The proposed regulations provide guidance needed to comply with statutory changes and affect individuals and corporations claiming foreign tax credits. The domestic small business entities that are subject to the foreign tax credit rules in the Code and this notice of proposed rulemaking are generally those domestic small business entities that are at least 10 percent corporate shareholders of foreign corporations, and so are eligible to claim dividends-received deductions or compute foreign taxes deemed paid under section 960 with respect to inclusions under subpart F and section 951A from controlled foreign corporations. Other provisions of the Act, such as the new separate foreign tax credit limitation category for foreign branch income and the repeal of the option to allocate and apportion interest expense on the basis of the fair market value (rather than tax basis) of a taxpayer's assets, might also affect domestic small business entities that operate in foreign jurisdictions. Data about the number of domestic small business entities potentially affected by these aspects of the Act, and therefore potentially by these proposed regulations, is not readily available.

However, the Treasury Department and IRS do not believe a substantial number of domestic small business entities will be affected by this notice of proposed rulemaking. Many of the more significant aspects of the proposed regulations, including all of the rules in proposed §§ 1.861–8(d)(2)(C), 1.861–10, 1.861–12, 1.861–13, 1.901(j)–1, 1.904–5, 1.904(b)–3, 1.954–1, 1.960–1 through 1.960–3, and 1.965–7 apply only to United States persons that operate a foreign business in corporate form, and, in most cases, only if the foreign corporation is a CFC. Because it takes significant resources and investment for a foreign business to operate outside of the United States in corporate form, and in particular to own a CFC, the owners of such businesses will infrequently be domestic small business entities. Consequently, the Treasury Department and the IRS do not believe that the proposed regulations will affect a substantial number of domestic small business entities. The Treasury Department and the IRS welcome comments regarding the amount and types of domestic small business entities that may be affected by this rule.

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

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

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

To the extent a domestic small business entity is affected by the Act, the proposed regulations help reduce their compliance costs by providing clarity, certainty, and flexibility to the taxpayer regarding how to take into account the changes made by the Act in claiming foreign tax credits. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act is not required with respect to the proposed regulations.

Notwithstanding this certification, the Treasury Department and the IRS invite comments on the impact of this rule on small entities.

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. The Treasury Department and the IRS invites the public to comment on this certification.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

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

Comments and Requests for Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under **ADDRESSES**. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at *www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by revising the entries for §§ 1.861–8, 1.861–9, 1.861–9T, 1.861–10(e), 1.861–11, 1.904–4, 1.904–5, 1.904–6, and 1.960–1 and adding entries for §§ 1.861–12, 1.861–13, 1.901(j)–1, 1.904–1, 1.904–2, 1.904–3, 1.960–2, 1.960–3, 1.960–4, 1.960–5, 1.965–5, and 1.965–7, to read in part as follows:

Authority: 26 U.S.C. 7805.

* * * * *

Section 1.861–8 also issued under 26 U.S.C. 250(c), 864(e)(7), and 882(c).

Sections 1.861–9 and 1.861–9T also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e)(7), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f).

Section 1.861–10(e) also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e)(7), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f).

Section 1.861–11 also issued under 26 U.S.C. 863(a), 26 U.S.C. 864(e)(7), 26 U.S.C. 865(i), and 26 U.S.C. 7701(f).

Section 1.861–12 also issued under 26 U.S.C. 864(e)(7).

Section 1.861–13 also issued under 26 U.S.C. 864(e)(7).

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Section 1.901(j)–1 also issued under 26 U.S.C. 901(j)(4).

* * * * *

Section 1.904–1 also issued under 26 U.S.C. 904(d)(7).

Section 1.904–2 also issued under 26 U.S.C. 904(d)(7).

Section 1.904–3 also issued under 26 U.S.C. 904(d)(7).

Section 1.904–4 also issued under 26 U.S.C. 250(c), 904(d)(2)(J)(i), 904(d)(6)(C), 26 U.S.C. 904(d)(7), and 26 U.S.C. 951A(f)(1)(B).

Section 1.904–5 also issued under 26 U.S.C. 904(d)(7), and 26 U.S.C. 951A(f)(1)(B).

Section 1.904–6 also issued under 26 U.S.C. 904(d)(7).

* * * * *

Section 1.960–1 also issued under 26 U.S.C. 960(f).

Section 1.960–2 also issued under 26 U.S.C. 960(f).

Section 1.960–3 also issued under 26 U.S.C. 960(f).

Section 1.960–4 also issued under 26 U.S.C. 951A(f)(1)(B) and 26 U.S.C. 960(f).

Section 1.965–5 also issued under 26 U.S.C. 965(o).

Section 1.965–7 also issued under 26 U.S.C. 965(o).

* * * * *

■ **Par. 2** Section 1.78–1 is revised to read as follows:

§ 1.78–1 Gross up for deemed paid foreign tax credit.

(a) *Taxes deemed paid by certain domestic corporations treated as a dividend.* If a domestic corporation chooses to have the benefits of the foreign tax credit under section 901 for any taxable year, an amount that is equal to the foreign income taxes deemed to be paid by the corporation for the year under section 960 (in the case of section 960(d), determined without regard to the phrase ''80 percent of'' in section 960(d)(1)) is, to the extent provided by this section, treated as a dividend (a *section 78 dividend*) received by the domestic corporation from the foreign corporation. A section 78 dividend is treated as a dividend for all purposes of the Code, except that it is not treated as a dividend for purposes of section 245 or 245A, and does not increase the earnings and profits of the domestic corporation or decrease the earnings and profits of the foreign corporation. Any reduction under section 907(a) of the foreign income taxes deemed paid with respect to combined foreign oil and gas income does not affect the amount treated as a section 78 dividend. *See* § 1.907(a)–1(e)(3). Similarly, any reduction under section 901(e) of the foreign income taxes deemed paid with respect to foreign mineral income does not affect the amount treated as a section 78 dividend. *See* § 1.901–3(a)(2)(i), (b)(2)(i)(b), and (d), *Example 8*. Any reduction under section 6038(c)(1)(B) in the foreign taxes paid or accrued by a foreign corporation is taken into account in determining foreign taxes deemed paid and the amount treated as a section 78 dividend. See, for example, § 1.6038–2(k)(5), *Example 1*. To the extent provided in the Code, section 78 does not apply to any tax not allowed as a credit. See, for example, sections 901(j)(3), 901(k)(7), 901(l)(4), 901(m)(6), and 908(b). For rules on determining the source of a section 78 dividend in computing the limitation on the foreign tax credit under section 904, see §§ 1.861–3(a)(3), 1.862–1(a)(1)(ii), and 1.904–5(m)(6). For rules on assigning a section 78 dividend to a separate category, see § 1.904–4(o).

(b) *Date on which section 78 dividend is received.* A section 78 dividend is considered received by a domestic corporation on the date on which—

(1) The corporation includes in gross income under section 951(a)(1)(A) the amounts by reason of which there are deemed paid under section 960(a) the foreign income taxes that give rise to that section 78 dividend, notwithstanding that the foreign income taxes may be carried back or carried over to another taxable year and deemed to be paid or accrued in such other taxable year under section 904(c); or

(2) The corporation includes in gross income under section 951A(a) the amounts by reason of which there are deemed paid under section 960(d) the foreign income taxes that give rise to that section 78 dividend.

(c) *Applicability date.* This section applies to taxable years of foreign corporations that begin after December 31, 2017, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. The second sentence of paragraph (a) of this section also applies to section 78 dividends that are received after December 31, 2017, by reason of taxes deemed paid under section 960(a) with respect to a taxable year of a foreign corporation beginning before January 1, 2018.

■ **Par. 3.** Section 1.861–8 is amended by:

■ 1. Removing the last sentence of paragraph (a)(1).

■ 2. Removing the third sentence through fifth sentences of paragraph (a)(4).

■ 3. Removing paragraph (a)(5).

■ 4. Revising paragraphs (c)(2) and (d)(2).

■ 5. Adding two sentences after the sixth sentence in paragraph (e)(1).

■ 6. Removing the first sentence of paragraph (e)(6)(i).

■ 7. Adding a new first sentence and a new second sentence to paragraph (e)(6)(i).

■ 8. Removing paragraphs (e)(6)(iii) and (e)(12)(iv).

■ 9. Adding paragraphs (e)(13) through (e)(15).

■ 10. Revising paragraph (f)(1)(i).

■ 11. Adding paragraph (h).

The revisions and additions read as follows:

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

* * * * *

(c) * * *

(2) *Apportionment based on assets.* Certain taxpayers are required by paragraph (e)(2) of this section and § 1.861–9T to apportion interest expense on the basis of assets. A taxpayer may apportion other deductions based on the comparative value of assets that generate income within each grouping, provided that this method reflects the factual relationship between the deduction and the groupings of income and is applied in accordance with the rules of § 1.861–9T(g). In general, such apportionments must be made either on the basis of the tax book value of those assets or, except in the case of interest expense, on the basis of their fair market value. *See* § 1.861–9(h). Taxpayers using the fair market value method for their last taxable year beginning before January 1, 2018, must change to the tax book value method (or the alternative tax book value method) for purposes of apportioning interest expense for their first taxable year beginning after December 31, 2017. The Commissioner's approval is not required for this change. In the case of any corporate taxpayer that—

(i) Uses tax book value or alternative tax book value, and

(ii) Owns directly or indirectly (within the meaning of § 1.861–12T(c)(2)(ii)(B)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote in any other corporation (domestic or foreign) that is not a member of the affiliated group (as defined in section 864(e)(5)), the taxpayer must adjust its basis in that stock in the manner described in § 1.861–12(c)(2).

* * * * *

(d) * * *

(2) *Allocation and apportionment to exempt, excluded, or eliminated income*—(i) *In general.* [Reserved]. For further guidance, see § 1.861–8T(d)(2)(i).

(ii) *Exempt income and exempt asset defined*—(A) *In general.* For purposes of this section, the term *exempt income* means any gross income to the extent that it is exempt, excluded, or eliminated for Federal income tax purposes. The term *exempt asset* means any asset to the extent income from the asset is (or is treated as under paragraph (d)(2)(ii)(B) or (C) of this section) exempt, excluded, or eliminated for Federal income tax purposes.

(B) [Reserved]. For further guidance, see § 1.861–8T(d)(2)(ii)(B).

(C) *Foreign-derived intangible income and inclusions under section 951A(a)*—(*1*) *Exempt income.* The term ''exempt income'' includes an amount of a domestic corporation's gross income included in foreign-derived intangible income (as defined in section 250(b)(1)), and also includes an amount of a domestic corporation's gross income from an inclusion under section 951A(a) and the gross up under section 78 attributable to such an inclusion, in each case equal to the amount of the deduction allowed under section 250(a) for such gross income (taking into account the reduction under section 250(a)(2)(B), if any). Therefore, for purposes of apportioning deductions using a gross income method, gross income does not include gross income included in foreign-derived intangible income, an inclusion under section 951A(a), or the gross up under section 78 attributable to an inclusion under section 951A(a), in an amount equal to the amount of the deduction allowed under section 250(a)(1)(A), (B)(i), or (B)(ii), respectively (taking into account the reduction under section 250(a)(2)(B), if any).

(*2*) *Exempt assets*—(*i*) *Assets that produce foreign-derived intangible income.* The term ''exempt asset'' includes the portion of a domestic corporation's assets that produce gross income included in foreign-derived intangible income equal to the amount of such assets multiplied by the fraction that equals the amount of the domestic corporation's deduction allowed under section 250(a)(1)(A) (taking into account the reduction under section 250(a)(2)(B)(i), if any) divided by its foreign-derived intangible income. No portion of the value of stock in a foreign corporation is treated as an exempt asset by reason of this paragraph (d)(2)(ii)(C)(*2*)(*i*), including by reason of a transfer of intangible property to a foreign corporation subject to section 367(d) that gives rise to income eligible for a deduction under section 250(a)(1)(A).

(*ii*) *Controlled foreign corporation stock that gives rise to inclusions under section 951A(a).* The term ''exempt asset'' includes a portion of the value of a United States shareholder's stock in a controlled foreign corporation if the United States shareholder is a domestic corporation that is eligible for a deduction under section 250(a) with respect to income described in section 250(a)(1)(B)(i) and all or a portion of the domestic corporation's stock in the controlled foreign corporation is characterized as GILTI inclusion stock. The portion of foreign corporation stock that is treated as an exempt asset for a taxable year equals the portion of the value of such foreign corporation stock (determined in accordance with §§ 1.861–9(g), 1.861–12, and 1.861–13) that is characterized as GILTI inclusion stock multiplied by a fraction that equals the amount of the domestic corporation's deduction allowed under section 250(a)(1)(B)(i) (taking into account the reduction under section 250(a)(2)(B)(ii), if any) divided by its GILTI inclusion amount (as defined in § 1.951A–1(c)(1) or, in the case of a member of a consolidated group, § 1.1502–51(b)) for such taxable year. The portion of controlled foreign corporation stock treated as an exempt asset under this paragraph (d)(2)(ii)(C)(*2*)(*ii*) is treated as attributable to the relevant categories of GILTI inclusion stock described in each of paragraphs (d)(2)(ii)(C)(*3*)(*i*) through (*v*) of this section based on the relative value of the portion of the stock in each such category.

(*3*) *GILTI inclusion stock.* For purposes of paragraph (d)(2)(ii)(C)(*2*)(*ii*) of this section, the term *GILTI inclusion stock* means the aggregate of the portions of the value of controlled foreign corporation stock that are—

(*i*) Assigned to the section 951A category under § 1.861–13(a)(2);

(*ii*) Assigned to a particular treaty category under § 1.861–13(a)(3)(i) (relating to resourced gross tested income stock);

(*iii*) Assigned under § 1.861–13(a)(1) to the gross tested income statutory grouping within the foreign source passive category less the amount described in § 1.861–13(a)(5)(iii)(A);

(*iv*) Assigned under § 1.861–13(a)(1) to the gross tested income statutory grouping within the U.S. source general category less the amount described in § 1.861–13(a)(5)(iv)(A); and

(*v*) Assigned under § 1.861–13(a)(1) to the gross tested income statutory grouping within the U.S. source passive category less the amount described in § 1.861–13(a)(5)(iv)(B).

(*4*) *Non-applicability to section 250(b)(3).* This paragraph (d)(2)(ii)(C) does not apply when apportioning deductions for purposes of determining deduction eligible income under the operative section of section 250(b)(3).

(*5*) *Example.* The following example illustrates the application of this paragraph (d)(2)(ii)(C).

(*i*) *Facts.* USP, a domestic corporation, directly owns all of the stock of CFC1 and CFC2, both of which are controlled foreign corporations. The tax book value of CFC1 and CFC2's stock is $10,000 and $9,000, respectively. Pursuant to § 1.861–13(a), $6,100 of the stock of CFC1 is assigned to the section 951A category under § 1.861–13(a)(2) (''section 951A category stock'') and the remaining $3,900 of the stock of CFC1 is assigned to the general category (''general category stock''). Additionally, $4,880 of the stock of CFC2 is section 951A category stock and the remaining $4,120 of the stock of CFC2 is general category stock. Under section 951A and the section 951A regulations (as defined in § 1.951A–1(a)(1)), USP's GILTI inclusion amount is $610. The portion of USP's deduction under section 250 described in section 250(a)(1)(B)(i) is $305. No portion of USP's deduction is reduced by reason of section 250(a)(2)(B)(ii).

(*ii*) *Analysis.* Under paragraph (d)(2)(ii)(C)(*1*) of this section, $305 of USP's gross income attributable to its GILTI inclusion amount is exempt income for purposes of apportioning deductions for purposes of section 904. Under paragraph (d)(2)(ii)(C)(*3*) of this section, the GILTI inclusion stock of CFC1 is the $6,100 of stock that is section 951A category stock and the GILTI inclusion stock of CFC2 is the $4,880 of stock that is section 951A category stock. Under paragraph (d)(2)(ii)(C)(*2*) of this section, the portion of the value of the stock of CFC1 and CFC2 that is treated as an exempt asset equals the portion of the value of the stock of CFC1 and CFC2 that is GILTI inclusion stock multiplied by 50% ($305/$610). Accordingly, the exempt portion of the stock of CFC1 is $3,050 (50% × $6,100) and the exempt portion of CFC2's stock is $2,440 (50% × $4,880). Therefore, the stock of CFC1 taken into account for purposes of apportioning deductions is $3,050 of non-exempt section 951A category stock and $3,900 of general category stock. The stock of CFC2 taken into account for purposes of apportioning deductions is $2,440 of non-exempt section 951A category stock and $4,120 of general category stock.

(d)(2)(iii) through (d)(2)(iii)(B) [Reserved]. For further guidance, see § 1.861–8T(d)(2)(iii) through § 1.861–8T(d)(2)(iii)(B).

(C) Dividends for which a deduction is allowed under section 245A;

(D) Foreign earned income as defined in section 911 and the regulations thereunder (however, the rules of § 1.911–6 do not require the allocation and apportionment of certain deductions, including home mortgage interest, to foreign earned income for purposes of determining the deductions disallowed under section 911(d)(6)); and

(E) Inclusions for which a deduction is allowed under section 965(c). *See* § 1.965–6(d).

(iv) *Value of stock attributable to previously taxed earnings and profits.* No portion of the value of stock in a controlled foreign corporation is treated as an exempt asset by reason of the adjustment under § 1.861–12(c)(2) in respect of previously taxed earnings and profits described in section 959(c)(1) or (c)(2) (including earnings and profits described in section 959(c)(2) by reason of section 951A(f)(1) and § 1.951A–6(b)(1)). *See also* § 1.965–6(d).

(e) * * * (1) * * * Paragraphs (e)(13) and (14) of this section contain rules with respect to the allocation and apportionment of the deduction allowed under section 250(a). Paragraph (e)(15) of this section contains rules with respect to the allocation and apportionment of a taxpayer's distributive share of a partnership's deductions. * * *

* * * * *

(6) * * * (i) *In general.* The deduction for foreign income, war profits and excess profits taxes (*foreign income taxes*) allowed by section 164 is allocated and apportioned among the applicable statutory and residual groupings under the principles of § 1.904–6(a)(1)(i), (ii), and (iv). The deduction for state and local taxes (*state income taxes*) allowed by section 164 is considered definitely related and allocable to the gross income with respect to which such state income taxes are imposed. * * *

* * * * *

(13) *Foreign-derived intangible income.* The portion of the deduction that is allowed for foreign-derived intangible income under section 250(a)(1)(A) (taking into account the reduction under section 250(a)(2)(B)(i), if any) is considered definitely related and allocable to the class of gross income included in the taxpayer's foreign-derived deduction eligible income (as defined in section 250(b)(4)). If necessary, the portion of the deduction is apportioned within the class ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income based on the relative amounts of foreign-derived deduction eligible income in each grouping.

(14) *Global intangible low-taxed income and related section 78 gross up.* The portion of the deduction that is allowed for the global intangible low-taxed income amount described in section 250(a)(1)(B)(i) (taking into account the reduction under section 250(a)(2)(B)(ii), if any) is considered definitely related and allocable to the class of gross income included under section 951A(a). If necessary (for example, because a portion of the inclusion under section 951A(a) is passive category income or U.S. source income), the portion of the deduction is apportioned within the class ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income based on the relative amounts of gross income in each grouping. Similar rules apply to allocate and apportion the portion of the deduction that is allowed for the section 78 gross up under section 250(a)(1)(B)(ii).

(15) *Distributive share of partnership deductions.* In general, if deductions are incurred by a partnership in which the taxpayer is a partner, the taxpayer's deductions that are allocated and apportioned include the taxpayer's distributive share of the partnership's deductions. See §§ 1.861–9(e), 1.861–17(f), and 1.904–4(n)(1)(ii) for special rules for apportioning a partner's distributive share of deductions of a partnership.

(f) * * *

(1) * * *

(i) *Separate foreign tax credit limitations.* Section 904(d)(1) and other sections described in § 1.904–4(m) require that a separate foreign tax credit limitation be determined with respect to each separate category of income specified in those sections. Accordingly, the foreign source income within each separate category described in § 1.904–5(a)(4)(v) constitutes a separate statutory grouping of income. U.S. source income is treated as income in the residual category for purposes of determining the limitation on the foreign tax credit.

* * * * *

(h) *Applicability date.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

■ **Par. 4.** Section 1.861–9 is amended by:

■ 1. Revising the section heading.

■ 2. Revising paragraphs (a) through (e)(1).

■ 3. Removing the last sentences in paragraph (e)(2) and (e)(3).

■ 4. Revising paragraphs (e)(4) through (f)(3)(i).

■ 5. Revising the heading of paragraph (f)(4).

■ 6. Removing the language ''noncontrolled section 902 corporations'' wherever it appears in paragraphs (f)(4)(i) and (f)(4)(ii) and adding the language ''noncontrolled 10-percent foreign owned corporations'' in its place.

■ 7. Removing the last sentence of paragraph (f)(4)(ii).

■ 8. Revising paragraph (f)(4)(iii).

■ 9. Revising paragraphs (f)(5) through (h)(3), and (h)(5).

■ 10. Revising the first and second sentences of paragraph (i)(2)(i).

■ 11. Removing the language ''paragraph (i)(2)'' from the third and fourth sentences of paragraph (i)(2) and adding the language ''paragraph (i)(2)(i)'' in its place.

■ 12. Revising paragraphs (j) and (k).

The revisions and additions read as follows:

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

(a) through (c)(4) [Reserved]. For further guidance, see § 1.861–9T(a) through (c)(4).

(5) *Section 163(j).* If a taxpayer is subject to section 163(j), the taxpayer's deduction for business interest expense is limited to the sum of the taxpayer's business interest income, 30 percent of the taxpayer's adjusted taxable income for the taxable year, and the taxpayer's floor plan financing interest expense. In the taxable year that any deduction is permitted for business interest expense with respect to a disallowed business interest carryforward, that business interest expense is apportioned for purposes of this section under rules set forth in paragraphs (d), (e), or (f) of this section (as applicable) as though it were incurred in the taxable year in which the expense is deducted.

(d) through (e)(1) [Reserved]. For further guidance, see § 1.861–9T(d) through (e)(1).

* * * * *

(4) *Entity rule for less than 10 percent limited partners and less than 10 percent corporate general partners*—(i) *Partnership interest expense.* A limited partner (whether individual or corporate) or corporate general partner whose ownership, together with ownership by persons that bear a relationship to the partner described in section 267(b) or section 707, of the capital and profits interests of the partnership is less than 10 percent directly allocates its distributive share of partnership interest expense to its distributive share of partnership gross income. Under § 1.904–4(n)(1)(ii), such a partner's distributive share of foreign source income of the partnership is treated as passive income (subject to the high-taxed income exception of section 904(d)(2)(B)(iii)(II)), except in the case of income from a partnership interest held in the ordinary course of the partner's active trade or business, as defined in § 1.904–4(n)(1)(ii)(B). A partner's distributive share of partnership interest expense (other than partnership interest expense that is directly allocated to identified property under § 1.861–10T) is apportioned in accordance with the partner's relative distributive share of gross foreign source income in each separate category and of gross domestic source income from the partnership. To the extent that partnership interest expense is directly allocated under § 1.861–10T, a

comparable portion of the income to which such interest expense is allocated is disregarded in determining the partner's relative distributive share of gross foreign source income in each separate category and domestic source income. The partner's distributive share of the interest expense of the partnership that is directly allocable under § 1.861–10T is allocated according to the treatment, after application of § 1.904–4(n)(1), of the partner's distributive share of the income to which the expense is allocated.

(e)(4)(ii) through (e)(7) [Reserved]. For further guidance, see § 1.861–9T(e)(4)(ii) through (e)(7).

(8) *Special rule for specified partnership loans*—(i) *In general.* For purposes of apportioning interest expense that is not directly allocable under paragraph (e)(4) of this section or § 1.861–10T, the disregarded portion of a specified partnership loan is not considered an asset of a SPL lender. The disregarded portion of a specified partnership loan is the portion of the value of the loan (as determined under paragraph (h)(4)(i) of this section) that bears the same proportion to the total value of the loan as the matching income amount that is included by the SPL lender for a taxable year with respect to the loan bears to the total amount of SPL interest income that is included directly or indirectly in gross income by the SPL lender with respect to the loan during that taxable year.

(ii) *Treatment of interest expense and interest income attributable to a specified partnership loan.* If a SPL lender (or any other person in the same affiliated group as the SPL lender) takes into account a distributive share of SPL interest expense, the SPL lender includes the matching income amount for the taxable year that is attributable to the same loan in gross income in the same statutory and residual groupings as the statutory and residual groupings of gross income from which the SPL interest expense is deducted by the SPL lender (or any other person in the same affiliated group as the SPL lender).

(iii) *Anti-avoidance rule for third party back-to-back loans.* If, with a principal purpose of avoiding the rules in this paragraph (e)(8), a person makes a loan to a person that is not related (within the meaning of section 267(b) or 707) to the lender, the unrelated person makes a loan to a partnership, and the first loan would constitute a specified partnership loan if made directly to the partnership, then the rules of this paragraph (e)(8) apply as if the first loan was made directly to the partnership. Such a series of loans will be subject to this recharacterization rule without regard to whether there was a principal purpose of avoiding the rules in this paragraph (e)(8) if the loan to the unrelated person would not have been made or maintained on substantially the same terms irrespective of the loan of funds by the unrelated person to the partnership. The principles of this paragraph (e)(8)(iii) also apply to similar transactions that involve more than two loans and regardless of the order in which the loans are made.

(iv) *Anti-avoidance rule for loans held by CFCs.* A loan receivable held by a controlled foreign corporation with respect to a loan to a partnership in which a United States shareholder (as defined in § 1.904–5(a)(4)(vi)) of the controlled foreign corporation owns an interest, directly or indirectly through one or more other partnerships or other pass-through entities (as defined in § 1.904–5(a)(4)(iv)), is recharacterized as a loan receivable held directly by the United States shareholder with respect to the loan to such partnership for purposes of this paragraph (e)(8) if the loan was made or transferred with a principal purpose of avoiding the rules in this paragraph (e)(8).

(v) *Interest equivalents.* The principles of this paragraph (e)(8) apply in the case of a partner, or any person in the same affiliated group as the partner, that takes into account a distributive share of an expense or loss (to the extent deductible) that is allocated and apportioned in the same manner as interest expense under § 1.861–9T(b) and has a matching income amount with respect to the transaction that gives rise to that expense or loss.

(vi) *Definitions.* For purposes of this paragraph (e)(8), the following definitions apply.

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

(B) *Matching income amount.* The term *matching income amount* means the lesser of the total amount of the SPL interest income included directly or indirectly in gross income by the SPL lender for the taxable year with respect to a specified partnership loan or the total amount of the distributive shares of the SPL interest expense of the SPL lender (or any other person in the same affiliated group as the SPL lender) with respect to the loan.

(C) *Specified partnership loan.* The term *specified partnership loan* means a loan to a partnership for which the loan receivable is held, directly or indirectly through one or more other partnerships, either by a person that owns an interest, directly or indirectly through one or more other partnerships, in the partnership, or by any person in the same affiliated group as that person.

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

(E) *SPL interest income.* The term *SPL interest income* means an item of gross interest income received or accrued with respect to a specified partnership loan.

(F) *SPL lender.* The term *SPL lender* means the person that holds the receivable with respect to a specified partnership loan. If a partnership holds the receivable, then any partner in the partnership (other than a partner described in paragraph (e)(4)(i) of this section) is also considered a SPL lender.

(9) *Characterizing certain partnership assets as foreign branch category assets.* For purposes of applying this paragraph (e) to section 904 as the operative section, a partner that is a United States person that has a distributive share of partnership income that is treated as foreign branch category income under § 1.904–4(f)(1)(i)(B) characterizes its pro rata share of the partnership assets that give rise to such income as assets in the foreign branch category.

(f) through (f)(1) [Reserved]. For further guidance, see § 1.861–9T(f) through (f)(1).

(2) *Section 987 QBUs of domestic corporations*—(i) *In general.* In the application of the asset method described in paragraph (g) of this section, a domestic corporation—

(A) Takes into account the assets of any section 987 QBU (as defined in § 1.987–1(b)(2)), translated according to the rules set forth in paragraph (g) of this section, and

(B) Combines with its own interest expense any deductible interest expense incurred by a section 987 QBU, translated according to the rules of section 987 and the regulations under that section.

(ii) *Coordination with section 987(3).* For purposes of computing foreign currency gain or loss under section 987(3) (including section 987 gain or loss recognized under § 1.987–5), the rules of this paragraph (f)(2) do not apply. *See* § 1.987–4.

(iii) *Example.* The following example illustrates the application of this paragraph (f)(2).

(A) *Facts.* X is a domestic corporation that operates B, a branch doing business in a foreign country. B is a section 987 QBU (as defined in § 1.987–1(b)(2)) as well as a foreign branch (as defined in § 1.904–

4(f)(3)(iii)). In 2020, without regard to B, X has gross domestic source income of $1,000 and gross foreign source general category income of $500 and incurs $200 of interest expense. Using the tax book value method of apportionment, X, without regard to B, determines the value of its assets that generate domestic source income to be $6,000 and the value of its assets that generate foreign source general category income to be $1,000. Applying the translation rules of section 987, X (through B) earned $500 of gross foreign source foreign branch category income and incurred $100 of interest expense. B incurred no other expenses. For 2020, the average functional currency book value of B's assets that generate foreign source foreign branch category income translated at the year-end rate for 2020 is $3,000.

(B) *Analysis.* The combined assets of X and B for 2020 (averaged under § 1.861–9T(g)(3)) consist 60% ($6,000/$10,000) of assets generating domestic source income, 30% ($3,000/$10,000) of assets generating foreign source foreign branch category income, and 10% ($1,000/$10,000) of assets generating foreign source general category income. The combined interest expense of X and B is $300. Thus, $180 ($300 × 60%) of the combined interest expense is apportioned to domestic source income, $90 ($300 × 30%) is apportioned to foreign source foreign branch category income, and $30 ($300 × 10%) is apportioned to foreign source general category income, yielding net U.S. source income of $820 ($1,000 − $180), net foreign source foreign branch category income of $410 ($500 − $90), and net foreign source general category income of $470 ($500 − $30).

(3) *Controlled foreign corporations*—(i) *In general.* For purposes of computing subpart F income and tested income and computing earnings and profits for all Federal income tax purposes, the interest expense of a controlled foreign corporation may be apportioned using either the asset method described in paragraph (g) of this section or the modified gross income method described in paragraph (j) of this section, subject to the rules of paragraph (f)(3)(ii) and (iii) of this section.

* * * * *

(4) *Noncontrolled 10-percent owned foreign corporations.* * * *

(iii) *Stock characterization.* The stock of a noncontrolled 10-percent owned foreign corporation is characterized under the rules in § 1.861–12(c)(4).

(f)(5) [Reserved]. For further guidance, see § 1.861–9T(f)(5).

(g) through (g)(1)(i) [Reserved]. For further guidance, see § 1.861–9T(g) through (g)(1)(i).

(ii) A taxpayer may elect to determine the value of its assets on the basis of either the tax book value or the fair market value of its assets. However, for taxable years beginning after December 31, 2017, the fair market value method is not allowed with respect to allocations and apportionments of interest expense. *See* section 864(e)(2). For rules concerning the application of an alternative method of valuing assets for purposes of the tax book value method, see paragraph (i) of this section. For rules concerning the application of the fair market value method, see paragraph (h) of this section.

(iii) [Reserved]

(iv) For rules relating to earnings and profits adjustments by taxpayers using the tax book value method for the stock in certain 10 percent owned corporations, see § 1.861–12(c)(2).

(v) [Reserved]

(2) *Asset values*—(i) *General rule*—(A) *Average of values.* For purposes of determining the value of assets under this section, an average of values (book or market) within each statutory grouping and the residual grouping is computed for the year on the basis of values of assets at the beginning and end of the year. For the first taxable year beginning after December 31, 2017 (*post-2017 year*), a taxpayer that determined the value of its assets on the basis of the fair market value method for purposes of apportioning interest expense in its prior taxable year may choose to determine asset values under the tax book value method (or the alternative tax book value method) by treating the value of its assets as of the beginning of the post-2017 year as equal to the value of its assets at the end of the first quarter of the post-2017 year, provided that each member of the affiliated group (as defined in § 1.861–11T(d)) determines its asset values on the same basis. Where a substantial distortion of asset values would result from averaging beginning-of-year and end-of-year values, as might be the case in the event of a major corporate acquisition or disposition, the taxpayer must use a different method of asset valuation that more clearly reflects the average value of assets weighted to reflect the time such assets are held by the taxpayer during the taxable year.

(B) *Tax book value method.* Under the tax book value method, the value of an asset is determined based on the adjusted basis of the asset. For purposes of determining the value of stock in a 10 percent owned corporation at the beginning and end of the year under the tax book value method, the tax book value is determined without regard to any adjustments under section 961(a) or 1293(d), see § 1.861–12(c)(2)(i)(B)(*1*), and before the adjustment required by § 1.861–12(c)(2)(i)(A) to the basis of stock in the 10 percent owned corporation. The average of the tax book value of the stock at the beginning and end of the year is then adjusted with respect to earnings and profits as described in § 1.861–12(c)(2)(i).

(g)(2)(ii) through (g)(2)(ii)(A)(*1*) [Reserved]. For further guidance, see § 1.861–9T(g)(2)(ii) through (g)(2)(ii)(A)(*1*).

(*2*) *United States dollar approximate separate transactions method.* In the case of a branch to which the United States dollar approximate separate transactions method of accounting described in § 1.985–3 applies, the beginning-of-year dollar amount of the assets is determined by reference to the end-of-year balance sheet of the branch for the immediately preceding taxable year, adjusted for United States generally accepted accounting principles and United States tax accounting principles, and translated into U.S. dollars as provided in § 1.985–3(c). The end-of-year dollar amount of the assets of the branch is determined in the same manner by reference to the end-of-year balance sheet for the current taxable year. The beginning-of-year and end-of-year dollar tax book value of assets, as so determined, within each grouping is then averaged as provided in paragraph (g)(2)(i) of this section.

(g)(2)(ii)(B) through (g)(3) [Reserved]. For further guidance, see § 1.861–9T(g)(2)(ii)(B) through (g)(3).

(h) *Fair market value method.* An affiliated group (as defined in section 1.861–11T(d)) or other taxpayer (the *taxpayer*) that elects to use the fair market value method of apportionment values its assets according to the methodology described in this paragraph (h). Effective for taxable years beginning after December 31, 2017, the fair market value method is not allowed for purposes of apportioning interest expense. *See* section 864(e)(2). However, a taxpayer may continue to apportion deductions other than interest expense that are properly apportioned based on fair market value according to the methodology described in this paragraph (h). *See* § 1.861–8(c)(2).

(h)(1) through (h)(3) [Reserved]. For further guidance, see § 1.861–9T(h)(1) through (h)(3).

* * * * *

(5) *Characterizing stock in related persons.* Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of § 1.861–12T(c)(3)(ii), except that the portion of

the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under § 1.861–9T(h)(2) shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904–4(b)).

* * * * *

(i) * * *

(2) * * * (i) Except as provided in this paragraph (i)(2)(i), a taxpayer may elect to use the alternative tax book value method. For the taxpayer's first taxable year beginning after December 31, 2017, the Commissioner's approval is not required to switch from the fair market value method to the alternative tax book value method for purposes of apportioning interest expense. * * *

* * * * *

(j) through (j)(2)(i) [Reserved]. For further guidance, see § 1.861–9T(j) through (j)(2)(i).

(ii) *Step 2.* Moving to the next higher-tier controlled foreign corporation, combine the gross income of such corporation within each grouping with its pro rata share (as determined under principles similar to section 951(a)(2)) of the gross income net of interest expense of all lower-tier controlled foreign corporations held by such higher-tier corporation within the same grouping adjusted as follows:

(A) Exclude from the gross income of the higher-tier corporation any dividends or other payments received from the lower-tier corporation other than interest income received from the lower-tier corporation;

(B) Exclude from the gross income net of interest expense of any lower-tier corporation any gross subpart F income, net of interest expense apportioned to such income;

(C) Exclude from the gross income net of interest expense of any lower-tier corporation any gross tested income as defined in § 1.951A–2(c)(1), net of interest expense apportioned to such income;

(D) Then apportion the interest expense of the higher-tier controlled foreign corporation based on the adjusted combined gross income amounts; and

(E) Repeat paragraphs (j)(2)(ii)(A) through (D) of this section for each next higher-tier controlled foreign corporation in the chain.

(k) *Applicability date.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

■ **Par. 5.** Section 1.861–10 is amended by:

■ 1. Revising paragraph (e)(8)(vi).

■ 2. Removing and reserving paragraph (e)(10).

■ 3. Adding paragraph (f).

The revisions and additions read as follows:

§ 1.861–10 Special allocations of interest expense.

* * * * *

(e) * * *

(8) * * *

(vi) *Classification of hybrid stock.* In determining the amount of its related group indebtedness for any taxable year, a U.S. shareholder must not treat stock in a related controlled foreign corporation as related group indebtedness, regardless of whether the related controlled foreign corporation claims a deduction for interest under foreign law for distributions on such stock. For purposes of determining the foreign base period ratio under paragraph (e)(2)(iv) of this section for a taxable year that ends on or after December 4, 2018, the rules of this paragraph (e)(8)(vi) apply to determine the related group debt-to-asset ratio in each taxable year included in the foreign base period, including in taxable years that end before December 4, 2018.

* * * * *

(10) [Reserved]

* * * * *

(f) *Applicability date.* This section applies to taxable years that end on or after December 4, 2018.

■ **Par. 6.** Section 1.861–11 is amended by:

■ 1. Revising paragraphs (a) through (c).

■ 2. Removing the language '', except that section 936 corporations are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section'' from the first sentence of paragraph (d)(1).

■ 3. Removing and reserving paragraph (d)(2).

■ 4. Adding paragraph (h).

The revisions and addition read as follows:

§ 1.861–11 Special rules for allocating and apportioning interest expense of an affiliated group of corporations.

(a) [Reserved]. For further guidance, see § 1.861–11T(a).

(b) *Scope of application*—(1) *Application of section 864(e)(1) and (5) (concerning the definition and treatment of affiliated groups).* Section 864(e)(1) and (5) and the portions of this section implementing section 864(e)(1) and (5) apply to the computation of foreign source taxable income for purposes of section 904 (relating to various limitations on the foreign tax credit). Section 864(e)(1) and (5) and the portions of this section implementing section 864(e)(1) and (5) also apply in connection with section 907 to determine reductions in the amount allowed as a foreign tax credit under section 901. Section 864(e)(1) and (5) and the portions of this section implementing section 864(e)(1) and (5) also apply to the computation of the combined taxable income of the related supplier and a foreign sales corporation (FSC) (under sections 921 through 927) as well as the combined taxable income of the related supplier and a domestic international sales corporation (DISC) (under sections 991 through 997).

(b)(2) through (c) [Reserved]. For further guidance, see § 1.861–11T(b)(2) through (c).

(d) * * *

(2) [Reserved]

* * * * *

(h) *Applicability dates.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

■ **Par. 7.** Section 1.861–12 is amended by:

■ 1. Revising paragraphs (a) through (c)(1).

■ 2. Revising the heading of paragraph (c)(2).

■ 3. Removing the language '', for taxable years beginning after April 25, 2006,'' from paragraph (c)(2)(i)(A).

■ 4. Revising paragraphs (c)(2)(i)(B) through (c)(3).

■ 5. Revising paragraph (c)(4).

■ 6. Removing paragraph (c)(5).

■ 7. Revising paragraphs (d) through (j).

■ 8. Adding paragraph (k).

The revisions and additions read as follows:

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

(a) *In general.* The rules in this section are applicable to taxpayers in apportioning expenses under an asset method to income in the various separate categories described in § 1.904–5(a)(4)(v), and supplement other rules provided in §§ 1.861–9 through 1.861–11T. The principles of the rules in this section are also applicable in apportioning expenses among statutory and residual groupings for any other operative section. See also § 1.861–8(f)(2)(i) for a rule requiring conformity of allocation methods and apportionment principles for all operative sections. Paragraph (b) of this section describes the treatment of inventories. Paragraph (c)(1) of this section concerns the treatment of various stock assets. Paragraph (c)(2) of this section describes a basis adjustment for stock in 10 percent owned corporations. Paragraph (c)(3) of this section sets forth rules for characterizing the stock in controlled foreign corporations. Paragraph (c)(4) of this section describes the treatment of stock of noncontrolled 10-percent owned foreign corporations. Paragraph (d)(1) of this section concerns the treatment of notes. Paragraph (d)(2) of this section concerns the treatment of notes of controlled foreign corporations. Paragraph (e) of this section describes the treatment of certain portfolio securities that constitute inventory or generate income primarily in the form of gains. Paragraph (f) of this section describes the treatment of assets that are subject to the capitalization rules of section 263A. Paragraph (g) of this section concerns the treatment of FSC stock and of assets of the related supplier generating foreign trade income. Paragraph (h) of this section concerns the treatment of DISC stock and of assets of the related supplier generating qualified export receipts. Paragraph (i) of this section is reserved. Paragraph (j) of this section sets forth an example illustrating the rules of this section, as well as the rules of § 1.861–9(g).

(b) through (c)(1) [Reserved]. For further guidance, see § 1.861–12T(b) through (c)(1).

(2) *Basis adjustment for stock in 10 percent owned corporations*—(i) * * *

(B) *Computational rules*—(*1*) *Adjustments to basis*—(*i*) *Application of section 961 or 1293(d).* For purposes of this section, a taxpayer's adjusted basis in the stock of a foreign corporation does not include any amount included in basis under section 961 or 1293(d) of the Code.

(*ii*) *Application of section 965(b).* If a taxpayer owned the stock of a specified foreign corporation (as defined in § 1.965–1(f)(45)) as of the close of the last taxable year of the specified foreign corporation that began before January 1, 2018, the taxpayer's adjusted basis in the stock of the specified foreign corporation for that taxable year and any subsequent taxable year is determined as if the taxpayer made the election described in § 1.965–2(f)(2)(i) (regardless of whether the election was actually made) but does not include the amount included (or that would be included if the election were made) in basis under § 1.965–2(f)(2)(ii)(A) (without regard to whether any portion of the amount is netted against the amounts of any other basis adjustments under § 1.965–2(h)(2)).

(*2*) *Amount of earnings and profits.* For purposes of this paragraph (c)(2), earnings and profits (or deficits) are computed under the rules of section 312 and, in the case of a foreign corporation, sections 964(a) and 986 for taxable years of the 10 percent owned corporation ending on or before the close of the taxable year of the taxpayer. Accordingly, the earnings and profits of a controlled foreign corporation includes all earnings and profits described in section 959(c). The amount of the earnings and profits with respect to stock of a foreign corporation held by the taxpayer is determined according to the attribution principles of section 1248 and the regulations under section 1248. The attribution principles of section 1248 apply without regard to the requirements of section 1248 that are not relevant to the determination of a shareholder's pro rata portion of earnings and profits, such as whether earnings and profits (or deficits) were derived (or incurred) during taxable years beginning before or after December 31, 1962.

(*3*) *Annual noncumulative adjustment.* The adjustment required by paragraph (c)(2)(i)(A) of this section is made annually and is noncumulative. Thus, the adjusted basis of the stock (determined without regard to prior years' adjustments under paragraph (c)(2)(i)(A) of this section) is adjusted annually by the amount of accumulated earnings and profits (or deficits) attributable to the stock as of the end of each year.

(*4*) *Translation of non-dollar functional currency earnings and profits.* Earnings and profits (or deficits) of a qualified business unit that has a functional currency other than the dollar must be computed under this paragraph (c)(2) in functional currency and translated into dollars using the exchange rate at the end of the taxpayer's current taxable year (and not the exchange rates for the years in which the earnings and profits or deficits were derived or incurred).

(C) *Examples.* The following examples illustrate the application of paragraph (c)(2)(i)(B) of this section.

(*1*) *Example 1: No election described in § 1.965–2(f)(2)(i)*—(*i*) *Facts.* USP, a domestic corporation, owns all of the stock of CFC1 and CFC2, both controlled foreign corporations. USP, CFC1, and CFC2 all use the calendar year as their U.S. taxable year. USP owned CFC1 and CFC2 as of December 31, 2017, and CFC1 and CFC2 were specified foreign corporations with respect to USP. USP did not make the election described in § 1.965–2(f)(2)(i), but if USP had made the election, USP's basis in the stock of CFC1 would have been increased by $75 under § 1.965–2(f)(2)(ii)(A) and USP's basis in the stock of CFC2 would have been decreased by $75 under § 1.965–2(f)(2)(ii)(B). For purposes of determining the value of the stock of CFC1 and CFC2 at the beginning of the 2019 taxable year, without regard to amounts included in basis under section 961 or 1293(d), USP's adjusted basis in the stock of CFC1 is $100 and its adjusted basis in the stock of CFC2 is $350 (before the application of this paragraph (c)(2)(i)(B)).

(*ii*) *Analysis.* Under paragraph (c)(2)(i)(B)(*1*) of this section, USP's adjusted basis in CFC1 and CFC2 is determined as if USP had made the election described in § 1.965–2(f)(2)(i), and therefore USP's adjusted basis in CFC2 includes the $75 reduction USP would have made to its basis in that stock under § 1.965–2(f)(2)(ii)(B). However, USP's adjusted basis in the stock of CFC1 does not include the $75 that USP would have included in its basis in that stock under § 1.965–2(f)(2)(ii)(A). Accordingly, for purposes of determining the value of stock of CFC1 and CFC2 at the beginning of the 2019 taxable year, USP's adjusted basis in the stock of CFC1 is $100 and USP's adjusted basis in the stock of CFC2 is $275 ($350 − $75).

(*2*) *Example 2: Election described in § 1.965–2(f)(2)(i)*—(*i*) *Facts.* USP, a domestic corporation, owns all of the stock of CFC1, which owns all of the stock of CFC2, both foreign corporations. USP, CFC1, and CFC2 all use the calendar year as their U.S. taxable year. USP owned CFC1, and CFC1 owned CFC2 as of December 31, 2017, and CFC1 and CFC2 were specified foreign corporations with respect to USP. USP made the election described in § 1.965–2(f)(2)(i). As a result of the election, USP was required to increase its basis in CFC1 by $90 under § 1.965–2(f)(2)(ii)(A), and to decrease its basis in CFC1 by $90 under § 1.965–2(f)(2)(ii)(B). Pursuant to § 1.965–2(h)(2), USP netted the increase of $90 against the decrease of $90 and made no net adjustment to the basis of the stock of CFC1. For purposes of determining the value of the stock of CFC1 at the beginning of the 2019 taxable year, without regard to amounts included in basis under section 961 or 1293(d), USP's adjusted basis in the stock of CFC1 is $600 (before the application of this paragraph (c)(2)(i)(B)).

(*ii*) *Analysis.* Under paragraph (c)(2)(i)(B)(*1*) of this section, USP's adjusted basis in CFC1 is determined as if USP had made the election described in § 1.965–2(f)(2)(i), and therefore USP's adjusted basis in CFC1 includes the $90 reduction USP would have made to its basis in that stock, without regard to the netting rule described in § 1.965–2(h)(2). However, USP's adjusted basis in the stock of CFC1 does not include the amount that would have been included in basis under § 1.965–2(f)(2)(ii)(A) without regard to the netting rule described in § 1.965–2(h)(2). Accordingly, for purposes of determining the value of stock of CFC1 at the beginning of the 2019 taxable year, USP's adjusted basis in the stock of CFC1 is $510 ($600 − $90).

(c)(2)(ii) through (c)(2)(vi) [Reserved]. For further guidance, see § 1.861–12T(c)(2)(ii) through (c)(2)(vi).

(3) *Characterization of stock of controlled foreign corporations*—(i) *Operative sections.* (A) *Operative sections other than section 904.* For purposes of applying this section to an operative section other than section 904,

stock in a controlled foreign corporation (as defined in section 957) is characterized as an asset in the relevant groupings on the basis of the asset method described in paragraph (c)(3)(ii) of this section, or the modified gross income method described in paragraph (c)(3)(iii) of this section. Stock in a controlled foreign corporation whose interest expense is apportioned on the basis of assets is characterized in the hands of its United States shareholders under the asset method described in paragraph (c)(3)(ii) of this section. Stock in a controlled foreign corporation whose interest expense is apportioned on the basis of modified gross income is characterized in the hands of its United States shareholders under the modified gross income method described in paragraph (c)(3)(iii) of this section.

(B) *Section 904 as operative section.* For purposes of applying this section to section 904 as the operative section, § 1.861–13 applies to characterize the stock of a controlled foreign corporation as an asset producing foreign source income in the separate categories described in § 1.904–5(a)(4)(v), or as an asset producing U.S. source income in the residual grouping, in the hands of the United States shareholder, and to determine the portion of the stock that gives rise to an inclusion under section 951A(a) that is treated as an exempt asset under § 1.861–8(d)(2)(ii)(C). Section 1.861–13 also provides rules for subdividing the stock in the various separate categories and the residual grouping into a section 245A subgroup and a non-section 245A subgroup in order to determine the amount of the adjustments required by section 904(b)(4) and § 1.904(b)–3(c) with respect to the section 245A subgroup, and provides rules for determining the portion of the stock that gives rise to a dividend eligible for a deduction under section 245(a)(5) that is treated as an exempt asset under § 1.861–8(d)(2)(ii)(B).

(ii) [Reserved]. For further guidance, see § 1.861–12T(c)(3)(ii).

(iii) *Modified gross income method.* Under the modified gross income method, the taxpayer characterizes the tax book value of the stock of the first-tier controlled foreign corporation based on the gross income, net of interest expense, of the controlled foreign corporation (as computed under § 1.861–9T(j) to include certain gross income, net of interest expense, of lower-tier controlled foreign corporations) within each relevant category for the taxable year of the controlled foreign corporation ending with or within the taxable year of the taxpayer. For this purpose, however, the gross income, net of interest expense, of the first-tier controlled foreign corporation includes the total amount of gross subpart F income, net of interest expense, of any lower-tier controlled foreign corporation that was excluded under the rules of § 1.861–9(j)(2)(ii)(B). The gross income, net of interest expense, of the first-tier controlled foreign corporation also includes the total amount of gross tested income, net of interest expense, of any lower-tier controlled foreign corporation that was excluded under the rules of § 1.861–9(j)(2)(ii)(C).

(4) *Characterization of stock of noncontrolled 10-percent owned foreign corporations*—(i) *In general.* Except in the case of a nonqualifying shareholder described in paragraph (c)(4)(ii) of this section, the principles of § 1.861–12(c)(3), including the relevant rules of § 1.861–13 when section 904 is the operative section, apply to characterize stock in a noncontrolled 10-percent owned foreign corporation (as defined in section 904(d)(2)(E)). Accordingly, stock in a noncontrolled 10-percent owned foreign corporation is characterized as an asset in the various separate categories on the basis of either the asset method described in § 1.861–12T(c)(3)(ii) or the modified gross income method described in § 1.861–12(c)(3)(iii). Stock in a noncontrolled 10-percent owned foreign corporation the interest expense of which is apportioned on the basis of assets is characterized in the hands of its shareholders under the asset method described in § 1.861–12T(c)(3)(ii). Stock in a noncontrolled 10-percent owned foreign corporation the interest expense of which is apportioned on the basis of gross income is characterized in the hands of its shareholders under the modified gross income method described in § 1.861–12(c)(3)(iii).

(ii) *Nonqualifying shareholders.* Stock in a noncontrolled 10-percent owned foreign corporation is characterized as a passive category asset in the hands of a shareholder that either is not a domestic corporation or is not a United States shareholder with respect to the noncontrolled 10-percent owned foreign corporation for the taxable year. Stock in a noncontrolled 10-percent owned foreign corporation is characterized as in the separate category described in section 904(d)(4)(C)(ii) in the hands of any shareholder with respect to whom look-through treatment is not substantiated. *See also* § 1.904–5(c)(4)(iii)(B). In the case of a noncontrolled 10-percent owned foreign corporation that is a passive foreign investment company with respect to a shareholder, stock in the noncontrolled 10-percent owned foreign corporation is characterized as a passive category asset in the hands of the shareholder if such shareholder does not meet the ownership requirements described in section 904(d)(2)(E)(i)(II).

(d) *Treatment of notes*—(1) *General rule.* [Reserved]. For further guidance, see § 1.861–12T(d)(1).

(2) *Characterization of related controlled foreign corporation notes.* The debt of a controlled foreign corporation is characterized in the same manner as the interest income derived from that debt obligation. See §§ 1.904–4 and 1.904–5(c)(2) for rules treating interest income as income in a separate category.

(e) through (j) [Reserved]. For further guidance, see § 1.861–12T(e) through (j).

(k) *Applicability date.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018. Section 1.861–12(c)(2)(i)(*B*)(*1*)(*ii*) also applies to the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, the taxable year in which or with which such taxable year of the foreign corporation ends.

■ **Par. 8.** § 1.861–13 is added to read as follows:

§ 1.861–13 Special rules for characterization of controlled foreign corporation stock.

(a) *Methodology.* For purposes of allocating and apportioning deductions for purposes of section 904 as the operative section, stock in a controlled foreign corporation owned directly or indirectly through a partnership or other pass-through entity by a United States shareholder is characterized by the United States shareholder under the rules described in this section. In general, paragraphs (a)(1) through (5) of this section characterize the stock of the controlled foreign corporation as an asset in the various statutory groupings and residual grouping based on the type of income that the stock of the controlled foreign corporation generates, has generated, or may reasonably be expected to generate when the income is included by the United States shareholder.

(1) *Step 1: Characterize stock as generating income in statutory groupings under the asset or modified gross income method*—(i) *Asset method.* United States shareholders using the asset method to characterize stock of a controlled foreign corporation must apply the asset method described in § 1.861–12T(c)(3)(ii) to assign the assets of the controlled foreign corporation to the statutory groupings described in

paragraphs (a)(1)(i)(A)(*1*) through (*10*) and (a)(1)(i)(B) of this section. If the controlled foreign corporation owns stock in a lower-tier noncontrolled 10-percent owned foreign corporation, the assets of the lower-tier noncontrolled 10-percent owned foreign corporation are assigned to a gross subpart F income grouping to the extent such assets generate income that, if distributed to the controlled foreign corporation, would be gross subpart F income of the controlled foreign corporation. *See also* § 1.861–12(c)(4).

(A) *General and passive categories.* Within each of the controlled foreign corporation's general category and passive category, each of the following subgroups within each category is a separate statutory grouping—

(*1*) Foreign source gross tested income;

(*2*) For each applicable treaty, U.S. source gross tested income that, when taken into account by a United States shareholder under section 951A, is resourced in the hands of the United States shareholder (*resourced gross tested income*);

(*3*) U.S. source gross tested income not described in paragraph (a)(1)(i)(A)(*2*) of this section;

(*4*) Foreign source gross subpart F income;

(*5*) For each applicable treaty, U.S. source gross subpart F income that, when included by a United States shareholder under section 951(a)(1), is resourced in the hands of the United States shareholder (*resourced gross subpart F income*);

(*6*) U.S. source gross subpart F income not described in paragraph (a)(1)(i)(A)(*5*) of this section;

(*7*) Foreign source gross section 245(a)(5) income;

(*8*) U.S. source gross section 245(a)(5) income;

(*9*) Any other foreign source gross income (*specified foreign source general category income* or *specified foreign source passive category income,* as the case may be); and

(*10*) Any other U.S. source gross income (*specified U.S. source general category gross income* or *specified U.S. source passive category gross income,* as the case may be).

(B) *Section 901(j) income.* For each country described in section 901(j), all gross income from sources in that country.

(ii) *Modified gross income method.* United States shareholders using the modified gross income method to characterize stock in a controlled foreign corporation must apply the modified gross income method under § 1.861–12(c)(3)(iii) to assign the modified gross income of the controlled foreign corporation to the statutory groupings described in paragraphs (a)(1)(i)(A)(*1*) through (*10*) and (a)(1)(i)(B) of this section. For this purpose, the rules described in §§ 1.861–12(c)(3)(iii) and 1.861–9T(j)(2) apply to combine gross income in a statutory grouping that is earned by the controlled foreign corporation with gross income of lower-tier controlled foreign corporations that is in the same statutory grouping. For example, foreign source general category gross tested income (net of interest expense) earned by the controlled foreign corporation is combined with its pro rata share of the foreign source general category gross tested income (net of interest expense) of lower-tier controlled foreign corporations. If the controlled foreign corporation owns stock in a lower-tier noncontrolled 10-percent owned foreign corporation, gross income of the lower-tier noncontrolled 10-percent owned foreign corporation is assigned to a gross subpart F income grouping to the extent that the income, if distributed to the upper-tier controlled foreign corporation, would be gross subpart F income of the upper-tier controlled foreign corporation. *See also* § 1.861–12(c)(4).

(2) *Step 2: Assign stock to the section 951A category.* A controlled foreign corporation is not treated as earning section 951A category income. The portion of the value of the stock of the controlled foreign corporation that is assigned to the section 951A category equals the value of the portion of the stock of the controlled foreign corporation that is assigned to the foreign source gross tested income statutory groupings within the general category (*general category gross tested income stock*) multiplied by the United States shareholder's inclusion percentage. Under § 1.861–8(d)(2)(ii)(C)(*2*)(*ii*), a portion of the value of stock assigned to the section 951A category may be treated as an exempt asset. The portion of the general category gross tested income stock that is not characterized as a section 951A category asset remains a general category asset and may result in expenses being disregarded under section 904(b)(4). See paragraph (a)(5)(ii) of this section and § 1.904(b)–3. No portion of the passive category gross tested income stock or U.S. source gross tested income stock is assigned to the section 951A category.

(3) *Step 3: Assign stock to a treaty category.* (i) *Inclusions under section 951A(a).* The portion of the value of the stock of the controlled foreign corporation that is assigned to a particular treaty category due to an inclusion of U.S. source income under section 951A(a) that was resourced under a particular treaty equals the value of the portion of the stock of the controlled foreign corporation that is assigned to the resourced gross tested income statutory grouping within each of the controlled foreign corporation's general or passive categories (*resourced gross tested income stock*) multiplied by the United States shareholder's inclusion percentage. Under § 1.861–8(d)(2)(ii)(C)(*2*)(*ii*), a portion of the value of stock assigned to a particular treaty category by reason of this paragraph (a)(3)(i) may be treated as an exempt asset. The portion of the resourced gross tested income stock that is not characterized as a treaty category asset remains a U.S. source general or passive category asset, as the case may be, that is in the residual grouping and may result in expenses being disregarded under section 904(b)(4) for purposes of determining entire taxable income under section 904(a). *See* paragraph (a)(5)(iv) of this section and § 1.904(b)–3.

(ii) *Inclusions under section 951(a)(1).* The portion of the value of the stock of the controlled foreign corporation that is assigned to a particular treaty category due to an inclusion of U.S. source income under section 951(a)(1) that was resourced under a treaty equals the value of the portion of the stock of the controlled foreign corporation that is assigned to the resourced gross subpart F income statutory grouping within each of the controlled foreign corporation's general category or passive category.

(4) *Step 4: Aggregate stock within each separate category and assign stock to the residual grouping.* The portions of the value of stock of the controlled foreign corporation assigned to foreign source statutory groupings that were not specifically assigned to the section 951A category under paragraph (a)(2) of this section (Step 2) are aggregated within the general category and the passive category to characterize the stock as general category stock and passive category stock, respectively. The portions of the value of stock of the controlled foreign corporation assigned to U.S. source statutory groupings that were not specifically assigned to a particular treaty category under paragraph (a)(3) of this section (Step 3) are aggregated to characterize the stock as U.S. source category stock, which is in the residual grouping. Stock assigned to the separate category for income described in section 901(j)(1) remains in that category.

(5) *Step 5: Determine section 245A and non-section 245A subgroups for each separate category and U.S. source category*—(i) *In general.* In the case of stock of a controlled foreign corporation that is held directly or indirectly through a partnership or other pass-through entity by a United States shareholder that is a domestic corporation, stock of the controlled foreign corporation that is general category stock, passive category stock, and U.S. source category stock is subdivided between a section 245A subgroup and a non-section 245A subgroup under paragraphs (a)(5)(ii) through (v) of this section for purposes of applying section 904(b)(4) and § 1.904(b)–3(c). Each subgroup is treated as a statutory grouping under § 1.861–8(a)(4) for purposes of allocating and apportioning deductions under §§ 1.861–8 through 1.861–14T and 1.861–17 in applying section 904 as the operative section. Deductions apportioned to each section 245A subgroup are disregarded under section 904(b)(4). *See* § 1.904(b)–3. Deductions apportioned to the statutory groupings for gross section 245(a)(5) income are not disregarded under section 904(b)(4); however, a portion of the stock assigned to those groupings is treated as exempt under § 1.861–8T(d)(2)(ii)(B).

(ii) *Section 245A subgroup of general category stock.* The portion of the general category stock of the controlled foreign corporation that is assigned to the section 245A subgroup of the general category equals the value of the general category gross tested income stock of the controlled foreign corporation that is not assigned to the section 951A category under paragraph (a)(2) of this section (Step 2), plus the value of the portion of the stock of the controlled foreign corporation that is assigned to the specified foreign source general category income statutory grouping.

(iii) *Section 245A subgroup of passive category stock.* The portion of passive category stock of the controlled foreign corporation that is assigned to the section 245A subcategory of the passive category equals the sum of—

(A) The value of the portion of the stock of the controlled foreign corporation that is assigned to the gross tested income statutory grouping within foreign source passive category income multiplied by a percentage equal to 100 percent minus the United States shareholder's inclusion percentage for passive category gross tested income; and

(B) The value of the portion of the stock of the controlled foreign corporation that was assigned to the specified foreign source passive category income statutory grouping.

(iv) *Section 245A subgroup of U.S. source category stock.* The portion of U.S. source category stock of the controlled foreign corporation that is assigned to the section 245A subgroup of the U.S. source category equals the sum of—

(A) The value of the portion of the stock of the controlled foreign corporation that is assigned to the U.S. source general category gross tested income statutory grouping multiplied by a percentage equal to 100 percent minus the United States shareholder's inclusion percentage for the general category;

(B) The value of the portion of the stock of the controlled foreign corporation that is assigned to the U.S. source passive category gross tested income statutory grouping multiplied by a percentage equal to 100 percent minus the United States shareholder's inclusion percentage for the passive category;

(C) The value of the resourced gross tested income stock of the controlled foreign corporation that is not assigned to a particular treaty category under paragraph (a)(3)(i) of this section (Step 3);

(D) The value of the portion of the stock of the controlled foreign corporation that is assigned to the specified U.S. source general category gross income statutory grouping; and

(E) The value of the portion of the stock of the controlled foreign corporation that is assigned to the specified U.S. source passive category gross income statutory grouping.

(v) *Non-section 245A subgroup.* The value of stock of a controlled foreign corporation that is not assigned to the section 245A subgroup within the general or passive category or the residual grouping is assigned to the non-section 245A subgroup within such category or grouping. The value of stock of a controlled foreign corporation that is assigned to the section 951A category, the separate category for income described in section 901(j)(1), or a particular treaty category is always assigned to a non-section 245A subgroup.

(b) *Definitions.* This paragraph (b) provides definitions that apply for purposes of this section.

(1) *Gross section 245(a)(5) income.* The term *gross section 245(a)(5) income* means all items of gross income described in section 245(a)(5)(A) and (B).

(2) *Gross subpart F income.* The term *gross subpart F income* means all items of gross income that are taken into account by a controlled foreign corporation in determining its subpart F income under section 952, except for items of gross income described in section 952(a)(5).

(3) *Gross tested income.* The term *gross tested income* has the meaning provided in § 1.951A–1(c)(1).

(4) *Inclusion percentage.* The term *inclusion percentage* has the meaning provided in § 1.960–2(c)(2).

(5) *Separate category.* The term *separate category* has the meaning provided in § 1.904–5(a)(4)(v).

(6) *Treaty category.* The term *treaty category* means a category of income earned by a controlled foreign corporation for which section 904(a), (b), and (c) are applied separately as a result of income being resourced under a treaty. See, for example, section 245(a)(10), 865(h), or 904(h)(10). A United States shareholder may have multiple treaty categories for amounts of income resourced by the United States shareholder under a treaty. *See* § 1.904–5(m)(7).

(7) *U.S. source category.* The term *U.S. source category* means the aggregate of U.S. source income in each separate category listed in section 904(d)(1).

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

(1) *Example 1: Asset method*—(i) *Facts*—(A) USP, a domestic corporation, directly owns all of the stock of a controlled foreign corporation, CFC1. The tax book value of CFC1's stock is $20,000. USP uses the asset method described in § 1.861–12T(c)(3)(ii) to characterize the stock of CFC1. USP's inclusion percentage is 70%.

(B) CFC1 owns the following assets with the following values as determined under §§ 1.861–9(g)(2) and 1.861–9T(g)(3): Assets that generate income described in the foreign source gross tested income statutory grouping within the general category ($4,000), assets that generate income described in the foreign source gross subpart F income statutory grouping within the general category ($1,000), assets that generate specified foreign source general category income ($3,000), and assets that generate income described in the foreign source gross subpart F income statutory grouping within the passive category ($2,000).

(C) CFC1 also owns all of the stock of CFC2, a controlled foreign corporation. The tax book value of CFC1's stock in CFC2 is $5,000. CFC2 owns the following assets with the following values as determined under §§ 1.861–9(g)(2) and 1.861–9T(g)(3): Assets that generate income described in the foreign source gross subpart F income statutory grouping within the general category ($2,250) and assets that generate specified foreign source general category income ($750).

(ii) *Analysis*—(A) *Step 1*—(*1*) *Characterization of CFC2 stock.* CFC2 has total assets of $3,000, $2,250 of which are in the foreign source gross subpart F income statutory grouping within the general category and $750 of which are in the specified foreign source general category income statutory grouping. Accordingly, CFC2's stock is characterized as $3,750 ($2,250/$3,000 × $5,000) in the foreign source gross subpart F income statutory grouping within the general category and $1,250 ($750/$3,000 × $5,000) in the specified foreign source general category income statutory grouping.

(*2*) *Characterization of CFC1 stock.* CFC1 has total assets of $15,000, $4,000 of which are in the foreign source gross tested income statutory grouping within the general category, $4,750 of which are in the foreign source gross subpart F income statutory grouping within the general category (including the portion of CFC2 stock assigned to that statutory grouping), $4,250 of which are in the specified foreign source general category income statutory grouping (including the portion of CFC2 stock assigned to that statutory grouping), and $2,000 of which are in the foreign source gross subpart F income statutory grouping within the passive category. Accordingly, CFC1's stock is characterized as $5,333 ($4,000/$15,000 × $20,000) in the foreign source gross tested income statutory grouping within the general category, $6,333 ($4,750/$15,000 × $20,000) in the foreign source gross subpart F income statutory grouping within the general category, $5,667 ($4,250/$15,000 × $20,000) in the specified foreign source general category income statutory grouping, and $2,667 ($2,000/$15,000 × $20,000) in the foreign source gross subpart F income statutory grouping within the passive category.

(B) *Step 2.* The portion of the value of the stock of CFC1 that is general category gross tested income stock is $5,333. USP's inclusion percentage is 70%. Accordingly, under paragraph (a)(2) of this section, $3,733 of the stock of CFC1 is assigned to the section 951A category and a portion thereof may be treated as an exempt asset under § 1.861–8(d)(2)(ii)(C)(*2*)(*ii*). The remainder, $1,600, remains a general category asset.

(C) *Step 3.* No portion of the stock of CFC1 is resourced gross tested income stock or assigned to the resourced gross subpart F income statutory grouping in any treaty category. Accordingly, no portion of the stock of CFC1 is assigned to a treaty category under paragraph (a)(3) of this section.

(D) *Step 4*—(*1*) *General category stock.* The total portion of the value of the stock of CFC1 that is general category stock is $13,600, which is equal to $1,600 (the portion of the value of the general category stock of CFC1 that was not assigned to the section 951A category in Step 2) plus $5,667 (the value of the portion of the stock of CFC1 assigned to the specified foreign source income statutory grouping within the general category) plus $6,333 (the value of the portion of the stock of CFC1 assigned to the foreign source gross subpart F income statutory grouping within the general category).

(*2*) *Passive category stock.* The total portion of the value of the stock of CFC1 that is passive category stock is $2,667.

(*3*) *U.S source category stock.* No portion of the value of the stock of CFC1 is U.S. source category stock.

(E) *Step 5*—(*1*) *General category stock.* Under paragraph (a)(5)(ii) of this section, the value of the stock of CFC1 assigned to the section 245A subgroup of general category stock is $7,267, which is equal to $1,600 (the portion of the value of the general category stock of CFC1 that was not assigned to the section 951A category in Step 2) plus $5,667 (the value of the portion of the stock of CFC1 assigned to the specified foreign source general category income statutory grouping). Under paragraph (a)(5)(v) of this section, the remainder of the general category stock of CFC1, $6,333, is assigned to the non-section 245A subgroup of general category stock.

(*2*) *Passive category stock.* No portion of the passive category stock of CFC1 is in the foreign source gross tested income statutory grouping or the specified foreign source passive category income statutory grouping. Accordingly, under paragraph (a)(5)(iii) of this section, no portion of the value of the stock of CFC1 is assigned to the section 245A subgroup of passive category stock. Under paragraph (a)(5)(v) of this section, the passive category stock of CFC1, $2,667 is assigned to the non-section 245A subgroup of passive category stock.

(*3*) *Section 951A category stock.* Under paragraph (a)(5)(v) of this section, all of the section 951A category stock, $3,733, is assigned to the non-section 245A subgroup of section 951A category stock.

(F) *Summary.* For purpose of the allocation and apportionment of expenses, $13,600 of the stock of CFC1 is characterized as general category stock, $7,267 of which is in the section 245A subgroup and $6,333 of which is in the non-section 245A subgroup; $2,667 of the stock of CFC1 is characterized as passive category stock, all of which is in the non-section 245A subgroup; and $3,733 of the stock of CFC1 is characterized as section 951A category stock, all of which is in the non-section 245A subgroup.

(2) *Example 2: Asset method with noncontrolled 10-percent owned foreign corporation*—(i) *Facts.* The facts are the same as in paragraph (c)(1)(i) of this section, except that CFC1 does not own CFC2 and instead owns 20% of the stock of FC2, a foreign corporation that is a noncontrolled 10-percent owned foreign corporation. The tax book value of CFC1's stock in FC2 is $5,000. FC2 owns assets with the following values as determined under §§ 1.861–9(g)(2) and 1.861–9T(g)(3): Assets that generate specified foreign source general category income ($3,000). All of the assets of FC2 generate income that, if distributed to CFC1 as a dividend, would be foreign source gross subpart F income in the general category to CFC1.

(ii) *Analysis*—(A) *Step 1*—(*1*) *Characterization of FC2 stock.* All of the assets of FC2 generate income that, if distributed to CFC1, would be foreign source gross subpart F income in the general category to CFC1. Accordingly, under paragraph (a)(1)(i) of this section, all of CFC1's stock in FC2 ($5,000) is characterized as in the foreign source gross subpart F income statutory grouping within the general category.

(*2*) *Characterization of CFC1 stock.* CFC1 has total assets of $15,000, $4,000 of which are in the foreign source gross tested income statutory grouping within the general category, $6,000 of which are in the foreign source gross subpart F income statutory grouping within the general category (including the FC2 stock assigned to that statutory grouping), $3,000 of which are in the specified foreign source general category income statutory grouping, and $2,000 of which are in the foreign source gross subpart F income statutory grouping within the passive category. Accordingly, CFC1's stock is characterized as $5,333 ($4,000/$15,000 × $20,000) in the foreign source gross tested income statutory grouping within the general category, $8,000 ($6,000/$15,000 × $20,000) in the foreign source gross subpart F income statutory grouping within the general category, $4,000 ($3,000/$15,000 × $20,000) in the specified foreign source general category income statutory grouping, and $2,667 ($2,000/$15,000 × $20,000) in the foreign source gross subpart F income statutory grouping within the passive category.

(B) *Step 2.* The analysis is the same as in paragraph (c)(1)(ii)(B) of this section.

(C) *Step 3.* The analysis is the same as in paragraph (c)(1)(ii)(C) of this section.

(D) *Step 4*—(*1*) *General category stock.* The total portion of the value of the stock of CFC1 that is general category stock is $13,600, which is equal to $1,600 (the portion of the value of the general category stock of CFC1 that was not assigned to the section 951A category in Step 2) plus $4,000 (the value of the portion of the stock of CFC1 assigned to the specified foreign source income statutory grouping within the general category general category) plus $8,000 (the value of the portion of the stock of CFC1 assigned to the foreign source gross subpart F income statutory grouping within the general category).

(*2*) *Passive category stock.* The analysis is the same as in paragraph (c)(1)(ii)(D)(*2*) of this section.

(E) *Step 5*—(*1*) *General category stock.* Under paragraph (a)(5)(ii) of this section, the value of the stock of CFC1 assigned to the section 245A subgroup of general category stock is $5,600, which is equal to $1,600 (the portion of the value of the general category stock of CFC1 that was not assigned to the section 951A category in Step 2) plus $4,000 (the value of the portion of the stock of CFC1 assigned to the specified foreign source general category income statutory grouping). Under paragraph (a)(5)(v) of this section, the remainder of the general category stock of CFC1, $8,000, is assigned to the non-section 245A subgroup of general category stock.

(*2*) *Passive category stock.* The analysis is the same as in paragraph (c)(1)(ii)(E)(*2*) of this section.

(*3*) *Section 951A category stock.* The analysis is the same as in paragraph (c)(1)(ii)(E)(*3*) of this section.

(F) *Summary.* For purpose of the allocation and apportionment of expenses, $13,600 of the stock of CFC1 is characterized as general category stock, $5,600 of which is in the section 245A subgroup and $8,000 of which is in the non-section 245A subgroup; $2,667 of the stock of CFC1 is characterized as passive category stock, all of which is in the non-section 245A subgroup; and $3,733 of the stock of CFC1 is characterized as section 951A category stock, all of which is in the non-section 245A subgroup.

(3) *Example 3: Modified gross income method*—(i) *Facts*—(A) USP, a domestic corporation, directly owns all of the stock of a controlled foreign corporation, CFC1. The tax book value of CFC1's stock is $100,000. CFC1 owns all of the stock of CFC2, a controlled foreign corporation. USP uses the modified gross income method described in § 1.861–12(c)(3)(iii) to characterize the stock in CFC1. USP's inclusion percentage is 100%.

(B) CFC1 earns $1,500 of foreign source gross tested income within the general category and $500 of foreign source gross subpart F income within the passive category. CFC1 incurs $200 of interest expense.

(C) CFC2 earns $3,000 of foreign source gross tested income within the general category, $2,000 of foreign source gross subpart F income within the general category, and $1,000 of specified foreign source general category income. CFC2 incurs $3,000 of interest expense.

(ii) *Analysis*—(A) *Step 1*—(*1*) *Determination of CFC2 gross income (net of interest expense).* CFC2 has total gross income of $6,000. CFC2's $3,000 of interest expense is apportioned among the statutory groupings of gross income based on the gross income of CFC2 to determine the gross income (net of interest expense) of CFC2 in each statutory grouping. As a result, $1,500 ($3,000/$6,000 × $3,000) of interest expense is apportioned to foreign source gross tested income within the general category, $1,000 ($2,000/$6,000 × $3,000) of interest expense is apportioned to foreign source gross subpart F income within the general category, and $500 ($1,000/$6,000 × $3,000) of interest expense is apportioned to specified foreign source general category income. Accordingly, CFC2 has the following amounts of gross income (net of interest expense): $1,500 ($3,000 − $1,500) of foreign source gross tested income within the general category, $1,000 ($2,000 − $1,000) of foreign source gross subpart F income within the general category, and $500 ($1,000 − $500) of specified foreign source general category income.

(*2*) *Determination of CFC1 gross income (net of interest expense).* Before including the gross income consisting of subpart F income and tested income (net of interest expense) of CFC2, CFC1 has total gross income of $2,500, including $500 of CFC2's specified foreign source general category income which is combined with CFC1's items of gross income under § 1.861–9(j)(2)(ii). CFC1's $200 of interest expense is apportioned among the statutory groupings of gross income of CFC1 to determine the gross income (net of interest expense) of CFC1 in each statutory grouping. As a result, $120 ($1,500/$2,500 × $200) of interest expense is apportioned to foreign source gross tested income within the general category, $40 ($500/$2,500 × $200) to foreign source gross subpart F income within the passive category, and $40 ($500/$2,500 × $200) to specified foreign source general category income. Accordingly, CFC1 has the following amounts of gross income (net of interest expense) before including the gross income (net of interest expense) of CFC2: $1,380 ($1,500 − $120) of foreign source gross tested income within the general category, $460 ($500 − $40) of foreign source gross subpart F income within the passive category, and $460 ($500 − $40) of specified foreign source general category income. After including the gross income consisting of subpart F income and tested income (net of interest expense) of CFC2, CFC1 has the following amounts of gross income (net of interest expense): $2,880 ($1,380 + $1,500) of foreign source gross tested income within the general category, $1,000 of foreign source gross subpart F income within the general category, $460 of specified foreign source general category income, and $460 of foreign source gross subpart F income within the passive category.

(*3*) *Characterization of CFC1 stock.* CFC1 is considered to have a total of $4,800 of gross income (net of interest expense) for purposes of characterizing the stock of CFC1. Accordingly, CFC1's stock is characterized as $60,000 ($2,880/$4,800 × $100,000) in the foreign source gross tested income statutory grouping within the general category, $20,834 ($1,000/$4,800 × $100,000) in the foreign source gross subpart F income statutory grouping within the general category, $9,583 ($460/$4,800 × $100,000) in the specified foreign source general category income statutory grouping, and $9,583 ($460/ $4,800 × $100,000) in the foreign source gross subpart F income statutory grouping within the passive category.

(B) *Step 2.* The portion of the value of the stock of CFC1 that is general category gross tested income stock is $60,000. USP's inclusion percentage is 100%. Accordingly, under paragraph (a)(2) of this section, all of the $60,000 of the stock of CFC1 is assigned to the section 951A category.

(C) *Step 3.* No portion of the stock of CFC1 is resourced gross tested income or assigned to the resourced gross subpart F income statutory group in any treaty category. Accordingly, no portion of the stock of CFC1 is assigned to a treaty category under paragraph (a)(3) of this section.

(D) *Step 4*—(*1*) *General category stock.* The total portion of the value of the stock of CFC1 that is general category stock is $30,417, which is equal to $20,834 (the value of the portion of the stock of CFC1 assigned to the subpart F income statutory grouping within the general category income statutory grouping) plus $9,583 (the value of the portion of the stock of CFC1 assigned to the specified foreign source general category income statutory grouping).

(*2*) *Passive category stock.* The total portion of the value of the stock of CFC1 that is passive category stock is $9,583.

(*3*) *U.S. source category stock.* No portion of the value of the stock of CFC1 is U.S. source category stock.

(E) *Step 5*—(*1*) *General category stock.* All of the value of the general category gross tested income stock of CFC1 was assigned to the section 951A category in Step 2. Accordingly, under paragraph (a)(5)(ii) of this section, the value of the stock of CFC1 assigned to the section 245A subgroup of general category stock is $9,583, which is equal to the value of the portion assigned to the specified foreign source general category income statutory grouping. Under paragraph (a)(5)(v) of this section, the remainder of the general category stock of CFC1, $20,834, is assigned to the non-section 245A subgroup of general category stock.

(*2*) *Passive category stock.* No portion of the passive category stock of CFC1 is in the foreign source gross tested income statutory grouping or the specified foreign source passive category income statutory grouping. Accordingly, under paragraph (a)(5)(iii) of this section, no portion of the value of the stock of CFC1 is assigned to the section 245A subgroup. Under paragraph (a)(5)(v) of this section, the passive category stock of CFC1, $9,534, is assigned to the non-section 245A subgroup of passive category stock.

(*3*) *Section 951A category stock.* Under paragraph (a)(5)(v) of this section, all of the section 951A category stock, $60,000, is assigned to the non-section 245A subgroup of section 951A category stock.

(F) *Summary.* For purposes of the allocation and apportionment of expenses, $60,000 of the stock of CFC1 is characterized as section 951A category stock, all of which is in the non-section 245A subgroup; $30,417 of the stock of CFC1 is characterized as general category stock, $9,583 of which is in the section 245A subgroup and $20,834 of which is in the non-section 245A subgroup; and $9,583 of the stock of CFC1 is characterized as passive category stock, all of which is in the non-section 245A subgroup.

(d) *Applicability dates.* This section applies for taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

§ 1.861–14 [Amended]

■ **Par. 9.** Section 1.861–14 is amended by:

■ 1. Removing the language '', except that section 936 corporations (as defined in § 1.861–11(d)(2)(ii)) are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section'' from the first sentence of paragraph (d)(1).

■ 2. Removing and reserving paragraph (d)(2).

■ **Par. 10.** Section 1.861–17 is amended by:

■ 1. Adding paragraph (e)(3).

■ 2. Removing and reserving paragraph (g).

■ 3. Adding paragraph (i).

The additions and revisions read as follows:

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

* * * * *

(e) * * *

(3) *Change of method for first taxable year beginning after December 31, 2017.* A taxpayer otherwise subject to the binding election described in paragraph

(e)(1) of this section may change its method once for its first taxable year beginning after December 31, 2017, without the prior consent of the Commissioner. The taxpayer's use of a new method constitutes a binding election to use the new method for its return filed for the first year for which the taxpayer uses the new method and for four taxable years thereafter.

* * * * *

(g) [Reserved]

* * * * *

(i) *Applicability date.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

■ **Par. 11.** Section 1.901(j)–1 is added to read as follows:

§ 1.901(j)–1 Denial of foreign tax credit with respect to certain foreign countries.

(a) *Sourcing rule for related party payments and inclusions.* Any income paid or accrued through one or more entities is treated as income from sources within a country described in section 901(j)(2) if the income was, without regard to such entities, from sources within that country.

(b) *Applicability date.* This section applies to taxable years that end on or after December 4, 2018.

■ **Par. 12.** § 1.904–1 is revised to read as follows:

§ 1.904–1 Limitation on credit for foreign taxes.

(a) *In general.* For each separate category described in § 1.904–5(a)(4)(v), the total credit for taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(c)) shall not exceed that proportion of the tax against which such credit is taken which the taxpayer's taxable income from foreign sources (but not in excess of the taxpayer's entire taxable income) in such separate category bears to his entire taxable income for the same taxable year.

(b) *Special computation of taxable income.* For purposes of computing the limitation under paragraph (a) of this section, the taxable income in the case of an individual, estate, or trust is computed without any deduction for personal exemptions under section 151 or 642(b).

(c) *Joint return.* In the case of spouses making a joint return, the applicable limitation prescribed by section 904(a) on the credit for taxes paid or accrued to foreign countries and possessions of the United States is applied with respect to the aggregate taxable income in each separate category from sources without the United States, and the aggregate taxable income from all sources, of the spouses.

(d) *Consolidated group.* For rules relating to the computation of the foreign tax credit limitation for a consolidated group, see § 1.1502–4.

(e) *Applicability dates.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

■ **Par. 13.** Section 1.904–2 is amended by:

■ 1. Revising paragraphs (a) through (d).

■ 2. Removing the language "904(d)" and adding the language "904(c)" in its place in paragraph (e).

■ 3. Removing and reserving paragraph (g).

■ 4. Revising paragraphs (h) and (i).

■ 5. Adding paragraphs (j) and (k).

The revisions and additions read as follows:

§ 1.904–2 Carryback and carryover of unused foreign tax.

(a) *Credit for foreign tax carryback or carryover.* A taxpayer who chooses to claim a credit under section 901 for a taxable year is allowed a credit under that section not only for taxes otherwise allowable as a credit but also for taxes deemed paid or accrued in that year as a result of a carryback or carryover of an unused foreign tax under section 904(c). However, the taxes so deemed paid or accrued are not allowed as a deduction under section 164(a). Foreign tax paid or accrued with respect to section 951A category income, including section 951A category income that is reassigned to a separate category for income resourced under a treaty, may not be carried back or carried forward or deemed paid or accrued under section 904(c). For special rules regarding these computations in case of taxes paid, accrued, or deemed paid with respect to foreign oil and gas extraction income or foreign oil related income, see section 907(f) and the regulations under that section.

(b) *Years to which foreign taxes are carried.* If the taxpayer chooses the benefits of section 901 for a taxable year, any unused foreign tax paid or accrued in that year is carried first to the immediately preceding taxable year and then, as applicable, to each of the ten succeeding taxable years, in chronological order, but only to the extent not absorbed as taxes deemed paid or accrued under paragraph (d) of this section in a prior taxable year.

(c) *Definitions.* This paragraph (c) provides definitions that apply for purposes of this section.

(1) *Unused foreign tax.* The term *unused foreign tax* means, with respect to each separate category for any taxable year, the excess of the amount of creditable foreign tax paid or accrued, or deemed paid under section 902 (as in effect on December 21, 2017) or section 960, in such year, over the applicable foreign tax credit limitation under section 904 for the separate category in such year. Unused foreign tax does not include any amount for which a credit is disallowed, including foreign income taxes for which a credit is disallowed or reduced when the tax is paid, accrued, or deemed paid.

(2) *Separate category.* The term *separate category* has the same meaning as provided in § 1.904–5(a)(4)(v).

(3) *Excess limitation*—(i) *In general.* The term *excess limitation* means, with respect to a separate category for any taxable year (the *excess limitation year*) and an unused foreign tax carried from another taxable year (the *excess credit year*), the amount (if any) by which the limitation for that separate category with respect to that excess limitation year exceeds the sum of—

(A) The creditable foreign tax actually paid or accrued or deemed paid under section 902 (as in effect on December 21, 2017) or section 960 with respect to the separate category in the excess limitation year, and

(B) The portion of any unused foreign tax for a taxable year preceding the excess credit year that is absorbed as taxes deemed paid or accrued in the excess limitation year under paragraph (a) of this section.

(ii) *Deduction years.* Excess limitation for a taxable year absorbs unused foreign tax, regardless of whether the taxpayer chooses to claim a credit under section 901 for the year. In such case, the amount of the excess limitation, if any, for the year is determined in the same manner as though the taxpayer had chosen to claim a credit under section 901 for that year. For purposes of this determination, if the taxpayer has an overall foreign loss account, the excess limitation in a deduction year is determined based on the amount of the overall foreign loss the taxpayer would have recaptured if the taxpayer had chosen to claim a credit under section 901 for that year and had not made an election under § 1.904(f)–2(c)(2) to recapture more of the overall foreign loss account than is required under § 1.904(f)–2(c)(1).

(d) *Taxes deemed paid or accrued*—(1) *Amount deemed paid or accrued.* The amount of unused foreign tax with respect to a separate category that is deemed paid or accrued in any taxable year to which such unused foreign tax may be carried under paragraph (b) of this section is equal to the smaller of—

(i) The portion of the unused foreign tax that may be carried to the taxable year under paragraph (b) of this section, or

(ii) The amount, if any, of the excess limitation for such taxable year with respect to such unused foreign tax.

(2) *Carryback or carryover tax deemed paid or accrued in the same separate category.* Any unused foreign tax, which is deemed to be paid or accrued under section 904(c) in the year to which it is carried, is deemed to be paid or accrued with respect to the same separate category as the category to which it was assigned in the year in which it was actually paid or accrued. However, see paragraphs (h) through (j) of this section for transition rules in the case of certain carrybacks and carryovers.

(3) *No duplicate disallowance of creditable foreign tax.* Foreign income taxes for which a credit is partially disallowed, including when the tax is paid, accrued, or deemed paid, are not reduced again by reason of the unused foreign tax being deemed to be paid or accrued in the year to which it is carried under section 904(c).

* * * * *

(g) [Reserved]

(h) *Transition rules for carryovers of pre-2003 unused foreign tax and carrybacks of post-2002 unused foreign tax paid or accrued with respect to dividends from noncontrolled section 902 corporations.* For transition rules for carryovers of pre-2003 unused foreign tax, and carrybacks of post-2002 unused foreign tax, paid or accrued with respect to dividends from noncontrolled section 902 corporations, see 26 CFR 1.904–2(h) (revised as of April 1, 2018).

(i) *Transition rules for carryovers of pre-2007 unused foreign tax and carrybacks of post-2006 unused foreign tax.* For transition rules for carryovers of pre-2007 unused foreign tax, and carrybacks of post-2006 unused foreign tax, see 26 CFR 1.904–2(i) (revised as of April 1, 2018).

(j) *Transition rules for carryovers and carrybacks of pre-2018 and post-2017 unused foreign tax*—(1) *Carryover of unused foreign tax*—(i) *In general.* For purposes of this paragraph (j), the terms *post-2017 separate category, pre-2018 separate category,* and *specified separate category* have the meanings set forth in § 1.904(f)–12(j)(1). The rules of this paragraph (j)(1) apply to reallocate to the taxpayer's post-2017 separate categories for foreign branch category income, general category income, passive category income, and specified separate categories of income, any unused foreign taxes (as defined in paragraph (c)(1) of this section) that were paid or accrued or deemed paid under sections 902 and 960 with respect to income in a pre-2018 separate category.

(ii) *Allocation to the same separate category.* Except as provided in paragraph (j)(1)(iii) of this section, to the extent any unused foreign taxes paid or accrued or deemed paid with respect to a separate category of income are carried forward to a taxable year beginning after December 31, 2017, such taxes are allocated to the same post-2017 separate category as the pre-2018 separate category from which the unused foreign taxes are carried.

(iii) *Exception for certain general category unused foreign taxes*—(A) *In general.* To the extent any unused foreign taxes paid or accrued (but not taxes deemed paid) with respect to general category income are carried forward to a taxable year beginning after December 31, 2017, a taxpayer may choose to allocate those taxes to the taxpayer's post-2017 separate category for foreign branch category income to the extent those taxes would have been allocated to the taxpayer's post-2017 separate category for foreign branch category income if the taxes were paid or accrued in a taxable year beginning after December 31, 2017. Any remaining unused foreign taxes paid or accrued or deemed paid with respect to general category income carried forward to a taxable year beginning after December 31, 2017, are allocated to the taxpayer's post-2017 separate category for general category income.

(B) *Rules regarding the exception.* A taxpayer applying the exception described in paragraph (j)(1)(iii)(A) of this section (the *branch carryover exception*) must apply the exception to all of its unused foreign taxes paid or accrued with respect to general category income that are carried forward to all taxable years beginning after December 31, 2017. A taxpayer may choose to apply the branch carryover exception on a timely filed original return (including extensions) or an amended return. A taxpayer that applies the exception on an amended return must make appropriate adjustments to eliminate any double benefit arising from application of the exception to years that are not open for assessment.

(2) *Carryback of unused foreign tax*—(i) *In general.* The rules of this paragraph (j)(2) apply to any unused foreign taxes that were paid or accrued, or deemed paid under section 960, with respect to income in a post-2017 separate category.

(ii) *Passive category income and specified separate categories of income described in § 1.904–4(m).* Any unused foreign taxes paid or accrued or deemed paid with respect to passive category income or a specified separate category of income in a taxable year beginning after December 31, 2017, that are carried back to a taxable year beginning before January 1, 2018, are allocated to the same pre-2018 separate category as the post-2017 separate category from which the unused foreign taxes are carried.

(iii) *General category income and foreign branch category income.* Any unused foreign taxes paid or accrued or deemed paid with respect to general category income or foreign branch category income in a taxable year beginning after December 31, 2017, that are carried back to a taxable year beginning before January 1, 2018, are allocated to the taxpayer's pre-2018 separate category for general category income.

(k) *Applicability date.* Paragraphs (a) through (i) of this section apply to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018. Paragraph (j) of this section applies to taxable years beginning after December 31, 2017. Paragraph (j)(2) of this section also applies to the last taxable year beginning before January 1, 2018.

■ **Par. 14.** Section 1.904–3 is amended by:

■ 1. Revising the section heading.

■ 2. Removing the language ''a husband and wife'' and adding the language ''spouses'' in its place in paragraphs (a), (b), (c), and (d).

■ 3. Adding a sentence to the end of paragraph (a).

■ 4. Removing the second and third sentences in paragraph (d).

■ 5. Revising paragraph (e).

■ 6. Revising paragraphs (f)(1) through (f)(3).

■ 7. Removing the language ''904(d)'' and adding the language ''904(c)'' in its place in paragraphs (f)(5)(i) and (ii).

■ 8. Removing paragraph (f)(6).

■ 9. Removing and reserving paragraph (g).

■ 10. Adding paragraph (h).

The additions and revisions read as follows:

§ 1.904–3 Carryback and carryover of unused foreign tax by spouses making a joint return.

(a) * * * The rules in this section apply separately with respect to each separate category as defined in § 1.904–5(a)(4)(v).

* * * * *

(e) *Amounts carried from or through a joint return year to or through a separate return year*—(1) *In general.* It is necessary to allocate to each spouse the spouse's share of an unused foreign tax or excess limitation for any taxable year for which the spouses filed a joint return if—

(i) The spouses file separate returns for the current taxable year and an unused foreign tax is carried thereto from a taxable year for which they filed a joint return;

(ii) The spouses file separate returns for the current taxable year and an unused foreign tax is carried to such taxable year from a year for which they filed separate returns but is first carried through a year for which they filed a joint return; or

(iii) The spouses file a joint return for the current taxable year and an unused foreign tax is carried from a taxable year for which they filed joint returns but is first carried through a year for which they filed separate returns.

(2) *Computation and adjustments.* In the cases described in paragraph (e)(1) of this section, the separate carryback or carryover of each spouse to the current taxable year shall be computed in the manner described in § 1.904–2 but with the modifications set forth in paragraph (f) of this section. Where applicable, appropriate adjustments are made to take into account the fact that, for any taxable year involved in the computation of the carryback or the carryover, either spouse has combined foreign oil and gas income described in section 907(b) with respect to which the limitation in section 907(a) applies.

(f) * * * (1) *Separate category limitation.* The limitation in a separate category of a particular spouse for a taxable year for which a joint return is made shall be the portion of the limitation on the joint return which bears the same ratio to such limitation as such spouse's foreign source taxable income (with gross income and deductions taken into account to the same extent as taken into account on the joint return) in such separate category (but not in excess of the joint foreign source taxable income) bears to the joint foreign source taxable income in such separate category.

(2) *Unused foreign tax.* For purposes of this section, the term *unused foreign tax* means, with respect to a particular spouse and separate category for a taxable year for which a joint return is made, the excess of the foreign tax paid or accrued by that spouse with respect to that separate category over that spouse's separate category limitation.

(3) *Excess limitation.* For purposes of this section, the term *excess limitation* means, with respect to a particular spouse and separate category for a taxable year for which a joint return is made, the excess of that spouse's separate category limitation over the foreign taxes paid or accrued by such spouse with respect to such separate category for such taxable year.

* * * * *

(g) [Reserved]

(h) *Applicability date.* This section is applicable for taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

■ **Par. 15.** § 1.904–4 is amended by:

■ 1. Revising paragraph (a).

■ 2. Removing the language ''1248; or'' from paragraph (b)(2)(i)(A) and adding the language ''1248;'' in its place.

■ 3. Removing the language ''1293.'' from paragraph (b)(2)(i)(B) and adding the language ''1293;'' in its place.

■ 4. Adding paragraphs (b)(2)(i)(C) and (D).

■ 5. Revising the first and second sentences of paragraph (b)(2)(ii).

■ 6. Removing the language ''shall not be'' from the first sentence of paragraph (c)(1) and adding the language ''is not'' in its place.

■ 7. Revising the second, third, and fourth sentences of paragraph (c)(1).

■ 8. Removing the last sentence of paragraph (c)(1).

■ 9. Revising the second, third, and fourth sentences, and adding a new sentence after the fourth sentence, of paragraph (c)(3).

■ 10. Revising paragraph (c)(4).

■ 11. Revising paragraph (c)(5)(ii).

■ 12. Removing the second and third sentences of paragraphs (c)(5)(iii)(A) and (B).

■ 13. Revising the first sentence of paragraph (c)(6)(i).

■ 14. Removing the language ''deemed paid or accrued'' and adding the language ''deemed paid'' in its place in the second sentence in paragraph (c)(6)(i).

■ 15. Removing the word ''taxable'' from the last sentence of paragraph (c)(6)(i).

■ 16. Revising the first, fourth, fifth, and sixth sentences of paragraph (c)(6)(iii).

■ 17. Removing the word ''taxable'' in the second sentence of paragraph (c)(6)(iii).

■ 18. Removing the language ''deemed paid or accrued'' and adding the language ''deemed paid'' in its place in the third sentence of paragraph (c)(6)(iii).

■ 19. Revising paragraph (c)(6)(iv).

■ 20. Revising the second sentence and the sixth sentence of paragraph (c)(7)(i).

■ 21. Removing the language ''general category income'' and adding the language ''income in another separate category'' in its place in the third sentence of paragraph (c)(7)(iii).

■ 22. Adding paragraph (d) and revising paragraph (e)(1).

■ 23. Removing and reserving paragraph (e)(2)(i)(W).

■ 24. Removing the last sentence of paragraph (e)(3)(ii).

■ 25. Removing paragraph (e)(5).

■ 26. Adding paragraphs (f) and (g).

■ 27. Revising paragraphs (h)(2), (h)(5)(i), (h)(5)(ii), and paragraphs (k) through (n).

■ 28. Adding paragraphs (o), (p), and (q).

The revisions and additions read as follows:

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

(a) *In general.* A taxpayer is required to compute a separate foreign tax credit limitation for income received or accrued in a taxable year that is described in section 904(d)(1)(A) (section 951A category income), 904(d)(1)(B) (foreign branch category income), 904(d)(1)(C) (passive category income), 904(d)(1)(D) (general category income), or paragraph (m) of this section (specified separate categories). For purposes of this section, the definitions in § 1.904–5(a)(4) apply.

(b) * * *

(2) * * *

(i) * * *

(C) Distributive shares of partnership income treated as passive category income under paragraph (n)(1) of this section, and income from the sale of a partnership interest treated as passive category income under paragraph (n)(2) of this section; or

(D) Income treated as passive category income under the look-through rules in § 1.904–5.

(ii) *Exceptions.* Passive income does not include any export financing interest (as defined in paragraph (h) of this section), any high-taxed income (as defined in paragraph (c) of this section), financial services income (as defined in paragraph (e)(1)(ii) of this section), or any active rents and royalties (as defined in paragraph (b)(2)(iii) of this section). In addition, passive income does not include any income that would otherwise be passive but is excluded from passive category income under § 1.904–5(b)(1). * * *

* * * * *

(c) * * * (1) * * * Income is considered to be high-taxed income if, after allocating expenses, losses, and other deductions of the United States person to that income under paragraph (c)(2) of this section, the sum of the foreign income taxes paid or accrued, and deemed paid under section 960, by the United States person with respect to such income (reduced by any portion of such taxes for which a credit is not allowed) exceeds the highest rate of tax specified in section 1 or 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph (c), income that would otherwise be passive income is determined to be high-taxed income, the income is treated as general category income, foreign branch category income, section 951A category income, or income in a specified separate category, as determined under the rules of this section, and any taxes imposed on that income are considered related to the same separate category of income under § 1.904–6. If, after application of this paragraph (c), passive income is zero or less than zero, any taxes imposed on the passive income are considered related to the same separate category of income to which the passive income (if not reduced to zero or less than zero) would have been assigned had the income been treated as high-taxed income (general category, foreign branch category, section 951A category, or a specified separate category). * * *

* * * * *

(3) * * * Paragraph (c)(4) of this section provides additional rules for inclusions under section 951(a)(1) or 951A(a) that are passive income, dividends from a controlled foreign corporation or noncontrolled 10-percent owned foreign corporation that are passive income, and income that is received or accrued by a United States person through a foreign QBU that is passive income. For purposes of this paragraph (c), a foreign QBU is a qualified business unit (as defined in section 989(a)), other than a controlled foreign corporation or noncontrolled 10-percent owned foreign corporation, that has its principal place of business outside the United States. These rules apply whether the income is received from a controlled foreign corporation of which the United States person is a United States shareholder, from a noncontrolled 10-percent owned foreign corporation of which the United States person is a United States shareholder that is a domestic corporation, or from any other person. In applying these rules, passive income is not treated as subject to a withholding tax or other foreign tax for which a credit is disallowed in full, for example, under section 901(k). * * *

(4) *Dividends and inclusions from controlled foreign corporations, dividends from noncontrolled 10-percent owned foreign corporations, and income attributable to foreign QBUs.* Except as provided in paragraph (c)(5) of this section, the rules of this paragraph (c)(4) apply to all dividends and all amounts included in gross income of a United States shareholder under section 951(a)(1) or 951A(a) with respect to the foreign corporation that (after application of the look-through rules of section 904(d)(3) and § 1.904–5) are attributable to passive income received or accrued by a controlled foreign corporation, all dividends from a noncontrolled 10-percent owned foreign corporation that are received or accrued by a United States shareholder that (after application of the look-through rules of section 904(d)(4) and § 1.904–5) are treated as passive income, and all amounts of passive income received or accrued by a United States person through a foreign QBU. The grouping rules of paragraph (c)(3)(i) through (iv) of this section apply separately to dividends, to inclusions under section 951(a)(1) and to inclusions under section 951A(a) with respect to each controlled foreign corporation of which the taxpayer is a United States shareholder, and to dividends with respect to each noncontrolled 10-percent owned foreign corporation of which the taxpayer is a United States shareholder that is a domestic corporation. The grouping rules of paragraph (c)(3)(i) through (iv) of this section also apply separately to income attributable to each foreign QBU of a controlled foreign corporation, noncontrolled 10-percent owned foreign corporation, any other look-through entity as defined in § 1.904–5(i), or any United States person.

(5) * * *

(ii) *Treatment of partnership income.* A partner's distributive share of income from a foreign or United States partnership that is treated as passive income under paragraph (n)(1)(ii) of this section (generally providing that a less than 10 percent partner's distributive share of partnership income is passive income) is treated as a single item of income and is not grouped with other amounts. A distributive share of income from a partnership that is treated as passive income under paragraph (n)(1)(i) of this section is grouped according to the rules in paragraph (c)(3) of this section, except that the portion, if any, of the distributive share of income attributable to income earned by a United States partnership through a foreign QBU is separately grouped under the rules of paragraph (c)(4) of this section.

* * * * *

(6) * * * (i) * * * The determination of whether an amount included in gross income under section 951(a)(1) or 951A(a) is high-taxed income is made in the taxable year the income is included in the gross income of the United States shareholder under section 951(a) or 951A(a) (for purposes of this paragraph (c), the *year of inclusion*). * * *

* * * * *

(iii) * * * If an item of income is considered high-taxed income in the year of inclusion and paragraph (c)(6)(i) of this section applies, then any increase in foreign income taxes imposed with respect to that item are considered to be related to the same separate category to which the income was assigned in the taxable year of inclusion. * * * The taxpayer shall treat any taxes paid or accrued, or deemed paid, on the distribution in excess of this amount as taxes related to the same category of income to which such inclusion would have been assigned had the income been treated as high-taxed income in the year of inclusion (general category income, section 951A category income, or income in a specified separate category). If these additional taxes are not creditable in the year of distribution, the carryover rules of section 904(c) apply (see section 904(c) and § 1.904–2(a) for rules disallowing carryovers in the section 951A category). For purposes of this paragraph (c)(6), the foreign tax on an inclusion under section 951(a)(1) or 951A(a) is considered increased on distribution of the earnings and profits associated with that inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) exceeds the total taxes deemed paid in the year of inclusion. * * *

(iv) *Increase in taxes paid by successors.* If passive earnings and profits previously included in income of a United States shareholder are distributed to a person that was not a United States shareholder of the distributing corporation in the year the earnings were included, any increase in foreign taxes paid or accrued, or deemed paid, on that distribution is treated as tax related to general category income (or income in a specified separate category, if applicable) in the case of earnings and profits previously included under section 951(a)(1), and is treated as tax related to section 951A category income (or income in a specified separate category, if applicable) in the case of earnings and profits previously included under section 951A(a), regardless of whether the previously-taxed income was considered high-taxed income under section 904(d)(2)(F) in the year of inclusion.

(7) * * * (i) * * * If the inclusion is considered to be high-taxed income, then the taxpayer shall treat the inclusion as general category income, section 951A category income or income in a specified separate category as provided in paragraph (c)(1) of this section. * * * For this purpose, the foreign tax on an inclusion under section 951(a)(1) or 951A(a) shall be considered reduced on distribution of the earnings and profits associated with the inclusion if the total taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is less than the total taxes deemed paid in the year of inclusion. * * *

* * * * *

(d) *General category income.* The term *general category income* means all income other than passive category income, foreign branch category income, section 951A category income, and income in a specified separate category. Any item that is excluded from the passive category under section 904(d)(2)(B)(iii) or § 1.904–5(b)(1) is included in general category income only to the extent that such item does not meet the definition of another separate category. General category income also includes income treated as general category income under the look-through rules referenced in § 1.904–5(a)(2).

(e) * * * (1) *In general*—(i) *Treatment of financial services income.* Financial services income that meets the definition of foreign branch category income is treated as income in that category. Financial services income of a controlled foreign corporation that is included in gross income of a United States shareholder under section 951A(a) is treated as section 951A category income in the hands of the United States shareholder. Financial services income that is neither treated as foreign branch category income nor treated as section 951A category income is treated as general category income.

(ii) *Definition of financial services income.* The term *financial services income* means income derived by a financial services entity, as defined in paragraph (e)(3) of this section, that is:

(A) Income derived in the active conduct of a banking, insurance, financing, or similar business (active financing income as defined in paragraph (e)(2) of this section);

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

(C) Incidental income as defined in paragraph (e)(4) of this section.

(2) * * *

(i) * * *

(W) [Reserved]

* * * * *

(f) *Foreign branch category income*—(1) *Foreign branch category income*—(i) *In general.* Except as provided in paragraph (f)(1)(ii) of this section, the term *foreign branch category income* means income of a United States person, other than a pass-through entity, that is—

(A) Income attributable to foreign branches of the United States person held directly or indirectly through disregarded entities;

(B) A distributive share of partnership income that is attributable to foreign branches held by the partnership directly or indirectly through disregarded entities, or held indirectly by the partnership through another partnership or other pass-through entity that holds the foreign branch directly or indirectly through disregarded entities; and

(C) Income from other pass-through entities determined under principles similar to those described in paragraph (f)(1)(i)(B) of this section.

(ii) *Passive category income excluded from foreign branch category income.* Income assigned to the passive category under paragraph (b) of this section is not foreign branch category income, regardless of whether the income is described in paragraph (f)(1)(i) of this section. Income that is treated as passive category income under the look-through rules in § 1.904–5 is also excluded from foreign branch category income, regardless of whether the income is attributable to a foreign branch. However, income that would be passive category income but for the application of section 904(d)(2)(B)(iii) (export financing interest and high-taxed income) or 904(d)(2)(C) (financial services income) and the regulations under those sections and also meets the definition of foreign branch category income is foreign branch category income.

(2) *Gross income attributable to a foreign branch*—(i) *In general.* Except as provided in this paragraph (f)(2), gross income is attributable to a foreign branch to the extent the gross income (as adjusted to conform to Federal income tax principles) is reflected on the separate set of books and records (as defined in § 1.989(a)–1(d)(1) and (2)) of the foreign branch. Gross income that is not attributable to the foreign branch and is therefore attributable to the foreign branch owner is treated as income in a separate category (other than the foreign branch category) under the other rules of this section.

(ii) *Income attributable to U.S. activities.* Gross income attributable to a foreign branch does not include items arising from activities carried out in the United States, regardless of whether the items are reflected on the foreign branch's separate books and records.

(iii) *Income arising from stock*—(A) *In general.* Except as provided in paragraph (f)(2)(iii)(B) of this section, gross income attributable to a foreign branch does not include items of income arising from stock of a corporation (whether foreign or domestic), including gain from the disposition of such stock or any inclusion under sections 951(a), 951A(a), or 1293(a).

(B) *Exception for dealer property.* Paragraph (f)(2)(iii)(A) of this section does not apply to gain recognized from dispositions of stock in a corporation, if the stock would be dealer property (as defined in § 1.954–2(a)(4)(v)) if the foreign branch were a controlled foreign corporation.

(iv) *Disposition of interests in certain entities*—(A) *In general.* Except as provided in paragraph (f)(2)(iv)(B) of this section, gross income attributable to a foreign branch does not include gain from the disposition of an interest in a partnership or other pass-through entity or an interest in a disregarded entity. See also paragraph (n)(2) of this section for general rules relating to the sale of a partnership interest.

(B) *Exception for sales by a foreign branch in the ordinary course of business.* The rule in paragraph (f)(2)(iv)(A) of this section does not apply to gain from the sale or exchange of an interest in a partnership or other pass-through entity or an interest in a disregarded entity if the gain is reflected on the books and records of a foreign branch and the interest is held by the foreign branch in the ordinary course of its active trade or business. An interest is considered to be held in the ordinary course of the foreign branch's active trade or business if the foreign branch engages in the same or a related trade or business as the partnership or other pass-through entity (other than through a less than 10 percent interest) or disregarded entity.

(v) *Adjustments to items of gross income reflected on the books and records.* If a principal purpose of recording or failing to record an item of gross income on the books and records of a foreign branch, or of making a disregarded payment described in paragraph (f)(2)(vi) of this section, is the avoidance of Federal income tax, the purposes of section 904, or the purposes of section 250 (in connection with section 250(b)(3)(A)(i)(VI)), the item must be attributed to one or more foreign branches or the foreign branch owner in a manner that reflects the substance of the transaction. For purposes of this paragraph (f)(2)(v), interest received by a foreign branch from a related person is presumed to be attributable to the foreign branch owner (and not to the foreign branch) unless the interest income meets the definition of financial services income under paragraph (e)(1)(ii) of this section. For purposes of this paragraph (f)(2)(v), a related person is any person that bears a relationship to the foreign branch owner described in section 267(b) or 707.

(vi) *Attribution of gross income to which disregarded payments are allocable*—(A) *In general.* If a foreign branch makes a disregarded payment to its foreign branch owner and the disregarded payment is allocable to non-passive category gross income of the foreign branch reflected on the foreign branch's separate set of books and records under paragraph (f)(2)(i) of this section, the gross income attributable to the foreign branch is adjusted downward to reflect the allocable amount of the disregarded payment, and the general category gross income attributable to the foreign branch owner is adjusted upward by the same amount, translated (if necessary) from the foreign branch's functional currency to U.S. dollars at the spot rate, as defined in § 1.988–1(d), on the date of the disregarded payment. Similarly, if a foreign branch owner makes a disregarded payment to its foreign branch and the disregarded payment is allocable to general category gross income of the foreign branch owner that was not reflected on the separate set of books and records of any foreign branch of the foreign branch owner, the gross income attributable to the foreign branch owner is adjusted downward to reflect the allocable amount of the disregarded payment, and the gross income attributable to the foreign branch is adjusted upward by the same amount, translated (if necessary) from U.S. dollars to the foreign branch's functional currency at the spot rate, as defined in § 1.988–1(d), on the date of the disregarded payment. An adjustment to the attribution of gross income under this paragraph (f)(2)(vi) does not change the total amount, character, or source of the United States person's gross income. Similar rules apply in the case of disregarded payments between a foreign branch and another foreign branch with the same foreign branch owner.

(B) *Allocation of disregarded payments*—(*1*) *In general.* Whether a disregarded payment is allocable to gross income of a foreign branch or its foreign branch owner, and the source and separate category of the gross income to which the disregarded payment is allocable, is determined under the following rules:

(*i*) Disregarded payments from a foreign branch owner to its foreign branch are allocable to gross income attributable to the foreign branch owner to the extent a deduction for that payment, if regarded, would be allocated and apportioned to general category gross income of the foreign branch owner under the principles of §§ 1.861–8 through 1.861–14T and 1.861–17 by treating foreign source general category gross income and U.S. source general category gross income each as a statutory grouping; and

(*ii*) Disregarded payments from a foreign branch to its foreign branch owner are allocable to gross income attributable to the foreign branch to the extent a deduction for that payment, if regarded, would be allocated and apportioned to gross income of the foreign branch under the principles of §§ 1.861–8 through 1.861–14T and 1.861–17 by treating foreign source gross income in the foreign branch category and U.S. source gross income in the foreign branch category each as a statutory grouping.

(*2*) *Disregarded sales of property.* The principles of paragraph (f)(2)(vi)(B)(*1*)(*i*) and (*ii*) of this section apply in the case of disregarded payments in consideration for the transfer of property between a foreign branch and its foreign branch owner to the extent the disregarded payment, if regarded, would, for purposes of determining gross income, be subtracted from gross receipts that are regarded for Federal income tax purposes.

(*3*) *Conditions and timing of reallocation.* The gross income attributable to the foreign branch is adjusted only in the taxable year, and only to the extent, that a disregarded payment, if regarded, would be allowed as a deduction or otherwise would be taken into account (for example, as an increase to cost of goods sold).

(C) *Exclusion of certain disregarded payments.* Paragraph (f)(2)(vi)(A) of this section does not apply to the following payments, accruals, or other transfers between a foreign branch and its foreign branch owner that are disregarded for Federal income tax purposes:

(*1*) Interest and interest equivalents that, if regarded, would be described in § 1.861–9T(b);

(*2*) Remittances from the foreign branch to its foreign branch owner, except as provided in paragraph (f)(2)(vi)(D) of this section; or

(*3*) Contributions of money, securities, and other property from the foreign branch owner to its foreign branch, except as set forth in paragraph (f)(2)(vi)(D) of this section.

(D) *Certain transfers of intangible property.* For purposes of applying this paragraph (f)(2)(vi), the amount of gross income attributable to a foreign branch (and the amount of gross income attributable to its foreign branch owner) that is not passive category income must be adjusted under the principles of paragraph (f)(2)(vi)(B) of this section to reflect all transactions that are disregarded for Federal income tax purposes in which property described in section 367(d)(4) is transferred to or from a foreign branch, whether or not a disregarded payment is made in connection with the transfer. In determining the amount of gross income that is attributable to a foreign branch that must be adjusted by reason of this paragraph (f)(2)(vi)(D), the principles of sections 367(d) and 482 apply. For example, if a foreign branch owner transfers property described in section 367(d)(4), the principles of section 367(d) are applied by treating the foreign branch as a separate corporation to which the property is transferred in exchange for stock of the corporation in a transaction described in section 351.

(E) *Amount of disregarded payments.* The amount of each disregarded payment used to make an adjustment under this paragraph (f)(2)(vi) (or the absence of any adjustment) must be determined in a manner that results in the attribution of the proper amount of gross income to each of a foreign branch and its foreign branch owner under the principles of section 482, applied as if the foreign branch were a corporation.

(F) *Ordering rules.* For purposes of applying this paragraph (f)(2)(vi), adjustments related to disregarded payments from a foreign branch to its foreign branch owner are computed first, followed by adjustments related to disregarded payments from a foreign branch owner to its foreign branch.

(3) *Definitions.* The following definitions apply for purposes of this paragraph (f).

(i) *Disregarded entity.* The term *disregarded entity* means an entity described in § 301.7701–2(c)(2) of this chapter that is disregarded as an entity separate from its owner for Federal income tax purposes.

(ii) *Disregarded payment.* The term *disregarded payment* means any amount described in paragraph (f)(3)(ii)(A) or (B) of this section.

(A) *Payments to or from a disregarded entity.* An amount described in this paragraph (f)(3)(ii)(A) is an amount that is paid to or by a disregarded entity in connection with a transaction that is disregarded for Federal income tax purposes and that is reflected on the separate set of books and records of a foreign branch.

(B) *Other disregarded amounts.* An amount described in this paragraph (f)(3)(ii)(B) is any amount reflected on the separate set of books and records of a foreign branch that would constitute an item of income, gain, deduction, or loss (other than an amount described in paragraph (f)(3)(ii)(A) of this section) if the transaction to which the amount is attributable were regarded for Federal income tax purposes.

(iii) *Foreign branch*—(A) *In general.* The term *foreign branch* means a qualified business unit (QBU), as defined in § 1.989(a)–1(b)(2)(ii) and (b)(3), that conducts a trade or business outside the United States. For an illustration of the principles of this paragraph (f)(3)(iii), see paragraph (f)(4)(i) *Example 1* of this section.

(B) *Trade or business outside the United States.* Activities carried out in the United States, whether or not such activities are described in § 1.989(a)–1(b)(3), do not constitute the conduct of a trade or business outside the United States. Activities carried out outside the United States that constitute a permanent establishment under the terms of an income tax treaty between the United States and the country in which the activities are carried out are presumed to constitute a trade or business conducted outside the United States for purposes of this paragraph (f)(3)(iii)(B). In determining whether activities constitute a trade or business under § 1.989(a)–1(c), disregarded payments are taken into account and may give rise to a trade or business, provided that the activities (together with any other activities of the QBU) would otherwise satisfy the rule in § 1.989(a)–1(c).

(C) *Activities of a partnership, estate, or trust*—(*1*) *Treatment as a foreign branch.* For purposes of this paragraph (f)(3)(iii), the activities of a partnership, estate, or trust that conducts a trade or business that satisfies the requirements of § 1.989(a)–1(b)(2)(ii)(A) (as modified by paragraph (f)(3)(iii)(B) of this section) are—

(*i*) Deemed to satisfy the requirements of § 1.989(a)–1(b)(2)(ii)(B); and

(*ii*) Comprise a foreign branch.

(*2*) *Separate set of books and records.* A foreign branch described in this paragraph (f)(3)(iii)(C) is treated as maintaining a separate set of books and records with respect to the activities described in paragraph (f)(3)(iii)(C)(*1*) of this section, and must determine, as the context requires, the items of gross income, disregarded payments, and any other items that would be reflected on those books and records in applying this paragraph (f) with respect to the foreign branch.

(iv) *Foreign branch owner.* The term *foreign branch owner* means, with respect to a foreign branch, the person (including a foreign or domestic partnership or other pass-through entity) that owns the foreign branch, either directly or indirectly through one or more disregarded entities. For this purpose, the foreign branch owner does not include the foreign branch or another foreign branch of the person that owns the foreign branch.

(v) *Remittance.* The term *remittance* means a transfer of property (within the meaning of section 317(a)) by a foreign branch that would be treated as a distribution if the foreign branch were treated as a separate corporation.

(4) *Examples.* The following examples illustrate the application of this paragraph (f).

(i) *Example 1: Determination of foreign branches and foreign branch owner*—(A) *Facts*—(*1*) P, a domestic corporation, is a partner in PRS, a domestic partnership. All other partners in PRS are unrelated to P. PRS conducts activities solely in Country A (the Country A Business), and those activities constitute a trade or business outside the United States within the meaning of paragraph (f)(3)(iii)(B) of this section. PRS reflects items of income, gain, loss, and expense of the Country A Business on the books and records of PRS's home office. PRS's functional currency is the U.S. dollar. PRS is in the business of manufacturing bicycles.

(*2*) PRS owns FDE1, a disregarded entity organized in Country B. FDE1 conducts activities in Country B (the Country B Business), and those activities constitute a trade or business outside the United States within the meaning of paragraph (f)(3)(iii)(B) of this section. FDE1 maintains a set of books and records that are separate from those of PRS, and the separate set of books and records reflects items of income, gain, loss, and expense with respect to the Country B Business. Country B Business's functional currency is the U.S. dollar. FDE1 is in the business of selling bicycles manufactured by PRS.

(*3*) FDE1 owns FDE2, a disregarded entity organized in Country C. FDE2 conducts activities in Country C (the Country C Business), and those activities constitute a trade or business outside the United States within the meaning of paragraph (f)(3)(iii)(B) of this section. FDE2 maintains a set of books and records that are separate from those of PRS and FDE1, and the separate set of books and records reflects items of income, gain, loss, and expense with respect to the Country C Business. Country C Business's functional currency is the U.S. dollar. FDE2 sells paper. FDE2's paper business is not related to FDE1's bicycle sales business, and FDE1 does not hold its interest in FDE2 in the ordinary course of its trade or business.

(B) *Analysis*—(*1*) Country A Business's activities comprise a trade or business conducted outside the United States within the meaning of § 1.989(a)–1(b)(2)(ii)(A) and (b)(3) (in each case, as modified by paragraph (f)(3)(iii) of this section). PRS does not maintain a separate set of books and records with respect to the Country A Business. However, under paragraph (f)(3)(iii)(C) of this section, the Country A Business's activities are deemed to satisfy the requirement of § 1.989(a)–1(b)(2)(ii)(B) that a QBU maintain a separate set of books and records with respect to the relevant activities. Thus, for purposes of this paragraph (f), the activities of the Country A Business constitute a QBU as defined in § 1.989–1(b)(2)(ii) and (b)(3), as modified by paragraph (f)(3)(iii) of this section, that conducts a trade or business outside the United States. Accordingly, the activities of the Country A Business constitute a foreign branch within the meaning of paragraph (f)(3)(iii) of this section. PRS, the person that owns the Country A Business, is the foreign branch owner, within the meaning of paragraph (f)(3)(iv) of this section, with respect to the Country A Business.

(*2*) Country B Business's activities comprise a trade or business outside the United States within the meaning of § 1.989(a)–1(b)(2)(ii)(A) and (b)(3) (in each case, as modified by paragraph (f)(3)(iii) of this section). PRS maintains a separate set of books and records with respect to the Country B Business, as described in § 1.989(a)–1(b)(2)(ii)(B). Thus, for purposes of this section, the activities of the Country B Business constitute a QBU as defined in § 1.989–1(b)(2)(ii) and (b)(3), as modified by paragraph (f)(3)(iii) of this section, that conducts a trade or business outside the United States. Accordingly, the activities of the Country B Business constitute a foreign branch within the meaning of paragraph (f)(3)(iii) of this section. Under paragraph (f)(3)(iv) of this section, PRS, the person that owns the Country B Business indirectly through FDE1 (a disregarded entity), but not including the activities of PRS that constitute the Country A business, is the foreign branch owner with respect to the Country B Business.

(*3*) The same analysis that applies to the Country B Business applies to the Country C Business. Accordingly, the activities of the Country C Business constitute a foreign branch within the meaning of paragraph (f)(3)(iii) of this section. PRS, the person that owns the Country C Business indirectly through FDE1 and FDE2 (disregarded entities), but not including the activities of PRS that constitute the Country A Business, is the foreign branch owner with respect to the Country C Business.

(ii) *Example 2: Sale of foreign branch*—(A) *Facts.* The facts are the same as in paragraph (f)(4)(i)(A) of this section, except that in 2019, FDE1 sold FDE2 to an unrelated person, recording gain from the sale on its books and records. In 2020, PRS sells FDE1 to another unrelated person, recording gain from the sale on its books and records. In each year, PRS allocates a portion of the gain to P.

(B) *Analysis*—(*1*) *Sale of FDE2.* Under paragraph (f)(1)(i)(B) of this section, P's distributive share of gain recognized by PRS in connection with the sales of FDE1 and FDE2 constitutes foreign branch category income if it is attributable to a foreign branch held by PRS directly or indirectly through one or more disregarded entities. PRS's gross income from the 2019 sale of FDE2 is reflected on the separate set of books and records maintained with respect to the Country B Business (a foreign branch) operated by FDE1. Therefore, absent an exception, under paragraph (f)(2)(i) of this section PRS's gross income from the sale of FDE2 would be attributable to the Country B Business, and would constitute foreign branch category income. However, under paragraph (f)(2)(iv) of this section, gross income attributable to the Country B Business does not include gain from the sale or exchange of an interest in FDE2, a disregarded entity, unless the interest in FDE2 is held by the Country B Business in the ordinary course of its active trade or business (within the meaning of paragraph (f)(2)(iv)(B) of this section). In this case, the Country B Business does not hold FDE2 in the ordinary course of its active trade or business within the meaning of paragraph (f)(2)(iv)(B) of this section. As a result, P's distributive share of gain from the sale of FDE2 is not attributable to a foreign branch, and is not foreign branch category income.

(*2*) *Sale of FDE1.* The analysis of PRS's sale of FDE1 in 2020 is the same as the analysis for the sale of FDE2, except that PRS, through its Country A Business, holds FDE1 in the ordinary course of its active trade or business within the meaning of paragraph (f)(2)(iv)(B) of this section because the Country A Business engages in a trade or business that is related to the trade or business of FDE1. Therefore, P's distributive share of gain from the sale of FDE1 is attributable to a foreign branch, and is foreign branch category income.

(iii) *Example 3: Disregarded payment for services*—(A) *Facts.* P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch within the meaning of paragraph (f)(3)(iii) of this section. FDE's functional currency is the U.S. dollar. In 2019, P accrued and recorded on its books and records (and not FDE's books and records) $1,000 of gross income from the performance of services to unrelated parties that was not passive category income, $400 of which was foreign source income in respect of services performed outside the United States by employees of FDE and $600 of which was United States source income in respect of services performed in the United States. Absent the application of paragraph (f)(2)(vi) of this section, the $1,000 of gross income earned by P would be general category income that would not be attributable to FDE. FDE provided services in support of P's gross income from services. P compensated FDE for its services with an arm's length payment of $400, which was disregarded for Federal income tax purposes. The deduction for the payment of $400 from P to FDE would be allocated and apportioned to the $400 of P's foreign source services income if the payment were regarded for Federal income tax purposes.

(B) *Analysis.* The disregarded payment from P, a United States person, to FDE, its foreign branch, is not recorded on FDE's separate books and records (as adjusted to conform to Federal income tax principles) within the meaning of paragraph (f)(2)(i) of this section because it is disregarded for United States tax purposes. However, the disregarded payment is allocable to gross income attributable to P because a deduction for the payment, if it were regarded, would be allocated to P's $1,000 of gross services income and apportioned between U.S. and foreign source income under § 1.861–8. Under paragraph (f)(2)(vi)(A) of this section, the amount of gross income attributable to the FDE foreign branch (and the gross income attributable to P) is adjusted to take the disregarded payment into account. As such, all of P's $400 of foreign source gross income from the performance of services is attributable to the FDE foreign branch for purposes of this section. Therefore, $400 of the foreign source gross income that P earned with respect to its services in 2019 constitutes gross income that is assigned to the foreign branch category.

(g) *Section 951A category income*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, the term *section 951A category income* means amounts included (directly or indirectly through a pass-through entity) in gross income of a United States person under section 951A(a).

(2) *Exceptions for passive category income.* Section 951A category income does not include any amounts included under section 951A(a) that are allocable to passive category income under § 1.904–5(c)(6). Section 951A category income also does not include any amounts treated as passive category income under paragraph (n)(2) of this section.

(h) * * *

(2) *Treatment of export financing interest.* Except as provided in paragraph (h)(3) of this section, if a taxpayer (including a financial services entity) receives or accrues export financing interest from an unrelated person, then that interest is not treated as passive category income. Instead, the interest income is treated as foreign branch category income, section 951A category income, general category income, or income in a specified separate category under the rules of this section.

* * * * *

(5) * * * (i) *Income other than interest.* If any foreign person receives or accrues income that is described in section 864(d)(7) (income on a trade or service receivable acquired from a related person in the same foreign country as the recipient) and such income would also meet the definition of export financing interest if section 864(d)(1) applied to such income (income on a trade or service receivable acquired from a related person treated as interest), then the income is considered to be export financing interest and is not treated as passive category income. The income is treated as foreign branch category income, section 951A category income, general category income, or income in a specified separate category under the rules of this section.

(ii) *Interest income.* If export financing interest is received or accrued by any foreign person and that income would otherwise be treated as related person factoring income of a controlled foreign corporation under section 864(d)(6) if section 864(d)(7) did not apply, section 904(d)(2)(B)(iii)(I) applies and the interest is not treated as passive category income. The income is treated as general category income in the hands of the controlled foreign corporation.

* * * * *

(k) *Separate category under section 904(d)(6) for items resourced under treaties*—(1) *In general.* Except as provided in paragraph (k)(4)(i) of this section, sections 904(a), (b), (c), (d), (f), and (g), and sections 907 and 960 are applied separately to any item of income that, without regard to a treaty obligation of the United States, would be treated as derived from sources within the United States, but under a treaty obligation of the United States such item of income would be treated as arising from sources outside the United States, and the taxpayer chooses the benefits of such treaty obligation.

(2) *Aggregation of items of income in each other separate category.* For purposes of applying the general rule of paragraph (k)(1) of this section, items of income in each other separate category of income that are resourced under each applicable treaty are aggregated in a single separate category for income in that separate category that is resourced under that treaty. For example, all items of general category income that would otherwise be treated as derived from sources within the United States but which the taxpayer chooses to treat as arising from sources outside the United

States pursuant to a provision of a bilateral U.S. income tax treaty are treated as income in a separate category for general category income resourced under the particular treaty. Resourced items are not combined with other income that is foreign source income under the Code, even if the other income arises from sources within the treaty country and is included in the same separate category to which the resourced income would be assigned without regard to section 904(d)(6).

(3) *Related taxes.* Foreign taxes are allocated to each separate category described in paragraph (k)(2) of this section in accordance with § 1.904–6.

(4) *Coordination with certain income tax treaty provisions*—(i) *Exception for special relief from double taxation for individual residents of treaty countries.* Section 904(d)(6)(A) and paragraph (k)(1) of this section do not apply to any item of income deemed to be from foreign sources by reason of the relief from double taxation rules in any U.S. income tax treaty that is solely applicable to United States citizens who are residents of the other Contracting State.

(ii) *U.S. competent authority assistance.* For purposes of applying paragraph (k)(1) of this section, if, under the mutual agreement procedure provisions of an applicable income tax treaty, the U.S. competent authority agrees to allow a taxpayer to treat an item of income as foreign source income, where such item of income would otherwise be treated as derived from sources within the United States, then the taxpayer is considered to have chosen the benefits of such treaty obligation to treat the item as foreign source income.

(5) *Coordination with other Code provisions.* Section 904(d)(6)(A) and paragraph (k)(1) of this section do not apply to any item of income to which any of sections 245(a)(10), 865(h), or 904(h)(10) applies. *See* paragraph (l) of this section.

(l) *Priority rule.* Income that meets the definitions of a specified separate category and another category of income described in section 904(d)(1) is subject to the separate limitation described in paragraph (m) of this section and is not treated as general category income, foreign branch category income, passive category income, or section 951A category income.

(m) *Income treated as allocable to a specified separate category.* If section 904(a), (b), and (c) are applied separately to any category of income under the Internal Revenue Code and regulations (for example, under section 245(a)(10), 865(h), 901(j), 904(d)(6), or 904(h)(10), and the regulations under those sections), that category of income is treated for all purposes of the Internal Revenue Code and regulations as if it were a separate category listed in section 904(d)(1). For purposes of this section, a separate category that is treated as if it were listed in section 904(d)(1) by reason of the first sentence in this paragraph (m) is referred to as a *specified separate category.*

(n) *Income from partnerships and other pass-through entities*—(1) *Distributive shares of partnership income*—(i) *In general.* Except as provided in paragraph (n)(1)(ii) of this section, a partner's distributive share of partnership income is characterized as passive category income to the extent that the distributive share is a share of income earned or accrued by the partnership in the passive category. A partner's distributive share of partnership income that is not described in the first sentence of this paragraph is treated as foreign branch category income, section 951A category income, general category income, or income in a specified separate category under the rules of this section. Similar principles apply for a person's share of income from any other pass-through entity.

(ii) *Less than 10 percent partners partnership interests*—(A) *In general.* Except as provided in paragraph (n)(1)(ii)(B) of this section, if any limited partner or corporate general partner owns less than 10 percent of the value in a partnership, the partner's distributive share of partnership income from the partnership is passive income to the partner (subject to the high-taxed income exception of section 904(d)(2)(B)(iii)(II)), and the partner's distributive share of partnership deductions from the partnership is allocated and apportioned under the principles of section 1.861–8 only to the partner's passive income from that partnership. See also § 1.861–9(e)(4) for rules for apportioning partnership interest expense.

(B) *Exception for partnership interest held in the ordinary course of business.* If a partnership interest described in paragraph (n)(1)(ii)(A) of this section is held in the ordinary course of a partner's active trade or business, the rules of paragraph (n)(1)(i) of this section apply for purposes of characterizing the partner's distributive share of the partnership income. A partnership interest is considered to be held in the ordinary course of a partner's active trade or business if the partner (or a member of the partner's affiliated group of corporations (within the meaning of section 1504(a) and without regard to section 1504(b)(3))) engages (other than through a less than 10 percent interest in a partnership) in the same or a related trade or business as the partnership.

(2) *Income from the sale of a partnership interest*—(i) *In general.* To the extent a partner recognizes gain on the sale of a partnership interest, that income shall be treated as passive category income to the partner, unless the income is considered to be high-taxed under section 904(d)(2)(B)(iii)(II) and paragraph (c) of this section.

(ii) *Exception for sale by 25-percent owner.* Except as provided in paragraph (f)(2)(iv) of this section, in the case of a sale of an interest in a partnership by a partner that is a 25-percent owner of the partnership, determined by applying section 954(c)(4)(B) and substituting ''partner'' for ''controlled foreign corporation'' every place it appears, for purposes of determining the separate category to which the income recognized on the sale of the partnership interest is assigned such partner is treated as selling the proportionate share of the assets of the partnership attributable to such interest.

(3) *Value of a partnership interest.* For purposes of paragraphs (n)(1) and (2) of this section, a partner will be considered as owning 10 percent of the value of a partnership for a particular year if the partner, together with any person that bears a relationship to the partner described in section 267(b) or 707, owns 10 percent of the capital and profits interest of the partnership. For this purpose, value will be determined at the end of the partnership's taxable year.

(o) *Separate category of section 78 gross up.* The amount included in income under section 78 by reason of taxes deemed paid under section 960 is assigned to the separate category to which the taxes are allocated under § 1.904–6(b).

(p) *Separate category of foreign currency gain or loss.* Foreign currency gain or loss recognized under section 986(c) with respect to a distribution of previously taxed earnings and profits (as described in section 959 or 1293(c)) is assigned to the separate category or categories of the previously taxed earnings and profits from which the distribution is made. See § 1.987–6(b) for rules on assigning section 987 gain or loss on a remittance from a section 987 QBU to a separate category or categories.

(q) *Applicability dates.* This section applies for taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

■ **Par. 16.** § 1.904–5 is amended by:

■ 1. Revising paragraphs (a), (b), and (c)(1).
■ 2. Revising the third and fourth sentences of paragraph (c)(2)(i).
■ 3. Removing the language ''noncontrolled section 902 corporation'' and adding the language ''noncontrolled 10-percent owned foreign corporation'' in its place in the heading and text of paragraph (c)(2)(iii).
■ 4. Revising paragraph (c)(3).
■ 5. Revising the first sentence, and removing the language ''paragraph'' and adding the language ''paragraph (c)(4)'' in its place in the second sentence, of paragraph (c)(4)(i).
■ 6. Revising paragraph (c)(4)(iii).
■ 7. Adding paragraphs (c)(5) and (6).
■ 8. Revising paragraphs (d)(1) and (2).
■ 9. Removing and reserving paragraph (f)(1).
■ 10. Removing paragraph (f)(3).
■ 11. Removing the language ''section 904(d)(3) and this section'' and adding the language ''paragraph (c) of this section'' in its place in the first sentence of paragraph (g).
■ 12. Removing the last sentence of paragraph (g).
■ 13. Revising paragraph (h).
■ 14. Removing the language ''paragraphs (i)(2), (3), and (4)'' and adding the language ''paragraphs (i)(2) and (3)'' in its place in the first sentence of paragraph (i)(1).
■ 15. Removing the language ''noncontrolled section 902 corporation'' and adding the language ''noncontrolled 10-percent owned foreign corporation'' in its place in the second sentence of paragraph (i)(1).
■ 16. Removing the language ''paragraph (i)(4)'' and adding the language ''paragraph (i)(3)'' in its place in the second sentence of paragraph (i)(1).
■ 17. Revising the sixth and seventh sentences of paragraph (i)(1).
■ 18. Revising paragraph (i)(2) and (3).
■ 19. Removing and reserving paragraph (i)(4).
■ 20. Removing the last sentence of paragraph (j).
■ 21. Adding the language ''under § 1.904–4'' after the language ''characterized'' in the first sentence of paragraph (k)(1).
■ 22. Revising paragraph (k)(2)(iii).
■ 23. Removing the language ''noncontrolled section 902 corporation'' and adding the language ''noncontrolled 10-percent owned foreign corporation'' in its place in paragraph (m)(1).
■ 24. Removing the language ''or amount treated as a dividend, including'' and adding the language ''which, for purposes of this paragraph (m), includes'' in its place in the third sentence of paragraph (m)(1).
■ 25. Removing the language ''951(a)(1)(A),'' and adding the language ''951(a)(1)(A), 951A(a),'' in its place in the fourth sentence of paragraph (m)(1).
■ 26. Revising paragraphs (m)(2)(ii), (m)(4)(i), and the first sentence of paragraph (m)(5)(i).
■ 27. Removing the language ''section 902(a) and section 960(a)(1)'' and adding the language ''section 960'' in its place in paragraph (m)(6).
■ 28. Removing the language ''904(g)(6)'' from the first sentence of paragraph (m)(7)(i) and adding the language ''904(h)(6)'' in its place.
■ 29. Removing the language ''904(g)'' from the first sentence of paragraph (m)(7)(i) and adding the language ''904(h)'' in its place.
■ 30. Removing the language ''(d) and (f)'' from the second sentence of paragraph (m)(7)(i) and adding the language ''(d), (f), and (g)'' in its place.
■ 31. Removing the language ''902,'' from the second sentence of paragraph (m)(7)(i).
■ 32. Removing the language ''noncontrolled section 902 corporation'' and adding the language ''noncontrolled 10-percent owned foreign corporation'' in its place, and by removing the language ''section 904(d)(1)'' and adding ''§ 1.904–4'' in its place in the first sentence of paragraph (n).
■ 33. Revising the last sentence of paragraph (n).
■ 34. Revising paragraph (o).

The additions and revisions read as follows:

§ 1.904–5 Look-through rules as applied to controlled foreign corporations and other entities.

(a) *Scope and definitions.* (1) *Look-through rules under section 904(d)(3) to passive category income.* Paragraph (c) of this section provides rules for determining the extent to which dividends, interest, rents, and royalties received or accrued by certain eligible persons, and inclusions under sections 951(a)(1) and 951A(a), are treated as passive category income. Paragraph (g) of this section provides rules applying the principles of paragraph (c) of this section to foreign source interest, rents, and royalties paid by a United States corporation to a related corporation. Paragraph (h) of this section provides rules for assigning a partnership payment to a partner described in section 707 to the passive category. Paragraph (i) of this section provides rules applying the principles of this section to assign distributions and payments from certain related entities to the passive category or to treat the distributions and payments as not in the passive category.

(2) *Other look-through rules under section 904(d).* Under section 904(d)(4) and paragraph (c)(4)(iii) of this section, certain dividends from noncontrolled 10-percent owned foreign corporations are treated as income in a separate category. Under section 904(d)(3)(H) and paragraph (j) of this section, certain inclusions under section 1293 are treated as income in a separate category. Paragraph (i) of this section provides rules applying the principles of this section to assign distributions from certain related entities to separate categories.

(3) *Other rules provided in this section.* Paragraph (b) of this section provides operative rules for this section. Paragraph (d) of this section provides rules addressing exceptions to passive category income for certain purposes in the case of controlled foreign corporations that meet the requirements of section 954(b)(3)(A) (de minimis rule) or section 954(b)(4) (high-tax exception). Paragraph (e) of this section provides rules for characterizing a controlled foreign corporation's foreign base company income and gross insurance income when section 954(b)(3)(B) (full inclusion rule) applies. Paragraph (f) of this section modifies the look-through rules for certain types of income. Paragraph (k) of this section provides ordering rules for applying the look-through rules. Paragraph (l) of this section provides examples illustrating the application of certain rules in this section. Paragraphs (m) and (n) of this section provide rules related to the resourcing rules described in section 904(h).

(4) *Definitions.* For purposes of this section, the following definitions apply:

(i) The term *controlled foreign corporation* has the meaning given such term by section 957 (taking into account the special rule for certain captive insurance companies contained in section 953(c)).

(ii) The term *look-through rules* means the rules described in this section that assign income to a separate category based on the separate category of the income to which it is allocable.

(iii) The term *noncontrolled 10-percent owned foreign corporation* has the meaning provided in section 904(d)(2)(E)(i).

(iv) The term *pass-through entity* means a partnership, S corporation, or any other person (whether domestic or foreign) other than a corporation to the extent that the income or deductions of the person are included in the income of one or more direct or indirect owners or beneficiaries of the person. For example, if a domestic trust is subject to Federal income tax on a portion of its income and its owners are subject to tax on the remaining portion, the domestic trust is treated as a domestic pass-through entity with respect to such remaining portion.

(v) The term *separate category* means, as the context requires, any category of income described in 904(d)(1)(A), (B), (C), or (D), any specified separate category of income as defined in § 1.904–4(m), or any category of earnings and profits to which income described in such provisions is attributable.

(vi) The term *United States shareholder* has the meaning given such term by section 951(b) (taking into account the special rule for certain captive insurance companies contained in section 953(c)), except that for purposes of this section, a United States shareholder includes any member of the controlled group of the United States shareholder. For this purpose the controlled group is any member of the affiliated group within the meaning of section 1504(a)(1) except that ''more than 50 percent'' is substituted for ''at least 80 percent'' wherever it appears in section 1504(a)(2). When used in reference to a noncontrolled 10-percent owned foreign corporation described in section 904(d)(2)(E)(i)(II), the term *United States shareholder* also means a taxpayer that meets the stock ownership requirements described in section 904(d)(2)(E)(i)(II).

(b) *Operative rules*—(1) *Assignment of income not assigned under the look-through rules.* Except as provided by the look-through rules, dividends, interest, rents, and royalties received or accrued by a taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder are excluded from passive category income. Income excluded from the passive category under this paragraph (b)(1) is assigned to another separate category (other than the passive category) under the rules in § 1.904–4.

(2) *Priority and ordering of look-through rules.* Except as provided in § 1.904–4(l), to the extent the look-through rules assign income to a separate category, the income is assigned to that separate category rather than the separate category to which the income would have been assigned under § 1.904–4 (not taking into account § 1.904–4(l)). See paragraph (k) of this section for ordering rules for applying the look-through rules.

(c) * * * (1) *Scope.* Subject to the exceptions in paragraph (f) of this section, paragraphs (c)(2) through (c)(6) (other than paragraph (c)(4)(iii)) of this section provide look-through rules with respect to interest, rents, royalties, dividends, and inclusions under section 951(a)(1) and 951A(a) that are received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder. Paragraph (c)(4)(iii) of this section provides a look-through rule for dividends received from a noncontrolled 10-percent owned foreign corporation by a domestic corporation that is a United States shareholder in the foreign corporation.

(2) * * * (i) * * * Related person interest is treated as passive category income to the extent it is allocable to passive category income of the controlled foreign corporation. If related person interest is received or accrued from a controlled foreign corporation by two or more persons, the amount of interest received or accrued by each person that is allocable to passive category income is determined by multiplying the amount of related person interest allocable to passive category income by a fraction. * * *

* * * * *

(3) *Rents and royalties.* Any rents or royalties received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder are treated as passive category income to the extent they are allocable to passive category income of the controlled foreign corporation under the principles of §§ 1.861–8 through 1.861–14T.

(4) * * * (i) * * * Except as provided in paragraph (d)(2) of this section, any dividend paid or accrued out of the earnings and profits of any controlled foreign corporation is treated as passive category income in proportion to the ratio of the portion of earnings and profits attributable to passive category income to the total amount of earnings and profits of the controlled foreign corporation. * * *

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(iii) *Look-through rule for dividends from noncontrolled 10-percent owned foreign corporations*—(A) *In general.* Except as provided in paragraph (c)(4)(iii)(B) of this section, any dividend that is distributed by a noncontrolled 10-percent owned foreign corporation and received or accrued by a domestic corporation that is a United States shareholder of such foreign corporation is treated as income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the noncontrolled 10-percent owned foreign corporation.

(B) *Inadequate substantiation.* A dividend distributed by a noncontrolled 10-percent owned foreign corporation is treated as income in the separate category described in section 904(d)(4)(C)(ii) if the Commissioner determines that the look-through characterization of the dividend cannot reasonably be determined based on the available information.

* * * * *

(5) *Inclusions under section 951(a)(1)(A)*—(i) Any amount included in gross income under section 951(a)(1)(A) is treated as passive category income to the extent the amount included is attributable to income received or accrued by the controlled foreign corporation that is passive category income. All other amounts included in gross income under section 951(a)(1)(A) are treated as general category income or income in a specified separate category under the rules in § 1.904–4. For rules concerning a distributive share of partnership income, see § 1.904–4(n). For rules concerning the gross up under section 78, see § 1.904–4(o). For rules concerning inclusions under section 951(a)(1)(B), see paragraph (c)(4)(i) of this section.

(ii) [Reserved]

(6) *Inclusions under section 951A(a).* Any amount included in gross income under section 951A(a) is treated as passive category income to the extent the amount included is attributable to income received or accrued by the controlled foreign corporation that is passive category income. All other amounts included in gross income under section 951A(a) are treated as section 951A category income or income in a specified separate category under the rules in § 1.904–4. For rules concerning a distributive share of partnership income, see § 1.904–4(n). For rules concerning the gross up under section 78, see § 1.904–4(o).

(d) * * * (1) *De minimis amount of subpart F income.* If the sum of a controlled foreign corporation's gross foreign base company income (determined under section 954(a) without regard to section 954(b)(5)) and gross insurance income (determined under section 953(a)) for the taxable year is less than the lesser of 5 percent of gross income or $1,000,000, then none of that income is treated as passive category income. In addition, if the test in the first sentence of this paragraph is satisfied, for purposes of paragraphs (c)(2)(ii)(D) and (E) of this section (apportionment of interest expense to passive income using the asset method), any passive category assets are not treated as passive category assets but are treated as assets in the general category or a specified separate category. The determination in the first sentence is made before the application of the exception for certain income subject to a high rate of foreign tax described in paragraph (d)(2) of this section.

(2) *Exception for certain income subject to high foreign tax.* Except as provided in § 1.904–4(c)(7)(iii) (relating to reductions in tax upon distribution), for purposes of the dividend look-through rule of paragraph (c)(4)(i) of this section, an item of net income that would otherwise be passive income (after application of the priority rules of § 1.904–4(l)) and that is received or accrued by a controlled foreign corporation is not treated as passive category income, and the earnings and profits attributable to such income is not treated as passive category earnings and profits, if the taxpayer establishes to the satisfaction of the Secretary under section 954(b)(4) that the income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11 (with reference to section 15, if applicable). Such income is treated as general category income or income in a specified separate category under the rules in § 1.904–4. The first sentence of this paragraph has no effect on amounts (other than dividends) paid or accrued by a controlled foreign corporation to a United States shareholder of such controlled foreign corporation to the extent those amounts are allocable to passive category income of the controlled foreign corporation.

* * * * *

(f) * * * (1) [Reserved]

* * * * *

(h) *Application of look-through rules to payments from a partnership or other pass-through entity.* Payments to a partner described in section 707 (*e.g.,* payments to a partner not acting in capacity as a partner) are characterized as passive category income to the extent that the payment is attributable under the principles of § 1.861–8 and this section to passive category income of the partnership, if the payments are interest, rents, or royalties that would be characterized under the controlled foreign corporation look-through rules of paragraph (c) of this section if the partnership were a foreign corporation, and the partner who receives the payment owns 10 percent or more of the value of the partnership (as determined under § 1.904–4(n)(3)). A payment by a partnership to a member of the controlled group (as defined in paragraph (a)(4)(vi) of this section) of the partner is characterized under the look-through rules of this paragraph (h) if the payment would be a section 707 payment entitled to look-through treatment if it were made to the partner. Similar principles apply for a payment from any other pass-through entity. The rules in this paragraph (h) do not apply with respect to interest to the extent the interest income is assigned to a separate category under the specified partnership loan rules described in § 1.861–9(e)(8).

(i) * * * (1) * * * For purposes of this paragraph (i)(1), indirect ownership of stock is determined under section 318 and the regulations under that section. In the case of a partnership or other pass-through entity, indirect ownership and value is determined under the rules in paragraph (i)(2) of this section.

(2) *Indirect ownership and value of a partnership interest.* A person is considered as owning, directly or indirectly, more than 50 percent of the value of a partnership if the person, together with other any person that bears a relationship to the first person that is described in section 267(b) or 707, owns more than 50 percent of the capital and profits interests of the partnership. For this purpose, value will be determined at the end of the partnership's taxable year. Similar principles apply for a person that owns a pass-through entity other than a partnership.

(3) *Special rule for dividends between certain foreign corporations.* Solely for purposes of dividend payments between controlled foreign corporations, noncontrolled 10-percent owned foreign corporations, or a controlled foreign corporation and a noncontrolled 10-percent owned foreign corporation, the two foreign corporations are considered related look-through entities if the same person is a United States shareholder of both foreign corporations.

(4) [Reserved]

* * * * *

(k) * * *

(2) * * *

(iii) Inclusions under sections 951(a)(1)(A) and 951A(a) and distributive shares of partnership income;

* * * * *

(m) * * *

(2) * * *

(ii) *Interest payments from noncontrolled 10-percent owned foreign corporations.* If interest is received or accrued by a shareholder from a noncontrolled 10-percent owned foreign corporation (where the shareholder is a domestic corporation that is a United States shareholder of such noncontrolled 10-percent owned foreign corporation), the rules of paragraph (m)(2)(i) of this section apply in determining the portion of the interest payment that is from sources within the United States, except that the related party interest rules of paragraph (c)(2)(ii)(C) of this section do not apply.

* * * * *

(4) * * * (i) *Rule.* Any dividend or distribution treated as a dividend under this paragraph (m) (including an amount included in gross income under section 951(a)(1)(B)) that is received or accrued by a United States shareholder from a controlled foreign corporation, or any dividend that is received or accrued by a domestic corporation from a noncontrolled 10-percent owned foreign corporation with respect to which the shareholder is a United States shareholder, are treated as income in a separate category derived from sources within the United States in proportion to the ratio of the portion of the earnings and profits of the controlled foreign corporation or noncontrolled 10-percent owned foreign corporation in the corresponding separate category from United States sources to the total amount of earnings and profits of the controlled foreign corporation or noncontrolled 10-percent owned foreign corporation in that separate category.

* * * * *

(5) * * * (i) * * * Any amount included in the gross income of a United States shareholder of a controlled foreign corporation under section 951(a)(1)(A), 951A, or in the gross income of a domestic corporation that is a United States shareholder of a noncontrolled 10-percent owned foreign corporation described in section 904(d)(2)(E)(i)(II) that is a qualified electing fund under section 1293 is treated as income subject to a separate category that is derived from sources within the United States to the extent the amount is attributable to income of the controlled foreign corporation or qualified electing fund, respectively, in the corresponding category of income from sources within the United States. * * *

* * * * *

(n) * * * Section 904(d)(3), (d)(4), and (h), and this section are then applied for purposes of characterizing and sourcing income received, accrued, or included by a United States shareholder of the foreign corporation that is attributable or allocable to income or earnings and profits of the foreign corporation.

(o) *Applicability dates.* This section is applicable for taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

■ **Par. 17.** § 1.904–6 is amended by:

■ 1. Revising the first sentence, and adding two sentences after the fourth sentence, of paragraph (a)(1)(i).

■ 2. Removing the language ''(unless it is a withholding tax that is not the final tax payable on the income as described in § 1.904–4(d))'' and adding the language ''(as defined in section 901(k)(1)(B))'' in its place in the new seventh sentence of paragraph (a)(1)(i).

■ 3. Revising paragraph (a)(1)(iv).

■ 4. Adding paragraphs (a)(2) and (3).

■ 5. Revising paragraph (b).

■ 6. Adding paragraph (d).

The revisions and additions read as follows:

§ 1.904–6 Allocation and apportionment of taxes.

(a) * * * (1) * * * (i) * * * The amount of foreign taxes paid or accrued with respect to a separate category (as defined in § 1.904–5(a)(4)(v)) of income (including United States source income within the separate category) includes only those taxes that are related to income in that separate category. * * * Income included in the foreign tax base is calculated under foreign law, but characterized as income in a separate category under United States tax principles. For example, a foreign tax imposed on an amount realized on the disposition of controlled foreign corporation stock that is characterized as a capital gain under foreign law but as a dividend under section 1248 is generally assigned to the general category, not the passive category. * * *

* * * * *

(iv) *Base and timing differences.* If, under the law of a foreign country or possession of the United States, a tax is imposed on a type of item that does not constitute income under Federal income tax principles (a *base difference*), such as gifts or life insurance proceeds, that tax is treated as imposed with respect to income in the separate category described in section 904(d)(2)(H)(i). If, under the law of a foreign country or possession of the United States, a tax is imposed on an item of income that constitutes income under Federal income tax principles but is not recognized for Federal income tax purposes in the current year (a *timing difference*), that tax is allocated and apportioned to the appropriate separate category or categories to which the tax would be allocated and apportioned if the income were recognized under Federal income tax principles in the year in which the tax was imposed. If the amount of an item of income as computed for foreign tax purposes is positive but is greater than the amount of income that is currently recognized for Federal income tax purposes, for example, due to a difference in depreciation conventions or the timing of recognition of gross income, or because of a permanent difference between U.S. and foreign tax law in the amount of deductions that are allowed to reduce gross income, the tax is allocated or apportioned to the separate category to which the income is assigned, and no portion of the tax is attributable to a base difference. In addition, a tax imposed on a distribution that is excluded from gross income under section 959(a) or section 959(b) is treated as attributable to a timing difference (and not a base difference) and is treated as tax imposed on the earnings and profits from which the distribution was paid.

(2) *Special rules for foreign branches*—(i) *In general.* Except as provided in this paragraph (a)(2), any foreign tax reflected on the books and records of a foreign branch under the principles of § 1.987–2(b) is allocated and apportioned under the rules of paragraph (a)(1) of this section.

(ii) *Disregarded reallocation transactions*—(A) *Foreign branch to foreign branch owner.* In the case of a disregarded payment from a foreign branch to a foreign branch owner that is treated as a disregarded reallocation transaction that results in foreign branch category income being reallocated to the general category, any foreign tax imposed solely by reason of that payment, such as a withholding tax imposed on the disregarded payment, is allocated and apportioned to the general category.

(B) *Foreign branch owner to foreign branch.* In the case of a disregarded payment from a foreign branch owner to a foreign branch that is treated as a disregarded reallocation transaction that results in general category income being reallocated to the foreign branch category, any foreign tax imposed solely by reason of that transaction is allocated and apportioned to the foreign branch category.

(iii) *Other disregarded payments*—(A) *Foreign branch to foreign branch owner.* In the case of a disregarded payment from a foreign branch to a foreign branch owner that is not a disregarded reallocation transaction, foreign tax imposed solely by reason of that disregarded payment is allocated and apportioned to a separate category under the principles of paragraph (a)(1) of this section based on the nature of the item (determined under Federal income tax principles) that is included in the foreign tax base. For example, if a remittance of an appreciated asset results in gain recognition under foreign law, the tax imposed on that gain is treated as attributable to a timing difference with respect to recognition of the gain, and is allocated and apportioned to the separate category to which gain on a sale of that asset would have been assigned if it were recognized for Federal income tax purposes. However, a gross basis withholding tax on a remittance is attributable to a timing difference in taxation of the income out of which the remittance is made, and is allocated and apportioned to the separate category or categories to which a section 987 gain or loss would be assigned under § 1.987–6(b).

(B) *Foreign branch owner to foreign branch.* In the case of a disregarded payment from a foreign branch owner to a foreign branch that is not a disregarded reallocation transaction, any foreign tax imposed solely by reason of that disregarded payment is allocated and apportioned to the foreign branch category.

(iv) *Definitions.* The following definitions apply for purposes of this paragraph (a)(2):

(A) *Disregarded reallocation transaction.* The term *disregarded reallocation transaction* means a disregarded payment or a transfer described in § 1.904–4(f)(2)(vi)(D) that results in an adjustment to the gross income attributable to the foreign branch under § 1.904–4(f)(2)(vi)(A).

(B) The terms *disregarded payment, foreign branch, foreign branch owner,* and *remittance* have the same meaning given to those terms in § 1.904–4(f)(3).

(3) *Taxes imposed on high-taxed income.* For rules on the treatment of taxes imposed on high-taxed income, see § 1.904–4(c).

(b) *Allocation and apportionment of deemed paid taxes and certain creditable foreign tax expenditures*—(1) *Taxes deemed paid under section 960(a) or (d).* If a domestic corporation that is a United States shareholder includes any amount in gross income under sections 951(a)(1)(A) or 951A(a), any foreign tax deemed paid with respect to such amount under section 960(a) or (d) is allocated to the separate category to which the inclusion is assigned.

(2) *Taxes deemed paid under section 960(b)(1).* If a domestic corporation that is a United States shareholder receives a distribution of previously taxed earnings and profits from a first-tier corporation that is excluded from the domestic corporation's income under section 959(a) and § 1.959–1, any foreign tax deemed paid under section 960(b)(1) with respect to such distribution is allocated to the same separate category as the annual PTEP account and PTEP group (as defined in

§ 1.960–3(c)) from which the distribution is made.

(3) *Taxes deemed paid under section 960(b)(2).* If a controlled foreign corporation receives a distribution of previously taxed earnings and profits from an immediately lower-tier corporation that is excluded from such controlled foreign corporation's gross income under section 959(b) and § 1.959–2, any foreign tax deemed paid under section 960(b)(2) with respect to such distribution is allocated to the same separate category as the annual PTEP account and PTEP group (as defined in § 1.960–3(c)) from which the distribution is made. *See also* § 1.960–3(c)(2).

(4) *Creditable foreign tax expenditures*—(i) *In general.* Except as provided in paragraph (b)(4)(ii) of this section, creditable foreign tax expenditures (CFTEs) allocated to a partner under § 1.704–1(b)(4)(viii)(*a*) are allocated for purposes of this section to the same separate category as the separate category to which the taxes were allocated in the hands of the partnership under the rules of paragraph (a) of this section.

(ii) *Foreign branch category.* CFTEs allocated to a partner in a partnership under § 1.704–1(b)(4)(viii)(*a*) are allocated and apportioned to the foreign branch category of the partner to the extent that:

(A) The CFTEs are allocated and apportioned by the partnership under the rules of paragraph (a) of this section to the general category;

(B) In the hands of the partnership, the CFTEs are related to general category income attributable to a foreign branch (as described in § 1.904–4(f)(2)) under the principles of paragraph (a) of this section; and

(C) The partner's distributive share of the income described in paragraph (b)(4)(ii)(B) of this section is foreign branch category income of the partner under § 1.904–4(f)(1)(i)(B).

* * * * *

(d) *Applicability dates.* This section is applicable for taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

■ **Par. 18.** Section 1.904(b)–3 is added to read as follows:

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

(a) *Disregard of certain dividends and deductions*—(1) *In general.* For purposes of section 904(a), in the case of a domestic corporation which is a United States shareholder with respect to a specified 10-percent owned foreign corporation (as defined in section 245A(b)), the domestic corporation's foreign source taxable income in a separate category and entire taxable income is determined without regard to the following items:

(i) Any dividend for which a deduction is allowed under section 245A;

(ii) Deductions properly allocable or apportioned to gross income in the section 245A subgroup as determined under paragraphs (b) and (c)(1) of this section; and

(iii) Deductions properly allocable or apportioned to stock of specified 10-percent owned foreign corporations in the section 245A subgroup as determined under paragraphs (b) and (c) of this section.

(2) *Deductions properly allocable or apportioned to the residual grouping.* Deductions that are properly allocable or apportioned to gross income or stock in the section 245A subgroup of the residual grouping (consisting of U.S. source income) are disregarded solely for purposes of determining entire taxable income under section 904(a).

(b) *Determining properly allocable or apportioned deductions.* The amount of deductions properly allocable or apportioned to gross income or stock described in paragraphs (a)(1)(ii) and (iii) of this section is determined by subdividing the United States shareholder's gross income and assets in each separate category described in § 1.904–5(a)(4)(v) into a section 245A subgroup and a non-section 245A subgroup. Gross income and assets in the residual grouping for U.S. source income are also subdivided into a section 245A subgroup and a non-section 245A subgroup. Each section 245A subgroup is treated as a statutory grouping under § 1.861–8(a)(4). Deductions properly allocable or apportioned to dividends or stock described in paragraphs (a)(1)(ii) and (iii) of this section only include those deductions that are allocated and apportioned under §§ 1.861–8 through 1.861–14T and 1.861–17 to the section 245A subgroups. The deduction allowed under section 245A(a) for dividends is allocated and apportioned solely among the section 245A subgroups on the basis of the relative amounts of gross income from such dividends in each section 245A subgroup.

(c) *Income and assets in the 245A subgroups*—(1) *In general.* For purposes of applying the allocation and apportionment rules under §§ 1.861–8 through 1.861–14T and 1.861–17 to the deductions of a United States shareholder, the only gross income included in a section 245A subgroup is dividend income for which a deduction is allowed under section 245A. The only asset included in a section 245A subgroup is the portion of the value of stock of each specified 10-percent owned foreign corporation that is assigned to the section 245A subgroup determined under paragraph (c)(2) of this section.

(2) *Assigning stock to a subgroup.* The value of stock of a specified 10-percent owned foreign corporation is characterized as an asset in a separate category described in § 1.904–5(a)(4)(v) or the residual grouping for U.S. source income under the rules of § 1.861–12(c). If the specified 10-percent owned foreign corporation is not a controlled foreign corporation, all of the value of its stock (other than the portion of stock assigned to the statutory groupings for gross section 245(a)(5) income under §§ 1.861–12(c)(4) and 1.861–13) in each separate category and in the residual grouping for U.S. source income is assigned to the section 245A subgroup in such separate category or residual grouping. If the specified 10-percent owned foreign corporation is a controlled foreign corporation, a portion of the value of stock in each separate category and in the residual grouping for U.S. source income is subdivided between a section 245A and non-section 245A subgroup under § 1.861–13(a)(5).

(d) *Coordination with OFL and ODL rules.* Section 904(b)(4) and this section apply before the operation of the overall foreign loss rules in section 904(f) and the overall domestic loss rules in section 904(g).

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

(1) *Facts*—(i) *Income and assets of USP.* USP is a domestic corporation. USP owns a factory in the United States with a tax book value of $21,000. USP also directly owns all of the stock of each of the following three controlled foreign corporations: CFC1, CFC2, and CFC3. USP's tax book value in each of CFC1, CFC2, and CFC3 is $10,000. USP incurs $1,500 of interest expense and earns $1,600 of U.S. source gross income. Under section 951A and the section 951A regulations (as defined in § 1.951A–1(a)(1)), USP's GILTI inclusion amount is $2,200. USP's deduction under section 250 is $1,100 (''section 250 deduction''), all of which is by reason of section 250(a)(1)(B)(i). No portion of USP's section 250 deduction is reduced by reason of section 250(a)(2)(B). None of the CFCs makes any distributions.

(ii) *Characterization of CFC stock.* After application of § 1.861–13(a), USP determined that $7,300 of the stock of each of CFC1, CFC2, and CFC3 is assigned to the section 951A category (''section 951A category stock'') in the non-section 245A subgroup and the remaining $2,700 of the stock of each of CFC1, CFC2, and CFC3 is assigned to the general category (''general category stock'') in the section 245A subgroup. Additionally, under § 1.861–8(d)(2)(ii)(C)(*2*), $3,650 of the stock of each of CFC1, CFC2, and CFC3 that is section 951A category stock is an exempt asset. Accordingly, with respect to the stock of its controlled foreign corporations in the aggregate, USP has $10,950 of section 951A category stock in a non-section 245A subgroup; $8,100 of general category stock in a section 245A subgroup; and $10,950 of stock that is an exempt asset.

(iii) *Apportioning of expenses.* Taking into account USP's factory and its stock in CFC1, CFC2, and CFC3, the tax book value of USP's assets for purposes of apportioning expenses is $40,050 (excluding the $10,950 of exempt assets). Under § 1.861–9T(g), USP's $1,500 of interest expense is apportioned as follows: $410 ($1,500 × $10,950/$40,050) to section 951A category income, $303 ($1,500 × $8,100/$40,050) to general category income, and the remaining $787 ($1,500 × $21,000/$40,050) to the residual U.S. source grouping. Under § 1.861–8(e)(14), all of USP's section 250 deduction is allocated and apportioned to section 951A category income.

(2) *Analysis*—(i) *USP's pre-credit U.S. tax.* USP's worldwide taxable income is $1,200, which equals its GILTI inclusion amount of $2,200 plus its U.S. source gross income of $1,600, less its deduction under section 250 of $1,100 and its interest expense of $1,500. For purposes of applying section 904(a), before taking into account any foreign tax credit under section 901, USP's federal income tax liability is 21% of $1,200, or $252.

(ii) *Application of section 904(b)(4).* Under section 904(d)(1), USP applies section 904(a) separately to each separate category of income.

(A) *General category income.* Before application of section 904(b)(4) and the rules in this section, USP's foreign source taxable income in the general category is a loss of $303, which equals $0 (USP's foreign source general category income) less $303 (interest expense apportioned to general category income), and USP's worldwide taxable income is $1,200. Under paragraph (d) of this section, the rules in section 904(f) and (g) apply after section 904(b)(4) and the rules in this section. Under paragraphs (b) and (c)(1) of this section, USP has no deductions properly allocable or apportioned to gross income in the section 245A subgroup because USP has no dividend income in the general category for which a deduction is allowed under section 245A. Under paragraphs (b) and (c) of this section, USP has $303 of deductions for interest expense that are properly allocable or apportioned to stock of specified 10-percent owned foreign corporations in the section 245A subgroup because USP's only general category assets are the general category stock of CFC1, CFC2, and CFC3, all of which are in the section 245A subgroup. Therefore, under paragraph (a) of this section, USP's foreign source taxable income in the general category and its worldwide taxable income are determined without regard to the $303 of deductions for interest expense. Accordingly, USP's foreign source taxable income in the general category is $0 and its worldwide taxable income is $1,503, and therefore, there is no separate limitation loss for purposes of section 904(f). Under section 904(a) and (d)(1) USP's foreign tax credit limitation for the general category is $0.

(B) *Section 951A category income.* Before application of section 904(b)(4) and the rules in this section, USP's foreign source taxable income in the section 951A category is $690, which equals $2,200 (USP's GILTI inclusion amount) less $1,100 (USP's section 250 deduction) less $410 (interest apportioned to section 951A category income). Under paragraphs (b) and (c)(1) of this section, USP has no deductions properly allocable and apportioned to gross income in a section 245A subgroup of the section 951A category. Under paragraphs (b) and (c) of this section, USP has no deductions properly allocable and apportioned to stock of specified 10-percent owned foreign corporations in a section 245A subgroup of section 951A category stock because no portion of section 951A category stock is assigned to a section 245A subgroup. *See* § 1.861–13(a)(5)(v). Therefore, under paragraph (a) of this section no adjustment is made to USP's foreign source taxable income in the section 951A category. However, the adjustments to USP's worldwide taxable income described in paragraph (e)(2)(ii)(A) of this section apply for purposes of calculating USP's foreign tax credit limitation for the section 951A category. Accordingly, USP's foreign source taxable income in the section 951A category is $690 and its worldwide taxable income is $1,503. Under section 904(a) and (d)(1), USP's foreign tax credit limitation for the section 951A category is $116 ($252 × $690/$1,503).

(f) *Applicability date.* Except as provided in this paragraph (f), this section applies to taxable years beginning after December 31, 2017. For a taxable year that both begins before January 1, 2018, and ends after December 31, 2017, this section applies without regard to the rules relating to inclusions arising under section 951A.

■ **Par. 19.** § 1.904(f)–12 is amended by adding and reserving paragraph (i) and adding paragraph (j) to read as follows:

§ 1.904(f)–12 Transition rules.

* * * * *

(i) [Reserved]

(j) *Recapture in years beginning after December 31, 2017, of separate limitation losses, overall foreign losses, and overall domestic losses incurred in years beginning before January 1, 2018*—(1) *Definitions*—(i) The term *pre-2018 separate categories* means the separate categories of income described in section 904(d) and any specified separate categories of income, as applicable to taxable years beginning before January 1, 2018.

(ii) The term *post-2017 separate categories* means the separate categories of income described in section 904(d) and any specified separate categories of income, as applicable to taxable years beginning after December 31, 2018.

(iii) The term *specified separate category* has the meaning set forth in § 1.904–4(m)).

(2) *Losses related to pre-2018 passive category income or a specified separate category of income*—(i) *Allocation of separate limitation loss or overall foreign loss account incurred in a pre-2018 separate category for passive category income or a specified separate category of income.* To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2018 separate category for passive category income or a specified separate category of income at the end of the taxpayer's last taxable year beginning before January 1, 2018, the amount of such balance is allocated on the first day of the taxpayer's next taxable year to the same post-2017 separate category as the pre-2018 separate category of the separate limitation loss or overall foreign loss account.

(ii) *Recapture of separate limitation loss or overall domestic loss that reduced pre-2018 passive category income or a specified separate category of income.* To the extent that at the end of the taxpayer's last taxable year beginning before January 1, 2018, a taxpayer has a balance in any separate limitation loss or overall domestic loss account which offset pre-2018 separate category income that was passive category income or income in a specified separate category, such loss is recaptured in subsequent taxable years as income in the same post-2017 separate category as the pre-2018 separate category of income that was offset by the loss.

(3) *Losses related to pre-2018 general category income*—(i) *Allocation of separate limitation loss or overall foreign loss account incurred in a pre-2018 separate category for general category income.* To the extent that a taxpayer has a balance in any separate limitation loss or overall foreign loss account in a pre-2018 separate category for general category income at the end of the taxpayer's last taxable year beginning before January 1, 2018, the amount of such balance is allocated on the first day of the taxpayer's next taxable year to the taxpayer's post-2017 separate category for general category income, or, if the taxpayer applies the exception described in § 1.904–2(j)(1)(iii), on a pro rata basis to the taxpayer's post-2017 separate categories for general category and foreign branch category income, based on the proportion in which any unused foreign taxes in the same pre-2018 separate category for general category income are allocated under § 1.904–2(j)(1)(iii)(A). If

the taxpayer has no unused foreign taxes in the pre-2018 separate category for general category income, then any loss account balance in that category is allocated to the post-2017 separate category for general category income.

(ii) *Recapture of separate limitation loss or overall domestic loss that reduced pre-2018 general category income.* To the extent that a taxpayer's separate limitation loss or overall domestic loss offset pre-2018 separate category income that was general category income, the balance in the loss account at the end of the taxpayer's last taxable year beginning before January 1, 2018, is recaptured in subsequent taxable years as income in the post-2017 separate category for general category income, or, if the taxpayer applies the exception described in § 1.904–2(j)(1)(iii), on a pro rata basis as income in the post-2017 separate categories for general category and foreign branch category income, based on the proportion in which any unused foreign taxes in the pre-2018 separate category for general category income are allocated under § 1.904–2(j)(1)(iii)(A). If the taxpayer has no unused foreign taxes in the pre-2018 separate category for general category income, then the loss account balance shall be recaptured in subsequent taxable years solely as income in the post-2017 separate category for general category income.

(4) *Treatment of foreign losses that are part of net operating losses incurred in pre-2018 taxable years which are carried forward to post-2017 taxable years.* A foreign loss that is part of a net operating loss incurred in a taxable year beginning before January 1, 2018, which is carried forward, pursuant to section 172, to a taxable year beginning after December 31, 2017, will be carried forward under the rules of § 1.904(g)–3(b)(2). For purposes of applying those rules, the portion of a net operating loss carryforward that is attributable to a foreign loss from the pre-2018 separate category for passive category income or a specified separate category of income will be treated as a loss in the same post-2017 separate category as the pre-2018 separate category. The portion of a net operating loss carryforward that is attributable to a foreign loss from the pre-2018 separate category for general category income must be treated as a loss in the post-2017 separate category for general or branch category income under the allocation principles of paragraph (j)(3)(i) of this section.

(5) *Applicability date.* This paragraph (j) applies to taxable years beginning after December 31, 2017.

§ 1.952–1 [Amended]

■ **Par. 20.** Section 1.952–1 is amended by removing the language ''§ 1.904–5(a)(1)'' and adding in its place the language ''§ 1.904–5(a)(4)(v)'' in the first sentence of paragraph (e)(5).

■ **Par. 21.** Section 1.954–1 is amended by:

■ 1. Removing the language ''§ 1.904–5(a)(1)'' and adding in its place the language ''§ 1.904–5(a)(4)(v)'' in the introductory text of paragraph (c)(1)(iii)(A).

■ 2. Removing the language ''section 960'' and adding in its place the language ''section 960(a) and § 1.960–2(b)(1)'' in the first sentence of paragraph (d)(3)(i).

■ 3. Removing the language ''section 960'' and adding in its place the language ''section 960(a)'' in the second sentence of paragraph (d)(3)(i).

■ 4. Revising the last sentence of paragraph (d)(3)(i).

■ 5. Adding a sentence at the end of paragraph (d)(3)(i).

■ 6. Removing the language ''section 960'' and adding in its place the language ''section 960(a) and § 1.960–2(b)(1)'' in paragraph (d)(3)(ii).

■ 7. Adding a sentence at the end of paragraph (d)(3)(ii).

■ 8. Removing paragraph (g)(4).

■ 9. Adding paragraph (h).

The revision and additions read as follows:

§ 1.954–1 Foreign base company income.

* * * * *

(d) * * *

(3) * * *

(i) * * * Except as provided in the next sentence, the amount of foreign income taxes paid or accrued with respect to a net item of income, determined in the manner provided in this paragraph (d), is not affected by a subsequent reduction in foreign income taxes attributable to a distribution to shareholders of all or part of such income. To the extent the foreign income taxes paid or accrued by the controlled foreign corporation are reasonably certain to be returned by the foreign jurisdiction imposing such taxes to a shareholder, directly or indirectly, through any means (including, but not limited to, a refund, credit, payment, discharge of an obligation, or any other method) on a subsequent distribution to such shareholder, the foreign income taxes are not treated as paid or accrued for purposes of this paragraph (d)(3)(i).

(ii) * * * However, notwithstanding the rules in § 1.904–4(c)(7), to the extent the foreign income taxes paid or accrued by the controlled foreign corporation are reasonably certain to be returned by the foreign jurisdiction imposing such taxes to a shareholder, directly or indirectly, through any means (including, but not limited to, a refund, credit, payment, discharge of an obligation, or any other method) on a subsequent distribution to such shareholder, the foreign income taxes are not treated as paid or accrued for purposes of this paragraph (d)(3)(ii).

* * * * *

(h) *Applicability dates*—(1) *Paragraphs (d)(3)(i) and (ii).* Paragraphs (d)(3)(i) and (ii) of this section apply to taxable years of a controlled foreign corporation ending on or after December 4, 2018.

(2) *Paragraph (g).* Paragraph (g) of this section applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

■ **Par. 22.** Section 1.960–1 is revised to read as follows:

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

(a) *Overview*—(1) *Scope of §§ 1.960–1 through 1.960–3.* This section and §§ 1.960–2 and 1.960–3 provide rules to associate foreign income taxes of a controlled foreign corporation with the income that a domestic corporation that is a United States shareholder of the controlled foreign corporation takes into account in determining a subpart F inclusion or GILTI inclusion amount of the domestic corporation, as well as to associate foreign income taxes of a controlled foreign corporation with distributions of previously taxed earnings and profits. These regulations provide the exclusive rules for determining the foreign income taxes deemed paid by a domestic corporation. Therefore, only foreign income taxes of a controlled foreign corporation that are associated under these rules with a subpart F inclusion or GILTI inclusion amount of a domestic corporation that is a United States shareholder of the controlled foreign corporation, or with previously taxed earnings and profits, are eligible to be deemed paid. This section provides definitions and computational rules for determining foreign income taxes deemed paid under section 960(a), (b), and (d). Section 1.960–2 provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation under section 960(a) and (d). Section 1.960–3 provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation, or by a controlled foreign corporation, under section 960(b).

(2) *Scope of this section.* Paragraph (b) of this section provides definitions for purposes of this section and §§ 1.960–2 and 1.960–3. Paragraph (c) of this section provides computational rules to coordinate the various calculations under this section and §§ 1.960–2 and 1.960–3. Paragraph (d) of this section provides rules for computing the income in an income group within a section 904 category, and for associating foreign income taxes with an income group. Paragraph (e) of this section provides a rule for the creditability of taxes associated with the residual income group. Paragraph (f) of this section provides an example illustrating the application of this section.

(b) *Definitions.* The following definitions apply for purposes of this section and §§ 1.960–2 and 1.960–3.

(1) *Annual PTEP account.* The term *annual PTEP account* has the meaning set forth in § 1.960–3(c)(1).

(2) *Controlled foreign corporation.* The term *controlled foreign corporation* means a foreign corporation described in section 957(a).

(3) *Current taxable year.* The term *current taxable year* means the U.S. taxable year of a controlled foreign corporation that is an inclusion year, or during which the controlled foreign corporation receives a section 959(b) distribution or makes a section 959(a) distribution or a section 959(b) distribution.

(4) *Current year taxes.* The term *current year taxes* means foreign income taxes paid or accrued by a controlled foreign corporation in a current taxable year. Foreign income taxes accrue when all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. *See* §§ 1.446–1(c)(1)(ii)(A) and 1.461–4(g)(6)(iii)(B) (economic performance exception for certain foreign taxes). Withholding taxes described in section 901(k)(1)(B) that are withheld from a payment accrue when the payment is made. Foreign income taxes calculated on the basis of net income recognized in a foreign taxable year accrue on the last day of the foreign taxable year. Accordingly, current year taxes include foreign withholding taxes that are withheld from payments made to the controlled foreign corporation during the current taxable year, and foreign income taxes that accrue in the controlled foreign corporation's current taxable year in which or with which its foreign taxable year ends. Additional payments of foreign income taxes resulting from a redetermination of foreign tax liability, including contested taxes that accrue when the contest is resolved, ''relate back'' and are considered to accrue as of the end of the foreign taxable year to which the taxes relate.

(5) *Foreign income taxes.* The term *foreign income taxes* means income, war profits, and excess profits taxes as defined in § 1.901–2(a), and taxes included in the term income, war profits, and excess profits taxes by reason of section 903 and § 1.903–1(a), that are imposed by a foreign country or a possession of the United States, including any such taxes that are deemed paid by a controlled foreign corporation under section 960(b). Income, war profits, and excess profits taxes do not include amounts excluded from the definition of those taxes pursuant to section 901 and the regulations under that section. See, for example, section 901(f), (g), and (i). Foreign income taxes also do not include taxes paid by a controlled foreign corporation for which a credit is disallowed at the level of the controlled foreign corporation. See, for example, sections 245A(e)(3), 901(k)(1), (l), and (m), 909, and 6038(c)(1)(B). Foreign income taxes, however, include taxes that may be deemed paid but for which a credit is reduced or disallowed at the level of the United States shareholder. See, for example, sections 901(e), 901(j), 901(k)(2), 908, 965(g), and 6038(c)(1)(A).

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

(7) *GILTI inclusion amount.* The term *GILTI inclusion amount* has the meaning set forth in § 1.951A–1(c)(1) (or, in the case of a member of a consolidated group, § 1.1502–51(b)).

(8) *Gross tested income.* The term *gross tested income* has the meaning set forth in § 1.951A–2(c)(1).

(9) *Inclusion percentage.* The term *inclusion percentage* has the meaning set forth in § 1.960–2(c)(2).

(10) *Inclusion year.* The term *inclusion year* means the U.S. taxable year of a controlled foreign corporation which ends during or with the taxable year of a United States shareholder of the controlled foreign corporation in which the United States shareholder includes an amount in income under section 951(a)(1) or 951A(a) with respect to the controlled foreign corporation.

(11) *Income group.* The term *income group* means a group of income described in paragraph (d)(2)(ii) of this section.

(12) *Partnership CFC.* The term *partnership CFC* has the meaning set forth in § 1.951A–5(e)(2).

(13) *Passive category.* The term *passive category* means the separate category of income described in section 904(d)(1)(C) and § 1.904–4(b).

(14) *Previously taxed earnings and profits.* The term *previously taxed earnings and profits* means earnings and profits described in section 959(c)(1) or (2), including earnings and profits described in section 959(c)(2) by reason of section 951A(f)(1) and § 1.951A–6(b)(1).

(15) *PTEP group.* The term *PTEP group* has the meaning set forth in § 1.960–3(c)(2).

(16) *PTEP group taxes.* The term *PTEP group taxes* has the meaning set forth in § 1.960–3(d)(1).

(17) *Recipient controlled foreign corporation.* The term *recipient controlled foreign corporation* has the meaning set forth in § 1.960–3(b)(2).

(18) *Reclassified previously taxed earnings and profits.* The term *reclassified previously taxed earnings and profits* has the meaning set forth in § 1.960–3(c)(4).

(19) *Reclassified PTEP group.* The term *reclassified PTEP group* has the meaning set forth in § 1.960–3(c)(4).

(20) *Residual income group.* The term *residual income group* has the meaning set forth in paragraph (d)(2)(ii)(D) of this section.

(21) *Section 904 category.* The term *section 904 category* means a separate category of income described in § 1.904–5(a)(4)(v).

(22) *Section 951A category.* The term *section 951A category* means the separate category of income described in section 904(d)(1)(A) and § 1.904–4(g).

(23) *Section 959 distribution.* The term *section 959 distribution* means a section 959(a) distribution or a section 959(b) distribution.

(24) *Section 959(a) distribution.* The term *section 959(a) distribution* means a distribution excluded from the gross income of a United States shareholder under section 959(a).

(25) *Section 959(b) distribution.* The term *section 959(b) distribution* means a distribution excluded from the gross income of a controlled foreign corporation for purposes of section 951(a) under section 959(b).

(26) *Section 959(c)(2) PTEP group.* The term *section 959(c)(2) PTEP group* has the meaning set forth in § 1.960–3(c)(4).

(27) *Subpart F inclusion.* The term *subpart F inclusion* has the meaning set forth in § 1.960–2(b)(1).

(28) *Subpart F income.* The term *subpart F income* has the meaning set forth in section 952 and § 1.952–1(a).

(29) *Subpart F income group.* The term *subpart F income group* has the meaning set forth in paragraph (d)(2)(ii)(B)(*1*) of this section.

(30) *Tested foreign income taxes.* The term *tested foreign income taxes* has the meaning set forth in § 1.960–2(c)(3).

(31) *Tested income.* The term *tested income* means the amount with respect to a controlled foreign corporation that is described in section 951A(c)(2)(A) and § 1.951A–2(b)(1).

(32) *Tested income group.* The term *tested income group* has the meaning set forth in paragraph (d)(2)(ii)(C) of this section.

(33) *United States shareholder.* The term *United States shareholder* has the meaning set forth in section 951(b).

(34) *U.S. shareholder partner.* The term *U.S. shareholder partner* has the meaning set forth in § 1.951A–5(e)(3).

(35) *U.S. shareholder partnership.* The term *U.S. shareholder partnership* has the meaning set forth in § 1.951A–5(e)(4).

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

(c) *Computational rules*—(1) *In general.* For purposes of computing foreign income taxes deemed paid by either a domestic corporation that is a United States shareholder with respect to a controlled foreign corporation under § 1.960–2 or 1.960–3 or by a controlled foreign corporation under § 1.960–3 for the current taxable year, the following rules apply in the following order, beginning with the lowest-tier controlled foreign corporation in a chain with respect to which the domestic corporation is a United States shareholder:

(i) First, items of gross income of the controlled foreign corporation for the current taxable year other than a section 959(b) distribution are assigned to section 904 categories and included in income groups within those section 904 categories under the rules in paragraph (d)(2) of this section. The receipt of a section 959(b) distribution by the controlled foreign corporation is accounted for under § 1.960–3(c)(3).

(ii) Second, deductions (other than for current year taxes) of the controlled foreign corporation for the current taxable year are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category. See paragraph (d)(3)(i) of this section. Additionally, the functional currency amounts of current year taxes of the controlled foreign corporation for the current taxable year are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category, and to reduce earnings and profits in any PTEP groups that were increased as provided in paragraph (c)(1)(i) of this section. See paragraph (d)(3)(ii) of this section. For purposes of computing foreign taxes deemed paid, current year taxes allocated and apportioned to income groups and PTEP groups in the section 904 categories are translated into U.S. dollars in accordance with section 986(a). See paragraph (c)(3) of this section.

(iii) Third, current year taxes deemed paid under section 960(a) and (d) by the domestic corporation with respect to income of the controlled foreign corporation are computed under the rules of § 1.960–2. In addition, foreign income taxes deemed paid under section 960(b)(2) with respect to the receipt of a section 959(b) distribution by the controlled foreign corporation are computed under the rules of § 1.960–3(b).

(iv) Fourth, any previously taxed earnings and profits of the controlled foreign corporation resulting from subpart F inclusions and GILTI inclusion amounts with respect to the controlled foreign corporation's current taxable year are separated from other earnings and profits of the controlled foreign corporation and added to an annual PTEP account, and a PTEP group within the PTEP account, under the rules of § 1.960–3(c).

(v) Fifth, paragraphs (c)(1)(i) through (iv) of this section are repeated for each next higher-tier controlled foreign corporation in the chain.

(vi) Sixth, with respect to the highest-tier controlled foreign corporation in a chain that is owned directly (or indirectly through a partnership) by the domestic corporation, foreign income taxes that are deemed paid under section 960(b)(1) in connection with the receipt of a section 959(a) distribution by the domestic corporation are computed under the rules of § 1.960–3(b).

(2) *Inclusion of current year items.* For a current taxable year, the items of income and deductions (including for taxes), and the U.S. dollar amounts of current year taxes, that are included in the computations described in this section and assigned to income groups and PTEP groups for the taxable year are the items that the controlled foreign corporation accrues and takes into account during the current taxable year.

(3) *Functional currency and translation.* The computations described in this paragraph (c) that relate to income and earnings and profits are made in the functional currency of the controlled foreign corporation (as determined under section 985), and references to taxes deemed paid are to U.S. dollar amounts (translated in accordance with section 986(a)).

(d) *Computing income in a section 904 category and an income group within a section 904 category*—(1) *Scope.* This paragraph (d) provides rules for assigning gross income (including gains) of a controlled foreign corporation for the current taxable year to a section 904 category and income group within a section 904 category, and for allocating and apportioning deductions (including losses and current year taxes) and the U.S. dollar amount of current year taxes of the controlled foreign corporation for the current taxable year among the section 904 categories, income groups within a section 904 category, and PTEP groups. For rules regarding maintenance of previously taxed earnings and profits in an annual PTEP account, and assignment of those previously taxed earnings and profits to PTEP groups, see § 1.960–3.

(2) *Assignment of gross income to section 904 categories and income groups within a category*—(i) *Assigning items of gross income to section 904 categories.* Items of gross income of the controlled foreign corporation for the current taxable year are first assigned to a section 904 category of the controlled foreign corporation under §§ 1.904–4 and 1.904–5, and under § 1.960–3(c)(1) in the case of gross income relating to a section 959(b) distribution received by the controlled foreign corporation. Income of a controlled foreign corporation, other than gross income relating to a section 959(b) distribution, cannot be assigned to the section 951A category or the foreign branch category. *See* § 1.904–4(f) and (g).

(ii) *Grouping gross income within a section 904 category*—(A) *In general.* Gross income within a section 904 category is assigned to an income group under the rules of this paragraph (d)(2)(ii), or to a PTEP group under the rules of § 1.960–3(c)(3). Gross income other than a section 959(b) distribution is assigned to a subpart F income group, tested income group, or residual income group.

(B) *Subpart F income groups*—(*1*) *In general.* The term *subpart F income group* means an income group within a section 904 category that consists of income that is described in paragraph (d)(2)(ii)(B)(*2*) of this section. Gross income that is treated as a single item of income under § 1.954–1(c)(1)(iii) is in a separate subpart F income group under paragraph (d)(2)(ii)(B)(*2*)(*i*) of this section. Items of gross income that give rise to income described in paragraph (d)(2)(ii)(B)(*2*)(*ii*) of this section are aggregated and treated as gross income in a separate subpart F income group. Similarly, items of gross income that give rise to income described in each one of paragraphs (d)(2)(ii)(B)(*2*)(*iii*) through (*v*) of this section are aggregated and treated as gross income in a separate subpart F income group.

(*2*) *Income in subpart F income groups.* The income included in subpart F income groups is:

(*i*) Items of foreign base company income treated as a single item of income under § 1.954–1(c)(1)(iii);

(*ii*) Insurance income described in section 952(a)(1);

(*iii*) Income subject to the international boycott factor described in section 952(a)(3);

(*iv*) Income from certain bribes, kickbacks and other payments described in section 952(a)(4); and

(*v*) Income subject to section 901(j) described in section 952(a)(5).

(C) *Tested income groups.* The term *tested income group* means an income group that consists of tested income within a section 904 category. Items of gross tested income in each section 904 category are aggregated and treated as gross income in a separate tested income group.

(D) *Residual income group.* The term *residual income group* means the income group within a section 904 category that consists of income not described in paragraph (d)(2)(ii)(B) or (C) of this section.

(E) *Examples.* The following examples illustrate the application of this paragraph (d)(2)(ii).

(*1*) *Example 1: Subpart F income groups*—(*i*) *Facts.* CFC, a controlled foreign corporation, is incorporated in Country X. CFC uses the ''u'' as its functional currency. At all relevant times, 1u=$1. CFC earns from sources outside of Country X portfolio dividend income of 100,000u, portfolio interest income of 1,500,000u, and 70,000u of royalty income that is not derived from the active conduct of a trade or business. CFC also earns 50,000u from the sale of personal property to a related person for use outside of Country X that gives rise to foreign base company sales income under section 954(d). Finally, CFC earns 45,000u for performing consulting services outside of Country X for related persons that gives rise to foreign base company services income under section 954(e). None of the income is taxed by Country X. The dividend income is subject to a 15 percent third-country withholding tax after application of the applicable income tax treaty. The interest income and the royalty income are subject to no third-country withholding tax. CFC incurs no expenses.

(*ii*) *Analysis.* Under paragraph (d)(2)(i) of this section and § 1.904–4, the interest income, dividend income, and royalty income are passive category income and the sales and consulting income are general category income. Under paragraph (d)(2)(ii)(B) of this section, CFC has a separate subpart F income group within the passive category with respect to the 100,000u of dividend income, which is foreign personal holding company income described in § 1.954–1(c)(1)(iii)(A)(*1*)(*i*) (dividends, interest, rents, royalties and annuities) that falls within a single group of income under § 1.904–4(c)(3)(i) for passive income that is subject to withholding tax of fifteen percent or greater. CFC also has a separate subpart F income group within the passive category with respect to the 1,500,000u of interest income and the 70,000u of royalty income (in total 1,570,000u) which together are foreign personal holding company income described in § 1.954–1(c)(1)(iii)(A)(*1*)(*i*) (dividends, interest, rents, royalties and annuities) that falls within a single group of income under § 1.904–4(c)(3)(iii) for passive income that is subject to no withholding tax or other foreign tax. With respect to its 50,000u of sales income, CFC has a separate subpart F income group with respect to foreign base company sales income described in § 1.954–1(c)(1)(iii)(A)(*2*)(*i*) within the general category. With respect to its 45,000u of services income, CFC has a separate subpart F income group with respect to foreign base company services income described in § 1.954–1(c)(1)(iii)(A)(*2*)(*ii*) within the general category.

(*2*) *Example 2: Tested income groups*—(*i*) *Facts.* CFC, a controlled foreign corporation, is incorporated in Country X. CFC uses the ''u'' as its functional currency. At all relevant times, 1u=$1. CFC earns 500u from the sale of goods to unrelated parties. CFC also earns 75u for performing consulting services for unrelated parties. All of its income is gross tested income. CFC incurs no deductions.

(*ii*) *Analysis.* Under paragraph (d)(2)(i) of this section and section 904 and § 1.904–4, the sales income and services income are both general category income. Under paragraph (d)(2)(ii)(C) of this section, with respect to the 500u of sales income and 75u services income (in total 575u), CFC has one tested income group within the general category.

(3) *Allocation and apportionment of deductions among section 904 categories, income groups within a section 904 category, and certain PTEP groups*—(i) *In general.* Gross income of the controlled foreign corporation in each income group within each section 904 category is reduced by deductions (including losses) of the controlled foreign corporation for the current taxable year under the following rules.

(A) First, the rules of sections 861 through 865 and 904(d) and the regulations under those sections (taking into account the rules of section 954(b)(5) and § 1.954–1(c), and section 951A(c)(2)(A)(ii) and § 1.951A–2(c)(3), as appropriate) apply to allocate and apportion to reduce gross income (or create a loss) in each section 904 category and income group within a section 904 category any deductions of the controlled foreign corporation that are definitely related to less than all of the controlled foreign corporation's gross income as a class. See paragraph (d)(3)(ii) of this section for special rules for allocating and apportioning current year taxes to section 904 categories, income groups, and PTEP groups.

(B) Second, related person interest expense is allocated to and apportioned among the subpart F income groups within the passive category under the principles of § 1.904–5(c)(2) and § 1.954–1(c)(1)(i).

(C) Third, any remaining deductions are allocated and apportioned to reduce gross income (or create a loss) in the section 904 categories and income groups within each section 904 category under the rules referenced in paragraph (d)(3)(i)(A) of this section. No deductions of the controlled foreign corporation for the current taxable year other than a deduction for current year taxes imposed solely by reason of the receipt of a section 959(b) distribution are allocated or apportioned to reduce earnings and profits in a PTEP group.

(ii) *Allocation and apportionment of current year taxes*—(A) *In general.* Current year taxes are allocated and apportioned among the section 904 categories under the rules of § 1.904–6(a)(1)(i) and (ii) on the basis of the amount of taxable income computed under foreign law in each section 904 category that is included in the foreign tax base. Current year taxes in a section 904 category are then allocated and apportioned among the income groups within a section 904 category under the principles of § 1.904–6(a)(1)(i) and (ii). If the amount of previously taxed earnings and profits in a PTEP group is increased in the current taxable year of the controlled foreign corporation under § 1.960–3(c)(3) by reason of the receipt of a section 959(b) distribution, then for purposes of allocating and apportioning current year taxes that are imposed solely by reason of the receipt of the section 959(b) distribution under this paragraph (d)(3)(ii)(A), the PTEP group is treated as an income group within the section 904 category. In applying § 1.904–6(a)(1)(i) and (ii) for purposes of this paragraph (d)(3)(ii)(A), the gross items of income and deduction calculated under foreign law that are included in a section 904 category, income group, or PTEP group that is treated as an income group are the items that are included in taxable income under foreign law for the foreign taxable year of the controlled foreign corporation that ends with or within the controlled foreign corporation's current taxable year. For purposes of determining foreign income taxes deemed paid under the rules in §§ 1.960–2 and 1.960–3, the U.S. dollar amounts of current year taxes are assigned to the section 904 categories, income groups, and PTEP groups, if any, to which the current year taxes are allocated and apportioned.

(B) *Base and timing differences*—(*1*) *In general.* Current year taxes that are attributable to a base difference described in § 1.904–6(a)(1)(iv) are not allocated and apportioned to any subpart F income group, tested income group or PTEP group, but are treated as related to income in the residual income group. Except as provided in paragraph (d)(3)(ii)(B)(*2*) of this section, current year taxes that are attributable to a timing difference described in § 1.904–6(a)(1)(iv) are treated as related to the appropriate section 904 category and income group within a section 904 category to which the particular tax would be assigned if the income on which the tax is imposed were recognized under Federal income tax principles in the year in which the tax was imposed.

(*2*) *Tax on previously taxed earnings and profits.* Current year taxes imposed solely by reason of the controlled foreign corporation's receipt of a section 959(b) distribution are not allocated and apportioned under the general rule for timing differences but are allocated or apportioned to a PTEP group. Current year taxes imposed with respect to previously taxed earnings and profits by reason of any other timing difference are allocated or apportioned, under the general rule described in paragraph (d)(3)(ii)(B)(*1*) of this section, to the income group to which the income that gave rise to the previously taxed earnings and profits was assigned in the inclusion year. For example, a net basis tax imposed on a controlled foreign corporation's receipt of a section 959(b) distribution by the corporation's country of residence is allocated or apportioned to a PTEP group. Similarly, a withholding tax imposed with respect to a controlled foreign corporation's receipt of a section 959(b) distribution is allocated and apportioned to a PTEP group. In contrast, a withholding tax imposed on a disregarded payment from a disregarded entity to its controlled foreign corporation owner is treated as a timing difference and is never treated as related to a PTEP group, even if all of the controlled foreign corporation's earnings are previously taxed earnings and profits, because the tax is not imposed solely by reason of a section 959(b) distribution. Such a withholding tax, however, may be treated as related to a subpart F income group or tested income group under the general rule for timing differences.

(e) *No deemed paid credit for current year taxes related to residual income group.* Current year taxes paid or accrued by a controlled foreign corporation that are allocated and apportioned under paragraph (d)(3)(ii) of this section to a residual income group cannot be deemed paid under section 960 for any taxable year.

(f) *Example.* The following example illustrates the application of this section and § 1.960–3.

(1) *Facts*—(i) *Income of CFC1 and CFC2.* CFC1, a controlled foreign corporation, conducts business in Country X. CFC1 uses the ''u'' as its functional currency. At all relevant times, 1u=$1. CFC1 owns all of the stock of CFC2, a controlled foreign corporation. CFC1 and CFC2 both use the calendar year as their U.S. and foreign taxable years. In 2019, CFC1 earns 2,000,000u of gross income that is foreign oil and gas extraction income, within the meaning of section 907(c)(1), and 2,000,000u of interest income from unrelated persons, for both U.S. and Country X tax law purposes. Country X exempts interest income from tax. In 2019, CFC1 also receives a section 959(b) distribution from CFC2 of 4,000,000u of previously taxed earnings and profits attributable to an inclusion under section 965(a) for CFC2's 2017 U.S. taxable year. The inclusion under section 965(a) was income in the general category. There are no PTEP group taxes associated with the previously taxed earnings and profits distributed by CFC2 at the level of CFC2. The section 959(b) distribution is treated as a dividend taxable to CFC1 under Country X law. In 2019, CFC2 earns no gross income and receives no distributions.

(ii) *Pre-tax deductions of CFC1 and CFC2.* For both U.S. and Country X tax purposes, in 2019, CFC1 incurs 1,500,000u of deductible expenses other than current year taxes that are allocable to all gross income. For U.S. tax purposes, under §§ 1.861–8 through 1.861–14T, 750,000u of such deductions are apportioned to each of CFC1's foreign oil and gas extraction income and interest income. Under Country X law, 1,000,000u of deductions are allocated and apportioned to the 4,000,000u treated as a dividend, and 500,000u of deductions are allocated and apportioned to the 2,000,000u of foreign oil and gas extraction income. Under Country X law, no deductions are allocable to the interest income. Country X imposes tax of 900,000u on a base of 4,500,000u (6,000,000u gross income − 1,500,000u deductions) consisting of 3,000,000u (4,000,000u − 1,000,000u) attributable to CFC1's section 959(b) distribution and 1,500,000u (2,000,000u − 500,000u) attributable to CFC1's foreign oil and gas extraction income. In 2019, CFC2 has no expenses (including current year taxes).

(iii) *United States shareholders of CFC1.* All of the stock of CFC1 is owned (within the meaning of section 958(a)) by corporate United States shareholders that use the calendar year as their U.S. taxable year. In 2019, the United States shareholders of CFC1 include in gross income subpart F inclusions in the passive category totaling $1,250,000 with respect to 1,250,000u of subpart F income of CFC1.

(2) *Analysis*—(i) *CFC2.* Under paragraph (c)(1) of this section, the computational rules of paragraph (c)(1) of this section are applied beginning with CFC2. However, CFC2 has no gross income or expenses in 2019 (the ''current taxable year''). Accordingly, the computational rules described in paragraph (c)(1)(i) through (iv) of this section are not relevant with respect to CFC2. Under paragraph (c)(1)(v) of this section, the rules in paragraph (c)(1)(i) through (iv) of this section are then applied to CFC1.

(ii) *CFC1.* (A) *Step 1.* Under paragraph (c)(1)(i) of this section, CFC1's items of gross income for the current taxable year are assigned to section 904 categories and included in income groups within those section 904 categories. In addition, CFC1's receipt of a section 959(b) distribution is assigned to a PTEP group. Under paragraph (d)(2)(i) of this section and § 1.904–4, the interest income is passive category income and the foreign oil and gas extraction income is general category income. Under paragraph (d)(2)(ii) of this section, the 2,000,000u of interest income is assigned to a subpart F income group (the ''subpart F income group'') within the passive category because it is foreign personal holding company income described in § 1.954–1(c)(1)(iii)(A)(*1*)(*i*) that falls within a single group of income under § 1.904–4(c)(3)(iii) for passive income that is subject to no withholding tax or other foreign tax. The 2,000,000u of foreign oil and gas extraction income is assigned to the residual income group within the general category. Under § 1.960–3(c), the 4,000,000u section 959(b) distribution is assigned to the PTEP group described in § 1.960–3(c)(2)(vii) within the 2017 annual PTEP account (the ''PTEP group'') within the general category.

(B) *Step 2*—(*1*) *Allocation and apportionment of deductions for expenses other than taxes.* Under paragraph (c)(1)(ii) of this section, CFC1's deductions for the current taxable year are allocated and apportioned among the section 904 categories, income groups within a section 904 category, and any PTEP groups that were increased as provided in paragraph (c)(1)(i) of this section. Under paragraph (d)(3)(i) of this section and § 1.861–8 through 1.861–14T, 750,000u of deductions are allocated and apportioned to the residual income group within the general category, and 750,000u of deductions are allocated and apportioned to the subpart F income group within the passive category. Therefore, CFC1 has 1,250,000u (2,000,000u − 750,000u) of pre-tax income attributable to the residual income group within the general category and 1,250,000u (2,000,000u − 750,000u) of pre-tax income attributable to the subpart F income group within the passive category. For U.S. tax purposes, no deductions other than current year taxes are allocated and apportioned to the 4,000,000u in CFC1's PTEP group.

(*2*) *Allocation and apportionment of current year taxes.* Under paragraph (c)(1)(ii) of this section, CFC1's current year taxes are allocated and apportioned among the section 904 categories, income groups within a section 904 category, and any PTEP groups that were increased as provided in paragraph (c)(1)(i) of this section. Under paragraphs (d)(3)(i) and (ii) of this section, for purposes of allocating and apportioning taxes to reduce the income in a section 904 category, an income group, or PTEP group, § 1.904–6(a)(1) and (ii) are applied to determine the amount of taxable income computed under Country X law in each section 904 category, income group, and PTEP group that is included in the Country X tax base. For Country X purposes, 1,000,000u of deductions are apportioned to CFC1's PTEP group within the general category, 500,000u of deductions are apportioned to the residual income group within the general category, and no deductions are apportioned to the subpart F income group in the passive category. Therefore, for Country X purposes, CFC1 has 3,000,000u of income attributable to the PTEP group within the general category, 1,500,000u of income attributable to the residual income group within the general category, and no income attributable to the subpart F income group within the passive category. Under paragraph (d)(3)(ii) of this section, 600,000u (3,000,000u/4,500,000u × 900,000u) of the 900,000u current year taxes paid by CFC1 are related to the PTEP group within the general category, and 300,000u (1,500,000u/4,500,000u × 900,000u) are related to the residual income group within the general category. No current year taxes are allocated or apportioned to the subpart F income group within the passive category because the interest expense is exempt from Country X tax. Thus, for U.S. tax purposes, CFC1 has 3,400,000u of previously taxed earnings and profits (4,000,000u − 600,000u) in the PTEP group within the general category, 1,250,000u of income in the subpart F income group within the passive category, and 950,000u of income (1,250,000u − 300,000u) in the residual income group within the general category. For purposes of determining foreign taxes deemed paid under section 960, CFC1 has $600,000 of foreign income taxes in the PTEP group within the general category and $300,000 of current year taxes in the residual income group within the general category. Under paragraph (e) of this section, the United States shareholders of CFC1 cannot claim a credit with respect to the $300,000 of taxes on CFC1's income in the residual income group.

(C) *Step 3.* Under paragraph (c)(1)(iii) of this section, the United States shareholders of CFC1 compute current year taxes deemed paid under section 960(a) and (d) and the rules of § 1.960–2. None of the Country X tax is allocated to CFC1's subpart F income group. Therefore, there are no current year taxes deemed paid by CFC1's United States shareholders with respect to their passive category subpart F inclusions. See § 1.960–2(b)(5) and (c)(7) for examples of the application of section 960(a) and (d) and the rules in § 1.960–2. Additionally, under paragraph (c)(1)(iii) of this section, foreign income taxes deemed paid under section 960(b)(2) by CFC1 are determined with respect to the section 959(b) distribution from CFC2 under the rules of § 1.960–3. There are no PTEP group taxes associated with the previously taxed earnings and profits distributed by CFC2 in the hands of CFC2. Therefore, there are no foreign income taxes deemed paid by CFC1 under section 960(b)(2) with respect to the section 959(b) distribution from CFC2. See § 1.960–3(e) for examples of the application of section 960(b) and the rules in § 1.960–3.

(D) *Step 4.* Under paragraph (c)(1)(iv) of this section, previously taxed earnings and profits resulting from subpart F inclusions and GILTI inclusion amounts with respect to CFC1's current taxable year are separated from CFC1's other earnings and profits and added to an annual PTEP account and PTEP group within the PTEP account, under the rules of § 1.960–3(c). The United States shareholders of CFC1 include in gross income subpart F inclusions totaling $1,250,000 with respect to 1,250,000u of subpart F income of CFC1, and the subpart F inclusions are passive category income. Therefore, under § 1.960–3(c)(2), 1,250,000u of previously taxed earnings and profits resulting from the subpart F inclusions is added to CFC1's PTEP group described in § 1.960–3(c)(2)(x) within the 2019 annual PTEP account within the passive category.

(E) *Step 5.* Paragraph (c)(1)(v) of this section does not apply because CFC1 is the highest-tier controlled foreign corporation in the chain.

(F) *Step 6.* Paragraph (c)(1)(vi) of this section does not apply because CFC1 did not make a section 959(a) distribution.

■ **Par. 23.** Section 1.960–2 is revised to read as follows:

§ 1.960–2 Foreign income taxes deemed paid under sections 960(a) and (d).

(a) *Scope.* Paragraph (b) of this section provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation under section 960(a). Paragraph (c) of this section provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation under section 960(d).

(b) *Foreign income taxes deemed paid under section 960(a)*—(1) *In general.* If a domestic corporation that is a United States shareholder of a controlled foreign corporation includes in gross income under section 951(a)(1)(A) its pro rata share of the subpart F income of the controlled foreign corporation (a *subpart F inclusion*), the domestic corporation is deemed to have paid the amount of the controlled foreign corporation's foreign income taxes that are properly attributable to the items of income in a subpart F income group of the controlled foreign corporation that give rise to the subpart F inclusion of the domestic corporation that is attributable to the subpart F income group. For each section 904 category, the domestic corporation is deemed to have paid foreign income taxes equal to the sum of the controlled foreign corporation's foreign income taxes that are properly attributable to the items of income in the subpart F income groups to which the subpart F inclusion is attributable. See § 1.904–6(b)(1) for rules on assigning the foreign income tax to a section 904 category. No foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B).

(2) *Properly attributable.* The amount of the controlled foreign corporation's foreign income taxes that are properly attributable to the items of income in the subpart F income group of the controlled foreign corporation to which a subpart F inclusion is attributable equals the domestic corporation's proportionate share of the current year taxes of the controlled foreign corporation that are allocated and apportioned under § 1.960–1(d)(3)(ii) to the subpart F income group. No other foreign income taxes are considered properly attributable to an item of income of the controlled foreign corporation.

(3) *Proportionate share*—(i) *In general.* A domestic corporation's proportionate share of the current year taxes of a controlled foreign corporation that are allocated and apportioned under § 1.960–1(d)(3)(ii) to a subpart F income group within a section 904 category of the controlled foreign corporation is equal to the total U.S. dollar amount of current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to the subpart F income group multiplied by a fraction (not to exceed one), the numerator of which is the portion of the domestic corporation's subpart F inclusion that is attributable to the subpart F income group and the denominator of which is the total net income in the subpart F income group, both determined in the functional currency of the controlled foreign corporation. If the numerator or denominator of the fraction is zero or less than zero, then the proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to the subpart F income group is zero.

(ii) *Effect of qualified deficits.* Neither an accumulated deficit nor any prior year deficit in the earnings and profits of a controlled foreign corporation reduces its net income in a subpart F income group. Accordingly, any such deficit does not affect the denominator of the fraction described in paragraph (b)(3)(i) of this section. However, the first sentence of this paragraph (b)(3)(ii) does not affect the application of section 952(c)(1)(B) for purposes of determining the domestic corporation's subpart F inclusion. Any reduction to the domestic corporation's subpart F inclusion under section 952(c)(1)(B) is reflected in the numerator of the fraction described in paragraph (b)(3)(i) of this section.

(iii) *Effect of current year E&P limitation or chain deficit.* To the extent that an amount of income in a subpart F income group is excluded from the subpart F income of the controlled foreign corporation under section 952(c)(1)(A) or (C), the net income in the subpart F income group that is the denominator of the fraction described in paragraph (b)(3)(i) of this section is reduced (but not below zero) by the amount excluded. The domestic corporation's subpart F inclusion that is the numerator of the fraction described in paragraph (b)(3)(i) of this section is based on the controlled foreign corporation's subpart F income computed with the application of section 952(c)(1)(A) and (C).

(4) *Domestic partnerships.* For purposes of applying this paragraph (b), in the case of a domestic partnership that is a U.S. shareholder partnership with respect to a partnership CFC, the distributive share of a U.S. shareholder partner of the U.S. shareholder partnership's subpart F inclusion with respect to the partnership CFC is treated as a subpart F inclusion of the U.S. shareholder partner with respect to the partnership CFC.

(5) *Example.* The following example illustrates the application of this paragraph (b).

(i) *Facts.* USP, a domestic corporation, owns 80% of the stock of CFC, a controlled foreign corporation. The remaining portion of the stock of CFC is owned by an unrelated person. USP and CFC both use the calendar year as their U.S. taxable year, and CFC also uses the calendar year as its foreign taxable year. CFC uses the ''u'' as its functional currency. At all relevant times, 1u=$1. For its U.S. taxable year ending December 31, 2018, after the application of the rules in § 1.960–1(d) the income of CFC after foreign taxes is assigned to the following income groups: 1,000,000u of dividend income in a subpart F income group within the passive category (''subpart F income group 1''); 2,400,000u of gain from commodities transactions in a subpart F income group within the passive category (''subpart F income group 2''); and 1,800,000u of foreign base company services income in a subpart F income group within the general category (''subpart F income group 3''). CFC has current year taxes, translated into U.S. dollars, of $740,000 that are allocated and apportioned as follows: $50,000 to subpart F income group 1; $240,000 to subpart F income group 2; and $450,000 to subpart F income group 3. USP has a subpart F inclusion with respect to CFC of 4,160,000u = $4,160,000, of which 800,000u is attributable to subpart F income group 1, 1,920,000u to subpart F income group 2, and 1,440,000u to subpart F income group 3.

(ii) *Analysis*—(A) *Passive category.* Under paragraphs (b)(2) and (3) of this section, the amount of CFC's current year taxes that are properly attributable to items of income in subpart F income group 1 to which a subpart F inclusion is attributable equals USP's proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to subpart F income group 1, which is $40,000 ($50,000 × 800,000u/1,000,000u). Under paragraphs (b)(2) and (3) of this section, the amount of CFC's current year taxes that are properly attributable to items of income in subpart F income group 2 to which a subpart F inclusion is attributable equals USP's proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to subpart F income group 2, which is $192,000 ($240,000 × 1,920,000u/2,400,000u). Accordingly, under paragraph (b)(1), USP is deemed to have paid $232,000 ($40,000 + $192,000) of passive category foreign income taxes of CFC with respect to its $2,720,000 subpart F inclusion in the passive category.

(B) *General category.* Under paragraphs (b)(2) and (3) of this section, the amount of CFC's current year taxes that are properly attributable items of income in subpart F income group 3 to which a subpart F inclusion is attributable equals USP's proportionate share of the foreign income taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to subpart F income group 3, which is $360,000 ($450,000 × 1,440,000u/1,800,000u). CFC has no other subpart F income groups within the general category. Accordingly, under paragraph (b)(1) of this section, USP is deemed to have paid $360,000 of general category foreign income taxes of CFC with respect to its $1,440,000 subpart F inclusion in the general category.

(c) *Foreign income taxes deemed paid under section 960(d)*—(1) *In general.* If a domestic corporation that is a United States shareholder of one or more controlled foreign corporations includes an amount in gross income under section 951A(a) and § 1.951A–1(b), the domestic corporation is deemed to have paid an amount of foreign income taxes equal to 80 percent of the product of its inclusion percentage multiplied by the sum of all tested foreign income taxes in the tested income group within each section 904 category of the controlled foreign corporation or corporations.

(2) *Inclusion percentage.* The term *inclusion percentage* means, with respect to a domestic corporation that is a United States shareholder of one or more controlled foreign corporations, the domestic corporation's GILTI inclusion amount divided by the aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i) with respect to the United States shareholder.

(3) *Tested foreign income taxes.* The term *tested foreign income taxes* means, with respect to a domestic corporation that is a United States shareholder of a controlled foreign corporation, the amount of the controlled foreign corporation's foreign income taxes that are properly attributable to tested income taken into account by the domestic corporation under section 951A and § 1.951A–1.

(4) *Properly attributable.* The amount of the controlled foreign corporation's foreign income taxes that are properly attributable to tested income taken into account by the domestic corporation under section 951A(a) and § 1.951A–1(b) equals the domestic corporation's proportionate share of the current year taxes of the controlled foreign corporation that are allocated and apportioned under § 1.960–1(d)(3)(ii) to the tested income group within each section 904 category of the controlled foreign corporation. No other foreign income taxes are considered properly attributable to tested income.

(5) *Proportionate share.* A domestic corporation's proportionate share of current year taxes of a controlled foreign corporation that are allocated and apportioned under § 1.960–1(d)(3)(ii) to a tested income group within a section 904 category of the controlled foreign corporation is the U.S. dollar amount of current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to a tested income group within a section 904 category of the controlled foreign corporation multiplied by a fraction (not to exceed one), the numerator of which is the portion of the tested income of the controlled foreign corporation in the tested income group within the section 904 category that is included in computing the domestic corporation's aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i), and the denominator of which is the income in the tested income group within the section 904 category, both determined in the functional currency of the controlled foreign corporation. If the numerator or denominator of the fraction is zero or less than zero, the domestic corporation's proportionate share of the current year taxes allocated and apportioned under § 1.960–1(d)(3)(ii) to the tested income group is zero.

(6) *Domestic partnerships.* See § 1.951A–5 for rules regarding the determination of the GILTI inclusion amount of a U.S. shareholder partner.

(7) *Examples.* The following examples illustrate the application of this paragraph (c).

(i) *Example 1: Directly owned controlled foreign corporation*—(A) *Facts.* USP, a domestic corporation, owns 100% of the stock of a number of controlled foreign corporations, including CFC1. USP and CFC1 each use the calendar year as their U.S. taxable year. CFC1 uses the ''u'' as its functional currency. At all relevant times, 1u=$1. For its U.S. taxable year ending December 31, 2018, after application of the rules in § 1.960–1(d), the income of CFC1 is assigned to a single income group: 2,000u of income from the sale of goods in a tested income group within the general category (''tested income group''). CFC1 has current year taxes, translated into U.S. dollars, of $400 that are all allocated and apportioned to the tested income group. For its U.S. taxable year ending December 31, 2018, USP has a GILTI inclusion amount determined by reference to all of its controlled foreign corporations, including CFC1, of $6,000, and an aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i) of $10,000. All of the income in CFC1's tested income group is included in computing USP's aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i).

(B) *Analysis.* Under paragraph (c)(5) of this section, USP's proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to CFC1's tested income group is $400 ($400 × 2,000u/2,000u). Therefore, under paragraph (c)(4) of this section, the amount of current year taxes properly attributable to tested income taken into account by USP under section 951A(a) and § 1.951A–1(b) is $400. Under paragraph (c)(3) of this section, USP's tested foreign income taxes with respect to CFC1 are $400. Under paragraph (c)(2) of this section, USP's inclusion percentage is 60% ($6,000/$10,000). Accordingly, under paragraph (c)(1) of this section, USP is deemed to have paid $192 of the foreign income taxes of CFC1 (80% × 60% × $400).

(ii) *Example 2: Controlled foreign corporation owned through domestic partnership*—(A) *Facts*—(*1*) US1, a domestic corporation, owns 95% of PRS, a domestic partnership. The remaining 5% of PRS is owned by US2, a domestic corporation that is unrelated to US1. PRS owns all of the stock of CFC1, a controlled foreign corporation. In addition, US1 owns all of the stock of CFC2, a controlled foreign corporation. US1, US2, PRS, CFC1, and CFC2 all use the calendar year as their taxable year. CFC1 and CFC2 both use the ''u'' as their functional currency. At all relevant times, 1u=$1. For its U.S. taxable year ending December 31, 2018, after application of the rules in § 1.960–1(d), the income of CFC1 is assigned to a single income group: 300u of income from the sale of goods in a tested income group within the general category (''CFC1's tested income group''). CFC1 has current year taxes, translated into U.S. dollars, of $100 that are all allocated and apportioned to CFC1's tested income group. The income of CFC2 is also assigned to a single income group: 200u of income from the sale of goods in a tested income group within the general category (''CFC2's tested income group''). CFC2 has current year taxes, translated into U.S. dollars, of $20 that are allocated and apportioned to CFC2's tested income group.

(*2*) In the same year, US1 is a U.S. shareholder partner with respect to CFC1, a partnership CFC, and accordingly, determines its GILTI inclusion amount under § 1.951A–5(c), as if US1 owned (within the meaning of section 958(a)) 95% of the stock of CFC1. Taking into account both CFC1 and CFC2, US1 has a GILTI inclusion amount in the general category of $485, and an aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i) within the general category of $485. 285u (95% × 300u) of the income in CFC1's tested income group and 200u of the income in CFC2's tested income group is included in computing US1's aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i) within the general category. Because US2 is not a U.S. shareholder partner with respect to CFC1, US2 does not take into account CFC1's tested income in determining its GILTI inclusion amount. However, under § 1.951A–5(b)(2), US2 includes in income $15, its distributive share of PRS's GILTI inclusion amount.

(B) *Analysis*—(*1*) *US1*—(*i*) *CFC1.* Under paragraph (c)(5) and (6) of this section, US1's proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to CFC1's tested income group is $95 ($100 × 285u/300u). Therefore, under paragraph (c)(4) of this section, the amount of the current year taxes properly attributable to tested income taken into account by US1 under section 951A(a) and § 1.951A–1(b) is $95. Under paragraph (c)(3) of this section, US1's tested foreign income taxes with respect to CFC1 are $95. Under paragraph (c)(2) of this section, US1's inclusion percentage is 100% ($485/$485). Accordingly, under paragraph (c)(1) of this section, US1 is deemed to have paid $76 of the foreign income taxes of CFC1 (80% × 100% × $95).

(*ii*) *CFC2.* Under paragraph (c)(5) of this section, US1's proportionate share of the foreign income taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to CFC2's tested income group is $20 ($20 × 200u/200u). Therefore, under paragraph (c)(4) of this section, the amount of foreign income taxes properly attributable to tested income taken into account by US1 under section 951A(a) and § 1.951A–1(b) is $20. Under paragraph (c)(3) of this section, US1's tested foreign income taxes with respect to CFC2 are $20. Under paragraph (c)(2) of this section, US1's inclusion percentage is 100% ($485/$485). Accordingly, under paragraph (c)(1) of this section, US1 is deemed to have paid $16 of the foreign income taxes of CFC2 (80% × 100% × $20).

(*2*) *US2.* US2 is not a United States shareholder of CFC1 or CFC2. Accordingly, under paragraph (c)(1) of this section, US2 is not deemed to have paid any of the foreign income taxes of CFC1 or CFC2.

■ **Par. 24.** Section 1.960–3 is revised to read as follows:

§ 1.960–3 Foreign income taxes deemed paid under section 960(b).

(a) *Scope.* Paragraph (b) of this section provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation, or by a controlled foreign corporation, under section 960(b). Paragraph (c) of this section provides rules for the establishment and maintenance of PTEP groups within an annual PTEP account. Paragraph (d) of this section defines the term PTEP group taxes. Paragraph (e) of this section provides examples illustrating the application of this section.

(b) *Foreign income taxes deemed paid under section 960(b)*—(1) *Foreign income taxes deemed paid by a domestic corporation with respect to a section 959(a) distribution.* If a controlled foreign corporation makes a distribution to a domestic corporation that is a United States shareholder with respect to the controlled foreign corporation and that distribution is, in whole or in part, a section 959(a) distribution with respect to a PTEP group within a section 904 category, the domestic corporation is deemed to have paid the amount of the foreign corporation's foreign income taxes that are properly attributable to the section 959(a) distribution with respect to the PTEP group and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year. See § 1.965–5(c)(1)(iii) for rules disallowing credits in relation to a distribution of certain previously taxed earnings and profits resulting from the application of section 965. For each section 904 category, the domestic corporation is deemed to have paid foreign income taxes equal to the sum of the controlled foreign corporation's foreign income taxes that are properly attributable to section 959(a) distributions with respect to all PTEP groups within the section 904 category. See § 1.904–6(b)(2) for rules on assigning the foreign income tax to a section 904 category.

(2) *Foreign income taxes deemed paid by a controlled foreign corporation with respect to a section 959(b) distribution.* If a controlled foreign corporation (*distributing controlled foreign corporation*) makes a distribution to another controlled foreign corporation (*recipient controlled foreign corporation*) and the distribution is, in whole or in part, a section 959(b) distribution from a PTEP group within a section 904 category, the recipient controlled foreign corporation is

deemed to have paid the amount of the distributing controlled foreign corporation's foreign income taxes that are properly attributable to the section 959(b) distribution from the PTEP group and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year. See § 1.904–6(b)(3) for rules on assigning the foreign income tax to a section 904 category.

(3) *Properly attributable.* The amount of foreign income taxes that are properly attributable to a section 959 distribution from a PTEP group within a section 904 category equals the domestic corporation's or recipient controlled foreign corporation's proportionate share of the PTEP group taxes with respect to the PTEP group within the section 904 category. No other foreign income taxes are considered properly attributable to a section 959 distribution.

(4) *Proportionate share.* A domestic corporation's or recipient controlled foreign corporation's proportionate share of the PTEP group taxes with respect to a PTEP group within a section 904 category is equal to the total amount of the PTEP group taxes with respect to the PTEP group multiplied by a fraction (not to exceed one), the numerator of which is the amount of the section 959 distribution from the PTEP group, and the denominator of which is the total amount of previously taxed earnings and profits in the PTEP group, both determined in the functional currency of the controlled foreign corporation. If the numerator or denominator of the fraction is zero or less than zero, then the proportionate share of the PTEP group taxes with respect to the PTEP group is zero.

(5) *Domestic partnerships.* For purposes of applying this paragraph (b), in the case of a domestic partnership that is a U.S. shareholder partnership with respect to a partnership CFC, the distributive share of a U.S. shareholder partner of a U.S. shareholder partnership's section 959(a) distribution from the partnership CFC is treated as a section 959(a) distribution received by the U.S. shareholder partner from the partnership CFC.

(c) *Accounting for previously taxed earnings and profits*—(1) *Establishment of annual PTEP account.* A separate, annual account (*annual PTEP account*) must be established for the previously taxed earnings and profits of the controlled foreign corporation to which inclusions under section 951(a) and GILTI inclusion amounts of United States shareholders of the CFC are attributable. Each account must correspond to the inclusion year of the previously taxed earnings and profits and to the section 904 category to which the inclusions under section 951(a) or GILTI inclusion amounts were assigned at the level of the United States shareholders. Accordingly, a controlled foreign corporation may have an annual PTEP account in the section 951A category or a treaty category (as defined in § 1.861–13(b)(6)), even though income of the controlled foreign corporation that gave rise to the previously taxed earnings and profits cannot initially be assigned to the section 951A category or a treaty category.

(2) *PTEP groups within an annual PTEP account.* The amount in an annual PTEP account is further assigned to one or more of the following groups of previously taxed earnings and profits (each, a *PTEP group*) within the account:

(i) Earnings and profits described in section 959(c)(1)(A) by reason of section 951(a)(1)(B) and not by reason of the application of section 959(a)(2);

(ii) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 965(a);

(iii) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 965(b)(4)(A);

(iv) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 951A;

(v) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 951(a)(1)(A) (other than as a result of the application of section 965);

(vi) Earnings and profits described in section 959(c)(1)(B);

(vii) Earnings and profits described in section 959(c)(2) by reason of section 965(a);

(viii) Earnings and profits described in section 959(c)(2) by reason of section 965(b)(4)(A);

(ix) Earnings and profits described in section 959(c)(2) by reason of section 951A;

(x) Earnings and profits described in section 959(c)(2) by reason of section 951(a)(1)(A) (other than as a result of the application of section 965).

(3) *Accounting for distributions of previously taxed earnings and profits.* With respect to a recipient controlled foreign corporation that receives a section 959(b) distribution, such distribution amount is added to the annual PTEP account, and PTEP group within the annual PTEP account, that corresponds to the inclusion year and section 904 category of the annual PTEP account, and PTEP group within the annual PTEP account, from which the distributing controlled foreign corporation is treated as making the distribution under section 959 and the regulations under that section. Similarly, with respect to a controlled foreign corporation that makes a section 959 distribution, such distribution amount reduces the annual PTEP account, and PTEP group within the annual PTEP account, that corresponds to the inclusion year and section 904 category of the annual PTEP account, and PTEP group within the annual PTEP account, from which the controlled foreign corporation is treated as making the distribution under section 959 and the regulations under that section. Earnings and profits in a PTEP group are reduced by the amount of current year taxes that are allocated and apportioned to the PTEP group under § 1.960–1(d)(3)(ii), and the U.S. dollar amount of the taxes are added to an account of PTEP group taxes under the rules in paragraph (d)(1) of this section.

(4) *Accounting for reclassifications of earnings and profits described in section 959(c)(2) to earnings and profits described in section 959(c)(1).* If an amount of previously taxed earnings and profits that is in a PTEP group described in paragraphs (c)(2)(vii) through (x) of this section (each, a *section 959(c)(2) PTEP group*) is reclassified as previously taxed earnings and profits described in section 959(c)(1) (*reclassified previously taxed earnings and profits*), the section 959(c)(2) PTEP group is reduced by the functional currency amount of the reclassified previously taxed earnings and profits. This amount is added to the corresponding PTEP group described in paragraphs (c)(2)(ii) through (v) of this section (each, a *reclassified PTEP group*) in the same section 904 category and same annual PTEP account as the reduced section 959(c)(2) PTEP group.

(d) *PTEP group taxes*—(1) *In general.* The term *PTEP group taxes* means the U.S. dollar amount of foreign income taxes (translated in accordance with section 986(a)) that are paid, accrued, or deemed paid with respect to an amount in each PTEP group within an annual PTEP account. The foreign income taxes that are paid, accrued, or deemed paid with respect to a PTEP group within an annual PTEP account of a controlled foreign corporation are—

(i) The sum of—

(A) The current year taxes paid or accrued by the controlled foreign corporation that are allocated and apportioned to the PTEP group under § 1.960–1(d)(3)(ii);

(B) Foreign income taxes that are deemed paid under section 960(b)(2) and paragraph (b)(2) of this section by the controlled foreign corporation with respect to a section 959(b) distribution received by the controlled foreign corporation, the amount of which is added to the PTEP group under paragraph (c)(3) of this section; and

(C) In the case of a reclassified PTEP group of the controlled foreign corporation, reclassified PTEP group taxes that are attributable to the section 959(c)(2) PTEP group that corresponds to the reclassified PTEP group;

(ii) Reduced by—

(A) Foreign income taxes that were deemed paid under section 960(b)(2) and paragraph (b)(2) of this section by another controlled foreign corporation that received a section 959(b) distribution from the controlled foreign corporation, the amount of which is subtracted from the controlled foreign corporation's PTEP group under paragraph (c)(3) of this section;

(B) Foreign income taxes that were deemed paid under section 960(b)(1) and paragraph (b)(1) of this section by a domestic corporation that is a United States shareholder of the controlled foreign corporation that received a section 959(a) distribution from the controlled foreign corporation, the amount of which is subtracted from the controlled foreign corporation's PTEP group under paragraph (c)(3) of this section; and

(C) In the case of a section 959(c)(2) PTEP group of the controlled foreign corporation, reclassified PTEP group taxes.

(2) *Reclassified PTEP group taxes.* Reclassified PTEP group taxes are foreign income taxes that are initially included in PTEP group taxes with respect to a section 959(c)(2) PTEP group under paragraph (d)(1)(i)(A) or (B) of this section multiplied by a fraction, the numerator of which is the portion of the previously taxed earnings and profits in the section 959(c)(2) PTEP group that become reclassified previously taxed earnings and profits, and the denominator of which is the total previously taxed earnings and profits in the section 959(c)(2) PTEP group.

(3) *Foreign income taxes deemed paid with respect to PTEP groups established for pre-2018 inclusion years.* Foreign income taxes paid or accrued with respect to an annual PTEP account, and a PTEP group within such account, that was established for an inclusion year that begins before January 1, 2018, are treated as PTEP group taxes of a controlled foreign corporation for purposes of this section only if those foreign income taxes were—

(i) Paid or accrued in a taxable year of the controlled foreign corporation that began before January 1, 2018;

(ii) Not included in a controlled foreign corporation's post-1986 foreign income taxes (as defined in section 902(c)(2) as in effect on December 21, 2017) used to compute foreign taxes deemed paid under section 902 (as in effect on December 21, 2017) in any taxable year that began before January 1, 2018; and

(iii) Not treated as deemed paid under section 960(a)(3) (as in effect on December 21, 2017) by a domestic corporation that was a United States shareholder of the controlled foreign corporation.

(e) *Examples.* The following examples illustrate the application of this section.

(1) *Example 1: Establishment of PTEP groups and PTEP accounts*—(i) *Facts.* USP, a domestic corporation, owns all of the stock of CFC1, a controlled foreign corporation. CFC1 owns all of the stock of CFC2, a controlled foreign corporation. USP, CFC1, and CFC2 each use the calendar year as their U.S. taxable year. CFC1 and CFC2 use the ''u'' as their functional currency. At all relevant times, 1u=$1. With respect to CFC2, USP includes in gross income a subpart F inclusion of 1,000,000u=$1,000,000 for the taxable year ending December 31, 2018. The inclusion is with respect to passive category income. In its U.S. taxable year ending December 31, 2019, CFC2 distributes 1,000,000u to CFC1. CFC2 has no earnings and profits except for the 1,000,000u of previously taxed earnings and profits resulting from USP's 2018 taxable year subpart F inclusion. CFC2's country of organization, Country X, imposes a withholding tax on CFC1 of 300,000u on CFC2's distribution to CFC1. Under § 1.960–1(d)(3)(ii), CFC1's 300,000u of current year taxes are allocated and apportioned to the PTEP group within the annual PTEP account within the section 904 category to which the 1,000,000u of previously taxed earnings and profits are assigned.

(ii) *Analysis*—(A) Under paragraph (c)(1) of this section, a separate annual PTEP account in the passive category for the 2018 taxable year is established for CFC2 as a result of USP's subpart F inclusion. Under paragraph (c)(2) of this section, this account contains one PTEP group, which is described in paragraph (c)(2)(x) of this section.

(B) Under paragraph (c)(3) of this section, in the 2019 taxable year, the 1,000,000u related to the section 959(b) distribution from CFC2 is added to CFC1's annual PTEP account for the 2018 taxable year in the passive category and to the PTEP group within such account described in paragraph (c)(2)(x) of this section. Similarly, CFC2's 2018 taxable year annual PTEP account within the passive category, and the PTEP group within such account described in paragraph (c)(2)(x) of this section, is reduced by the amount of the 1,000,000u section 959(b) distribution to CFC1. Additionally, CFC1's annual PTEP account for the 2018 taxable year in the passive category, and the PTEP group within such account described in paragraph (c)(2)(x) of this section, is reduced by the 300,000u of withholding taxes imposed on CFC1 by Country X. Therefore, CFC1's annual PTEP account for the 2018 taxable year within the passive category and the PTEP group within such account described in paragraph (c)(2)(x) of this section is 700,000u.

(C) Under paragraph (d)(1) of this section, the 300,000u of withholding tax is translated into U.S. dollars and $300,000 is added to the PTEP group taxes with respect to CFC1's PTEP group described in paragraph (c)(2)(x) of this section within the annual PTEP account for the 2018 taxable year within the passive category.

(2) *Example 2: Foreign income taxes deemed paid under section 960(b)*—(i) *Facts.* USP, a domestic corporation, owns 100% of the stock of CFC1, which in turn owns 60% of the stock of CFC2, which in turn owns 100% of the stock of CFC3. USP, CFC1, CFC2, and CFC3 all use the calendar year as their U.S. taxable year. CFC1, CFC2, and CFC3 all use the ''u'' as their functional currency. At all relevant times, 1u=$1. On July 1, 2020, CFC2 distributes 600u to CFC1 and the entire distribution is a section 959(b) distribution (''distribution 1''). On October 1, 2020, CFC1 distributes 800u to USP and the entire distribution is a section 959(a) distribution (''distribution 2''). CFC1 and CFC2 make no other distributions in the year ending December 31, 2020, earn no other income, and incur no taxes on distribution 1 or distribution 2. Before taking into account distribution 1, CFC2 has 1,000u in a PTEP group described in paragraph (c)(2)(x) of this section within an annual PTEP account for the 2016 taxable year within the general category. The previously taxed earnings and profits in CFC2's PTEP group relate to subpart F income of CFC3 that was included by USP in 2016. CFC3 distributed the earnings and profits to CFC2 before the 2020 taxable year and, solely as a result of the distribution of the previously taxed earnings and profits, CFC2 incurred withholding and net basis tax, resulting in $150 of PTEP group taxes with respect to the PTEP group. Before taking into account distribution 1 and distribution 2, CFC1 has 200u in a PTEP group described in paragraph (c)(2)(ix) of this section within an annual PTEP account for the 2018 taxable year within the section 951A category. The previously taxed earnings and profits in CFC1's PTEP group relate to the portion of a GILTI inclusion amount that was included by USP in 2018 and allocated to CFC2 under section 951A(f)(2) and § 1.951A–6(b)(2). CFC2 distributed the earnings and profits to CFC1 before the 2020 taxable year and, solely as a result of the distribution of the previously taxed earnings and profits, CFC1 incurred withholding and net basis tax, resulting in $25 of PTEP group taxes with respect to the PTEP group.

(ii) *Analysis*—(A) *Foreign income taxes deemed paid by CFC1.* With respect to distribution 1 from CFC2 to CFC1, under paragraph (b)(4) of this section CFC1's proportionate share of PTEP group taxes with respect to CFC2's PTEP group described in paragraph (c)(2)(x) of this section within an annual PTEP account for the 2016 taxable year within the general category is $90 ($150 × 600u/1,000u). Under paragraph (b)(3) of this section, the amount of foreign income taxes that are properly attributable to distribution 1 is $90. Accordingly, under paragraph (b)(2) of this section, CFC1 is deemed to have paid $90 of general category foreign income taxes of CFC2 with respect to its 600u section 959(b) distribution in the general category.

(B) *Adjustments to PTEP accounts of CFC1 and CFC2.* Under paragraph (c)(3) of this section, the 600u related to distribution 1 is added to CFC1's PTEP group described in paragraph (c)(2)(x) of this section within an annual PTEP account for the 2016 taxable year within the general category. Similarly, CFC2's PTEP group described in paragraph (c)(2)(x) of this section within an annual PTEP account for the 2016 taxable year within the general category is reduced by 600u, the amount of the section 959(b) distribution to CFC1. Additionally, under paragraph (d) of this section, CFC1's PTEP group taxes with respect to its PTEP group described in paragraph (c)(2)(x) of this section within an annual PTEP account for the 2016 taxable year within the general category are increased by $90 and CFC2's PTEP group described in paragraph (c)(2)(x) of this section within an annual PTEP account for the 2016 taxable year within the general category are reduced by $90.

(C) *Foreign income taxes deemed paid by USP.* With respect to distribution 2 from CFC1 to USP, because CFC1 has PTEP groups in more than one section 904 category, this section is applied separately to each section 904 category (that is, distribution 2 of 800u is applied separately to the 200u of CFC1's PTEP group described in paragraph (c)(2)(ix) of this section and 600u of CFC1's PTEP group described in paragraph (c)(2)(x) of this section).

(*1*) *Section 951A category.* Under paragraph (b)(4) of this section, USP's proportionate share of PTEP group taxes with respect to CFC1's PTEP group described in paragraph (c)(2)(ix) of this section within an annual PTEP account for the 2018 taxable year within the section 951A category is $25 ($25 × 200u/200u). Under paragraph (b)(3) of this section, the amount of foreign income taxes within the section 951A category that are properly attributable to distribution 2 is $25. Accordingly, under paragraph (b)(1) of this section USP is deemed to have paid $25 of section 951A category foreign income taxes of CFC1 with respect to its 200u section 959(a) distribution in the section 951A category.

(*2*) *General category.* Under paragraph (b)(4) of this section, USP's proportionate share of PTEP group taxes with respect to CFC1's PTEP group described in paragraph (c)(2)(x) of this section within an annual PTEP account for the 2016 taxable year within the general category is $90 ($90 × 600u/600u). Under paragraph (b)(3) of this section, the amount of foreign income taxes that are properly attributable to distribution 2 is $90. Accordingly, under paragraph (b)(1), USP is deemed to have paid $90 of general category foreign income taxes of CFC1 with respect to its 600u section 959(a) distribution in the general category.

■ **Par. 25.** Section 1.960–4 is amended by:

■ 1. Removing the language ''960(b)(1)'' and adding the language ''960(c)(1)'' in its place wherever it appears.

■ 2. Adding two sentences at the end of paragraph (a)(1).

■ 3. Revising the last sentence of paragraph (d).

The addition and revision read as follows:

§ 1.960–4 Additional foreign tax credit in year of receipt of previously taxed earnings and profits.

(a) * * * (1) * * * For purposes of this section, an amount included in gross income under section 951A(a) is treated as an amount included in gross income under section 951(a). The amount of the increase in the foreign tax credit limitation allowed by this section is determined with regard to each separate category of income described in § 1.904–5(a)(4)(v).

* * * * *

(d) * * * For purposes of this paragraph (d), the term ''foreign income taxes'' includes foreign income taxes paid or accrued, foreign income taxes deemed paid or accrued under section 904(c), and foreign income taxes deemed paid under section 960, for the taxable year of inclusion.

* * * * *

§ 1.960–5 [Amended]

■ **Par. 26.** Section 1.960–5 is amended by removing the language ''951(a)'' and adding the language ''951(a) or 951A(a)'' in its place in paragraph (a)(1).

§ 1.960–6 [Amended]

■ **Par. 27.** Section 1.960–6 is amended by removing the language ''960(b)(1)'' and adding the language ''960(c)(1)'' in its place in paragraph (a).

■ **Par. 28.** Section 1.960–7 is revised to read as follows:

§ 1.960–7 Applicability dates.

Applicability dates. Sections 1.960–1 through 1.960–6 apply to a taxable year of a foreign corporation beginning after December 31, 2017, and a taxable year of a domestic corporation that is a United States shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends.

■ **Par. 29.** Section 1.965–5, as proposed to be added at 83 FR 39562 (August 9, 2018), is amended by adding paragraph (c)(1)(iii) to read as follows:

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

* * * * *

(c) * * *

(1) * * *

(iii) *Foreign income taxes deemed paid under section 960(b) (as applicable to taxable years of controlled foreign corporations beginning after December 31, 2017, and to taxable years of United States persons in which or with which such taxable years of foreign corporations end).* No credit is allowed for the applicable percentage of foreign income taxes deemed paid under section 960(b) (as in effect for a taxable year of a controlled foreign corporation beginning after December 31, 2017, and a taxable year of a United States person in which or with which such controlled foreign corporation's taxable year ends) and § 1.960–3(b)(1) 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. The foreign income taxes deemed paid under § 1.960–3(b)(1) with respect to a distribution to the domestic corporation of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits is equal to the foreign income taxes properly attributable to a distribution from the distributing controlled foreign corporation's individual PTEP groups described in § 1.960–3(c)(2)(ii), (iii), (vii), or (viii). For purposes of this paragraph (c)(1)(iii), the terms ''properly attributable'' and ''PTEP group'' have the meanings set forth in § 1.960–3(b)(3) and (c)(2) respectively. In addition, foreign income taxes that would have been deemed paid under section 960(a)(1) (as in effect on December 21, 2017) with respect to the portion of a section 965(a) earnings amount that was reduced under § 1.965–1(b)(2) or § 1.965–8(b) are not eligible to be deemed paid under section 960(b) and § 1.960–3(b)(1) or any other section of the Code.

* * * * *

■ **Par. 30.** Section 1.965–7, as proposed to be added at 83 FR 39564 (August 9, 2018), is amended by adding three sentences at the end of paragraph (e)(1)(i) and adding paragraph (e)(1)(iv) to read as follows:

§ 1.965–7 Elections, payment, and other special rules.

* * * * *

(e) * * *

(1) * * *

(i) * * * If the section 965(n) election creates or increases a net operating loss under section 172 for the taxable year, then the taxable income of the person for the taxable year cannot be less than the amount described in paragraph (e)(1)(ii) of this section. The amount of deductions equal to the amount by which a net operating loss is created or increased for the taxable year by reason of the section 965(n) election (the ''deferred amount'') is not taken into account in computing taxable income or the separate foreign tax credit limitations under section 904 for that year. The source and separate category (as defined in § 1.904–5(a)(4)(v)) components of the deferred amount are determined in accordance with paragraph (e)(1)(iv) of this section.

* * * * *

(iv) *Effect of section 965(n) election*—(A) *In general.* The section 965(n) election for a taxable year applies solely for purposes of determining the amount of net operating loss under section 172 for the taxable year and determining the amount of taxable income for the taxable year (computed without regard to the deduction allowable under section 172) that may be reduced by net operating loss carryovers or carrybacks to such taxable year under section 172. Paragraph (e)(1)(iv)(B) of this section provides a rule for coordinating the section 965(n) election's effect on section 172 with the computation of the separate foreign tax credit limitations under section 904.

(B) *Ordering rule for allocation and apportionment of deductions for purposes of the section 904 limitation.* The effect of a section 965(n) election with respect to a taxable year on the computation of the separate foreign tax credit limitations under section 904 is computed as follows and in the following order.

(*1*) Deductions that would have been allowed for the taxable year but for the section 965(n) election, other than the amount of any net operating loss carryover or carryback to that year that is not allowed by reason of the section 965(n) election, are allocated and apportioned under §§ 1.861–8 through 1.861–17 to the relevant statutory and residual groupings, taking into account the amount described in paragraph (e)(1)(ii) of this section. The source and separate category of the net operating loss carryover or carryback to the taxable year, if any, is determined under the rules of § 1.904(g)–3(b), taking into account the amount described in paragraph (e)(1)(ii) of this section. If the amount of the net operating loss carryover or carryback to the taxable year is reduced by reason of the section 965(n) election to an amount less than the U.S. source loss component of the net operating loss, the potential carryovers (or carrybacks) of the separate limitation losses that are part of the net operating loss are proportionately reduced as provided in § 1.904(g)–3(b)(3)(ii).

(*2*) If a net operating loss is created or increased for the taxable year by reason of the section 965(n) election, the deferred amount (as defined in paragraph (e)(1)(i) of this section) is not allowed as a deduction for the taxable year. See paragraph (e)(1)(i) of this section. The deferred amount (which is the corresponding addition to the net operating loss for the taxable year) comprises a ratable portion of the deductions (other than the deduction allowed under section 965(c)) allocated and apportioned to each statutory and residual grouping under paragraph (e)(1)(iv)(B)(*1*) of this section. Such ratable portion equals the deferred amount multiplied by a fraction, the numerator of which is the deductions allocated and apportioned to the statutory or residual grouping under paragraph (e)(1)(iv)(B)(*1*) of this section (other than the section 965(c) deduction) and the denominator of which is the total deductions (other than the section 965(c) deduction) described in paragraph (e)(1)(iv)(B)(*1*) of this section. Accordingly, the fraction described in the previous sentence takes into account the deferred amount.

(*3*) Taxable income and the separate foreign tax credit limitations under section 904 for the taxable year are computed without taking into account any deferred amount. Deductions allocated and apportioned to the statutory and residual groupings under paragraph (e)(1)(iv)(B)(*1*)) of this section, to the extent deducted in the taxable year rather than deferred to create or increase a net operating loss, are combined with income in the statutory and residual groupings to which those deductions are assigned in order to compute the amount of separate limitation income or loss in each separate category and U.S. source income or loss for the taxable year. Section 904(b), (f), and (g) are then applied to determine the applicable foreign tax credit limitations for the taxable year.

* * * * *

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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