

**DEPARTMENT OF THE TREASURY****Internal Revenue Service****26 CFR Parts 1 and 301**

[TD 9922]

RIN 1545-BP21; 1545-BP22

**Guidance Related to the Allocation and Apportionment of Deductions and Foreign Taxes, Foreign Tax Redeterminations, Foreign Tax Credit Disallowance Under Section 965(g), Consolidated Groups, Hybrid Arrangements and Certain Payments Under Section 951A****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Final and temporary regulations and removal of temporary regulations.

**SUMMARY:** This document contains final regulations that provide guidance relating to the allocation and apportionment of deductions and creditable foreign taxes, the definition of financial services income, foreign tax redeterminations, availability of foreign tax credits under the transition tax, the application of the foreign tax credit limitation to consolidated groups, adjustments to hybrid deduction accounts to take into account certain inclusions in income by a United States shareholder, conduit financing arrangements involving hybrid instruments, and the treatment of certain payments under the global intangible low-taxed income provisions.

**DATES:** *Effective Date:* These regulations are effective on January 11, 2021.

*Applicability Dates:* For dates of applicability, see §§ 1.245A(e)-1(h)(2), 1.704-1(b)(1)(ii)(b)(1), 1.861-8(h), 1.861-9(k), 1.861-12(k), 1.861-14(k), 1.861-17(h), 1.861-20(i), 1.881-3(f), 1.904-4(q), 1.904-6(g), 1.904(b)-3(f), 1.904(g)-3(l), 1.905-3(d), 1.905-4(f), 1.905-5(f), 1.951A-7(d), 1.954-1(h), 1.954-2(i), 1.960-7, 1.965-9, 1.1502-4(f), and 301.6689-1(e).

**FOR FURTHER INFORMATION CONTACT:**

Concerning § 1.245A(e)-1, Andrew L. Wigmore, (202) 317-5443; concerning §§ 1.861-8, 1.861-9(b), 1.861-12, 1.861-14, 1.861-17, and 1.954-2(h), Jeffrey P. Cowan, (202) 317-4924; concerning §§ 1.704-1, 1.861-9(e), 1.904-4(e), 1.904(b)-3, 1.904(g)-3, 1.1502-4, and 1.1502-21, Jeffrey L. Parry, (202) 317-4916; concerning §§ 1.861-20, 1.904-4(c), 1.904-6, 1.960-1, and 1.960-7, Suzanne M. Walsh, (202) 317-4908; concerning § 1.881-3, Richard F. Owens, (202) 317-6501; concerning §§ 1.965-5 and 1.965-9, Karen J. Cate, (202) 317-4667; concerning §§ 1.905-3,

1.905-4, 1.905-5, 1.954-1, 301.6227-1, and 301.6689-1, Corina Braun, (202) 317-5004; concerning § 1.951A-2, Jorge M. Oben, at (202) 317-6934 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:****Background****I. Rules Relating to Foreign Tax Credits**

On December 7, 2018, the Department of the Treasury (the “Treasury Department”) and the IRS published proposed regulations (REG-105600-18) relating to foreign tax credits in the **Federal Register** (83 FR 63200) (the “2018 FTC proposed regulations”). The 2018 FTC proposed regulations addressed several significant changes that the Tax Cuts and Jobs Act (Pub. L. 115-97, 131 Stat. 2054, 2208 (2017)) (the “TCJA”) made with respect to the foreign tax credit rules and related rules for allocating and apportioning deductions in determining the foreign tax credit limitation. Certain provisions of the 2018 FTC proposed regulations relating to §§ 1.78-1, 1.861-12(c)(2), and 1.965-7 were finalized as part of TD 9866, published in the **Federal Register** (84 FR 29288) on June 21, 2019.

The remainder of the 2018 FTC proposed regulations were finalized on December 17, 2019 in TD 9882, published in the **Federal Register** (84 FR 69022) (the “2019 FTC final regulations”). On the same date, the Treasury Department and the IRS published proposed regulations (REG-105495-19) relating to foreign tax credits in the **Federal Register** (84 FR 69124) (the “2019 FTC proposed regulations”). The 2019 FTC proposed regulations related to changes made by the TCJA and other foreign tax credit issues. Correcting amendments to the 2019 FTC final regulations and the 2019 FTC proposed regulations were published in the **Federal Register** on May 15, 2020, see 85 FR 29323 (2019 FTC final regulations) and 85 FR 29368 (2019 FTC proposed regulations). A public hearing on the proposed regulations was held on May 20, 2020.

On November 7, 2007, the **Federal Register** published temporary regulations (TD 9362) at 72 FR 62771 and a notice of proposed rulemaking by cross-reference to the temporary regulations at 72 FR 62805 relating to sections 905(c), 986(a), and 6689 of the Internal Revenue Code (“Code”). Portions of these temporary regulations were finalized in the 2019 FTC final regulations, while certain portions were repropounded in the 2019 FTC proposed regulations.

This document contains final regulations (the “final regulations”)

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

**II. Rules Relating to Hybrid Deduction Accounts, Hybrid Instruments Used in Conduit Financing Arrangements, and Certain Payments Under Section 951A**

On December 28, 2018, the Treasury Department and the IRS published proposed regulations (REG-104352-18) relating to hybrid arrangements, including hybrid arrangements to which section 245A(e) applies, in the **Federal Register** (83 FR 67612) (the “2018 hybrids proposed regulations”). Those regulations were finalized as part of TD 9896, published in the **Federal Register** (85 FR 19802) on April 8, 2020 (the “2020 hybrids final regulations”). On the same date, the Treasury Department and the IRS published proposed regulations (REG-106013-19) in the **Federal Register** (85 FR 19858) (the “2020 hybrids proposed regulations”). Correcting amendments to the 2020 hybrids final regulations and the 2020 hybrids proposed regulations were published in the **Federal Register** on August 4, 2020, August 11, 2020, and August 12, 2020. See 85 FR 47027 (2020 hybrids final regulations), 85 FR 48485 (2020 hybrids proposed regulations), and 85 FR 48651 (2020 hybrids final regulations).

The 2020 hybrids proposed regulations address hybrid deduction accounts under section 245A(e), hybrid instruments used in conduit financing arrangements under section 881, and certain payments under section 951A (relating to global intangible low-taxed income). The Treasury Department and

the IRS received written comments with respect to the 2020 hybrids proposed regulations. All written comments received in response to the 2020 hybrids proposed regulations are available at [www.regulations.gov](http://www.regulations.gov) or upon request. A public hearing on the 2020 hybrids proposed regulations was not held because there were no requests to speak.

This document contains final regulations addressing the following issues: (1) The reduction to a hybrid deduction account under section 245A(e) by reason of an amount included in the gross income of a domestic corporation under section 951(a) or 951A(a) with respect to a controlled foreign corporation (“CFC”); (2) the treatment of a hybrid instrument as a financing transaction for purposes of the conduit financing rules under section 881; and (3) the treatment under section 951A of certain prepayments made to a related CFC after December 31, 2017, and before the CFC’s first taxable year beginning after December 31, 2017.

### III. Scope of Provisions and Comments Discussed in This Preamble

This rulemaking finalizes, without substantive change, certain provisions in the 2019 FTC proposed regulations and the 2020 hybrids proposed regulations with respect to which the Treasury Department and IRS did not receive any comments. See, for example, § 1.904(b)–3, § 1.904(g)–3, § 1.951A–2(c)(6), § 1.951A–7(d), § 1.1502–4, or § 301.6689–1. These provisions are generally not discussed in this preamble.

Comments received that do not pertain to the 2019 FTC proposed regulations or the 2020 hybrids proposed regulations, or that are otherwise outside the scope of this rulemaking, are generally not addressed in this preamble but may be considered in connection with future guidance projects.

### Summary of Comments and Explanation of Revisions

#### I. Rules Under Section 245A(e) To Reduce Hybrid Deduction Accounts

##### A. Overview

Section 245A(e) was added to the Code by the TCJA. Section 245A(e) and the 2020 hybrids final regulations neutralize the double non-taxation effects of a hybrid dividend or tiered hybrid dividend by either denying the section 245A(a) dividends received deduction with respect to the dividend or requiring an inclusion under section 951(a)(1)(A) with respect to the dividend, depending on whether the

dividend is received by a domestic corporation or a CFC. The 2020 hybrids final regulations require that certain shareholders of a CFC maintain a hybrid deduction account with respect to each share of stock of the CFC that the shareholder owns, and provide that a dividend received by the shareholder from the CFC is a hybrid dividend or tiered hybrid dividend to the extent of the sum of those accounts. A hybrid deduction account with respect to a share of stock of a CFC reflects the amount of hybrid deductions of the CFC that have been allocated to the share, reduced by the amount of hybrid deductions that gave rise to a hybrid dividend or tiered hybrid dividend.

The 2020 hybrids proposed regulations generally reduced a hybrid deduction account with respect to a share of stock of a CFC by three categories of amounts included in the gross income of a domestic corporation with respect to the share, including an “adjusted subpart F inclusion” or an “adjusted GILTI inclusion” with respect to the share. See proposed § 1.245A(e)–1(d)(4)(i)(B)(1) and (2). An adjusted subpart F inclusion or an adjusted GILTI inclusion with respect to a share is intended to measure, in an administrable manner, the extent to which a domestic corporation’s inclusion under section 951(a)(1)(A) (“subpart F inclusion”) or inclusion under section 951A (“GILTI inclusion amount”) attributable to the share is likely “included in income” in the United States—that is, taken into account in income and not offset by, for example, foreign tax credits associated with the inclusion and, in the case of a GILTI inclusion amount, the deduction under section 250(a)(1)(B).

The final regulations retain the basic approach and structure of the 2020 hybrids proposed regulations that reduced hybrid deduction accounts, with certain revisions. Part I.B of this Summary of Comments and Explanation of Revisions discusses the revisions as well as comments received that relate to these rules.

#### B. Computation of Adjusted Subpart F Income Inclusion and Adjusted GILTI Inclusion

##### 1. In General

Comments suggested several refinements or clarifications to the computation of an adjusted subpart F inclusion or adjusted GILTI inclusion with respect to a share of stock of a CFC, generally so that the adjusted subpart F inclusion or adjusted GILTI inclusion more closely reflects the extent that the subpart F inclusion or GILTI inclusion

amount is in fact included in income in the United States.

##### 2. Section 904 Limitation

Under the 2020 hybrids proposed regulations, an adjusted subpart F inclusion or adjusted GILTI inclusion with respect to a share of stock is computed by taking into account foreign income taxes that, as a result of the application of section 960(a) or (d), are likely to give rise to deemed paid credits eligible to be claimed by the domestic corporation with respect to the subpart F inclusion or adjusted GILTI inclusion. See proposed § 1.245A(e)–1(d)(4)(ii)(A) and (B). To minimize complexity, the 2020 hybrids proposed regulations did not take into account any limitations on foreign tax credits when computing foreign income taxes that are likely to give rise to deemed paid credits. See proposed § 1.245A(e)–1(d)(4)(ii)(D). A comment suggested that the final regulations take into account the limitation under section 904.

The Treasury Department and the IRS agree with the comment for computing an adjusted GILTI inclusion. Foreign income taxes that by reason of section 904 do not currently give rise to deemed paid credits eligible to be claimed with respect to the GILTI inclusion amount are not creditable in another year through a carryback or carryover. See section 904(c). Thus, there is generally no ability for such excess foreign income taxes to reduce the extent that an amount taken into account in income by the domestic corporation is included in income in the United States. The final regulations therefore provide that such foreign income taxes are not taken into account when computing an adjusted GILTI inclusion. See § 1.245A(e)–1(d)(4)(ii)(D)(2)(iii) and (G). If the application of this rule results in circularity or ordering rule issues, a taxpayer may, solely for purposes of computing the adjusted GILTI inclusion, apply any reasonable method to compute the amount of foreign income taxes the creditability of which is limited by section 904.<sup>1</sup>

<sup>1</sup> For example, in certain cases the section 904 limitation may be affected by the extent to which section 245A(e) applies to a dividend paid by the CFC (in particular, in connection with allocating and apportioning deductions under §§ 1.861–8 through 1.861–20); the application of section 245A(e) to the dividend may depend on the extent to which a hybrid deduction account is reduced by reason of an adjusted GILTI inclusion; and the adjusted GILTI inclusion may in turn depend on the section 904 limitation. In such a case, to avoid circularity issues, a taxpayer may compute the section 904 limitation for purposes of determining the adjusted GILTI inclusion by, for instance, using simultaneous equations, or applying an ordering rule pursuant to which, solely for purposes of

The final regulations do not adopt a similar rule for computing an adjusted subpart F inclusion. This is because foreign income taxes that by reason of section 904 do not currently give rise to deemed paid credits eligible to be claimed with respect to the subpart F inclusion may become creditable in another year under section 904(c). Consequently, for example, the foreign income taxes could in a later year reduce the extent that an amount is included in income in the United States, and could thus inappropriately result in an outcome similar to the one that would have occurred had the foreign income taxes given rise to deemed paid credits in the year of the subpart F inclusion and thereby reduced the extent that the subpart F inclusion was subject to tax in the United States at the full statutory rate. The Treasury Department and the IRS have determined that special rules to prevent such results would be complex or burdensome as they would require, for instance, tracking the creditability of the foreign income taxes over prior or later years (potentially through a 10-year period), and then adjusting the hybrid deduction account as the foreign income taxes become creditable.

### 3. Section 250 Deduction

Under the 2020 hybrids proposed regulations, an adjusted GILTI inclusion is computed by taking into account the portion of the deduction allowed under section 250 by reason of section 250(a)(1)(B) that the domestic corporation is likely to claim with respect to the GILTI inclusion amount. See proposed § 1.245A(e)–1(d)(4)(ii)(B). The 2020 hybrids proposed regulations did not take into account any limitations on the deduction under section 250(a)(2)(B). See *id.* A comment suggested that the final regulations take into account the taxable income limitation under section 250(a)(2).

The Treasury Department and the IRS agree with the comment, because taking into account the taxable income limitation results in an adjusted GILTI inclusion that more closely reflects the extent to which the GILTI inclusion amount is included in income in the United States. The final regulations thus provide a rule to this effect. See § 1.245A(e)–1(d)(4)(ii)(B) and (H). Similar to the rule discussed in Part I.B.2 of this Summary of Comments and Explanation of Revisions (related to the section 904 limitation), a taxpayer may,

determining the adjusted GILTI inclusion, the section 904 limitation is determined without regard to the application of section 245A(e) (as well as any other provision the application of which depends on the extent to which section 245A(e) applies).

solely for purposes of computing an adjusted GILTI inclusion, apply any reasonable method to compute the extent to which the portion of a deduction allowed under section 250 by reason of section 250(a)(1)(B) is limited under section 250(a)(2)(B).

### 4. Limit on Reduction of a Hybrid Deduction Account

The 2020 hybrids proposed regulations provided a limit to ensure that an adjusted subpart F inclusion or adjusted GILTI inclusion with respect to a share of stock of a CFC does not reduce the hybrid deduction account by an amount greater than the hybrid deductions allocated to the share for the taxable year multiplied by a fraction, the numerator of which is the subpart F income or tested income, as applicable, of the CFC for the taxable year and the denominator of which is the CFC's taxable income. See proposed § 1.245A(e)–1(d)(4)(i)(B)(1)(ii) and (d)(4)(i)(B)(2)(ii). In cases in which the CFC's taxable income is zero or negative, the 2020 hybrids proposed regulations prevented distortions to the fraction—which would otherwise occur because the fraction would involve dividing by zero or a negative number—by providing that the fraction is considered to be zero. See proposed § 1.245A(e)–1(d)(4)(i)(B)(1)(ii) and (d)(4)(i)(B)(2)(ii).

Distortions to the fraction could also occur if the CFC's taxable income is greater than zero but less than its subpart F income or tested income (due to losses in one category of income) because, absent a rule to address, the fraction would be greater than one. The final regulations eliminate these distortions by modifying the fraction so that the numerator and denominator only reflect items of gross income. See § 1.245A(e)–1(d)(4)(i)(B)(1)(ii) and (d)(4)(i)(B)(2)(ii).

### 5. Clarifications

Comments recommended that the final regulations clarify whether an adjusted subpart F inclusion or adjusted GILTI inclusion can be negative and result in an increase to the hybrid deduction account (that is, whether the hybrid deduction account can be reduced by a negative amount). The final regulations clarify that an adjusted subpart F inclusion or adjusted GILTI inclusion cannot be negative and thus cannot result in an increase to the hybrid deduction account. See § 1.245A(e)–1(d)(4)(ii)(A) and (B).

A comment also recommended that the final regulations clarify whether the computation of an adjusted subpart F inclusion takes into account an amount

that the domestic corporation includes in gross income by reason of section 964(e)(4). As noted in the comment, an amount that the domestic corporation includes in gross income by reason of section 964(e)(4) is in many cases offset by a 100 percent dividends received deduction under section 245A(a), and thus no portion of the amount is included in income in the United States (that is, taken into account in income and not offset by a deduction or credit particular to the inclusion). The final regulations clarify that the computation of an adjusted subpart F inclusion does not take into account an amount that a domestic corporation includes in gross income by reason of section 964(e)(4), to the extent that a deduction under section 245A(a) is allowed for the amount. See § 1.245A(e)–1(d)(4)(ii)(A).

### 6. Comments Outside the Scope of the 2020 Hybrids Proposed Regulations

In response to a comment, the 2020 hybrids final regulations clarified that a deduction or other tax benefit may be a hybrid deduction regardless of whether it is used currently under the foreign tax law. See § 1.245A(e)–1(d)(2). The preamble to the 2020 hybrids final regulations explained that even though a deduction or other tax benefit may not be used currently, it could be used in another taxable period and thus could produce double non-taxation. The preamble also noted that it could be complex or burdensome to determine whether a deduction or other tax benefit is used currently and, to the extent not used currently, to track the deduction or other tax benefit and add it to the hybrid deduction account if it is in fact used.

Comments submitted with respect to the 2020 hybrids proposed regulations raised additional issues involving the extent to which a hybrid deduction account should be adjusted based on the availability-for-use of a deduction or other tax benefit under the foreign tax law. These issues include the extent to which (or the mechanism by which) a hybrid deduction account should be adjusted when a deduction or other tax benefit reflected in the account is subsequently disallowed under the foreign tax law (for example, by reason of a foreign audit) or an economically equivalent adjustment is made under the foreign tax law, or the deduction or other tax benefit expires or otherwise cannot be used under the foreign tax law. The Treasury Department and the IRS are studying these comments, which are outside the scope of the 2020 hybrids proposed regulations, and may address these issues in a future guidance project.

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

### A. Stewardship Expenses, Litigation Damages Awards and Settlement Payments, Net Operating Losses, Interest Expense, and Other Expenses

#### 1. Stewardship Expenses

The 2019 FTC proposed regulations made several changes to the rules for allocating and apportioning stewardship expenses, which are generally expenses incurred to oversee a related corporation. Although the 2019 FTC proposed regulations did not change the definition of stewardship expenses, the regulations did provide that expenses incurred with respect to partnerships are treated as stewardship expenses. The 2019 FTC proposed regulations also expanded the types of income to which stewardship expenses are allocated to include not only dividends but also other inclusions received with respect to stock. The 2019 FTC proposed regulations further provided that stewardship expenses are to be apportioned based on the relative values of stock held by a taxpayer, as computed for purposes of allocating and apportioning the taxpayer's interest expense. Additionally, the preamble to the 2019 FTC proposed regulations requested comments regarding how to distinguish stewardship expenses from supportive expenses.

Several comments addressed the definition of stewardship expenses. Some comments recommended that the current regulations' definition be retained without changes. One comment recommended that, because stewardship is among those activities that are not treated as providing a benefit to a related party under the section 482 regulations, such expenses should be treated as supportive expenses. Another recommended that the definition of stewardship expenses be narrowed to apply solely to expenses that result from oversight with respect to foreign subsidiaries or non-affiliated domestic entities. Comments also requested clarification on how to identify and distinguish between stewardship and supportive expenses and sought greater flexibility in identifying stewardship expenses. One comment recommended that further guidance be left to a separate project.

The final regulations generally retain the existing definition of stewardship expenses as either duplicative or shareholder activities as described in § 1.482-9(l)(3)(iii) or (iv). Therefore, stewardship expenses either duplicate

an expense incurred by the related entity without providing an additional benefit to that entity or are incurred primarily to protect the taxpayer's investment in another entity or to facilitate the taxpayer's compliance with its own reporting, legal or regulatory requirements. In contrast, supportive expenses are typically incurred in order to enhance the income-producing capabilities of the taxpayer itself, and so are definitely related and allocable to all, or broad classes, of the taxpayer's gross income. See § 1.861-8(b)(3). The fact that expenses attributable to stewardship activities do not provide a benefit to the related party does not mean that the expenses are supportive of all of the taxpayer's income-producing activity. Instead, expenses categorized under §§ 1.861-8(e)(4)(ii) and 1.482-9(l)(3)(iii) and (iv) as stewardship expenses are properly allocated to income generated by the related party (and included in income of the taxpayer as a dividend or other inclusion), rather than to income earned directly by the taxpayer.

Comments recommended that the definition of stewardship expenses be expanded to include expenses incurred with respect to branches and disregarded entities, in addition to corporations and partnerships. The Treasury Department and the IRS agree that stewardship expenses can also be incurred with respect to all business entities (whether foreign or domestic) as described in § 301.7701-2(a) and not only those business entities that are classified as corporations or partnerships for Federal income tax purposes. Therefore, the final regulations at § 1.861-8(e)(4)(ii)(A) provide that stewardship expenses incurred with respect to oversight of disregarded entities are also subject to allocation and apportionment under the rules of § 1.861-8(e)(4). However, the Treasury Department and the IRS have determined that it is inappropriate to extend the definition of stewardship expense to include oversight expenses incurred with respect to an unincorporated branch of the taxpayer, since the branch's income is income of the taxpayer itself, not income of a separate entity in which the taxpayer is protecting its investment, and any reporting, legal or regulatory requirements that apply to an unincorporated branch of the taxpayer apply to the taxpayer itself.

Comments also requested that the final regulations make clear that stewardship expenses can be allocated and apportioned to income and assets of all affiliated and consolidated group members, noting that a portion of the

dividends and stock with respect to domestic affiliates may be treated as exempt income or assets under section 864(e)(3) and § 1.861-8(d)(2)(ii) and excluded from the apportionment formula, which could reduce apportionment of expenses to U.S. source income. In response to the comments, the final regulations at § 1.861-8(e)(4)(ii)(A) provide that the affiliated group rules in § 1.861-14 do not apply for purposes of allocating and apportioning stewardship expenses. As a result, stewardship expenses incurred by one member of an affiliated group in order to oversee the activities of another member of the group are allocated and apportioned by the investor taxpayer on a separate entity basis, with reference to the investor's stock in the affiliated member. See § 1.861-8(e)(4)(ii)(A). Furthermore, in response to comments, the final regulations at § 1.861-8(e)(4)(ii)(C) provide that the exempt income and asset rules in section 864(e)(3) and § 1.861-8(d)(2) do not apply for purposes of apportioning stewardship expenses.

Comments were also received regarding the rules for allocating stewardship expenses solely to income arising from the entity for which the stewardship expenses are being incurred in order to protect that investment. One comment argued that the rule in the prior final regulations for allocating stewardship expenses solely to dividend income should be retained and should not be expanded to include inclusions such as those under the GILTI rules. In contrast, another comment agreed with the approach to expand allocation to include shareholder-level inclusions such as GILTI inclusions in light of the changes made by the TCJA.

The Treasury Department and the IRS have determined that allocating stewardship expenses to all types of income derived from ownership of the entity, rather than solely dividend income, is appropriate because dividends do not fully capture all of the statutory and residual groupings to which income from stock is assigned. Limiting the allocation of stewardship expenses only to dividends would preclude allocation to stock in a CFC or passive foreign investment company ("PFIC") whose income gave rise only to subpart F, GILTI, or PFIC inclusions, even if the expense clearly relates to overseeing activities that generate income in the CFC or PFIC that give rise to such inclusions. Therefore, the Treasury Department and IRS agree with the comment supporting the expansion of stewardship expense allocation in

proposed § 1.861–8(e)(4)(ii)(B) to include shareholder-level inclusions.

One comment recommended adding dividends eligible for a section 245A deduction to the list of income inclusions to which stewardship expenses are allocable. The existing regulations are already clear, however, that stewardship expenses are allocable to dividends. This allocation is not affected by the fact that dividends may qualify for the deduction under section 245A, which does not convert the dividends into exempt or excluded income for purposes of allocating and apportioning deductions. See § 1.861–8(d)(2)(iii)(C). To the extent that stewardship expense is allocated and apportioned to dividend income in the section 245A subgroup, section 904(b)(4) requires certain adjustments to the taxpayer's foreign source taxable income and entire taxable income for purposes of computing the applicable foreign tax credit limitation. Accordingly, the final regulations are not modified in response to the comment.

In response to a request for comments in the 2019 FTC proposed regulations on possible exceptions to the general rule for the allocation and apportionment of stewardship expenses, several comments recommended allowing taxpayers to show that stewardship expense factually relates only to the relevant income of a specific income-producing entity or entities. The Treasury Department and the IRS agree that stewardship expenses may be factually related to the taxpayer's ownership of a specific entity (or entities) and should not be allocated and apportioned to the income derived from all entities in a group without taking into account the factual connection between the stewardship expense and the entity being overseen. Accordingly, the final regulations at § 1.861–8(e)(4)(ii)(B) clarify that at the allocation step (but before applying the apportionment rules), only the gross income derived from entities to which the taxpayer's stewardship expense has a factual connection are included and, in such cases, the apportionment rule applies based on the tax book value of the taxpayer's investment in those particular entities. This approach recognizes that stewardship activities are not fungible in the same manner as interest expense.

With respect to the apportionment of stewardship expenses, several comments recommended retaining the flexibility of the prior final regulations, which provide for several permissible methods of apportionment, or alternatively apportioning stewardship

expenses on the basis of gross income, rather than assets. One comment questioned the appropriateness of applying the apportionment rule used for interest expense in the context of stewardship expenses.

The Treasury Department and the IRS have determined that it is appropriate to provide a single, clear rule for the apportionment of stewardship expenses and that the asset-based rule for interest expense apportionment is the most appropriate method. The Treasury Department and the IRS have also determined that an explicit rule provides certainty for both taxpayers and the IRS and will minimize disputes. By definition, stewardship expenses typically relate to protecting the value of the taxpayer's ownership interest in another entity. Therefore, such expenses should be apportioned on the basis of the tax book value (or alternative tax book value) of the taxpayer's interest in the entity (or entities) in question, since that value more closely approximates the income generated by the entity over time, while income distributed from an entity (or entities) and taxed to the owner can vary from year to year and may not properly reflect all the income-generating activity of the entity. Although stewardship activities may be definitely related to indirectly-owned entities, the Treasury Department and the IRS have determined that apportioning stewardship expenses based on the value of an indirectly-owned entity would lead to unnecessary complexity for taxpayers and administrative burdens for the IRS; instead, such expenses are apportioned based on the values of the entities that are owned directly by the taxpayer. See § 1.861–8(e)(4)(ii)(C).

For purposes of determining the value of an entity, the final regulations at § 1.861–8(e)(4)(ii)(C) provide that the value of the stock in an affiliated corporation is characterized as if the corporation were not affiliated and the stock is characterized by the taxpayer in the same ratios in which the affiliate's assets are characterized for purposes of allocating and apportioning the group's interest expense. The final regulations also provide that the tax book value of a taxpayer's investment in a disregarded entity is determined and characterized under the rules that would apply if the entity's stock basis were regarded for purposes of allocating and apportioning the investor taxpayer's interest expense.

## 2. Litigation Damages Awards, Prejudgment Interest, and Settlement Payments

The 2019 FTC proposed regulations included special rules for the allocation

and apportionment of damages awards, prejudgment interest, and settlement payments incurred in settlement of, or in anticipation of, claims for damages arising from product liability, events incident to the production or sale of goods or provision of services, and investor suits. Damages or settlement awards related to product liability, or events incident to the production or sale of goods or provision of services, are allocated to the class of gross income produced by the specific sales of products or services that gave rise to the claims for damages or injury, or to the class of gross income produced by the assets involved in the production or sales activity, respectively. Damages awards related to shareholder suits are allocated to all income of the corporation and apportioned based on the relative values of all of the corporation's assets that produce income in the statutory and residual groupings.

One comment suggested that the proposed rules lacked clearly articulated rationales, in contrast to, for example, the rules for R&E expenditures. The Treasury Department and the IRS have determined that the rules included in the 2019 FTC proposed regulations for specific types of litigation-related expenses are consistent with the general principles of the allocation and apportionment rules, which are based on the factual connection between deductions and the class of gross income to which they relate. See § 1.861–8(b)(1). Accordingly, no change is made in the final regulations in response to this comment. However, the final regulations at § 1.861–8(e)(5)(ii) include a new paragraph heading and a sentence to clarify that the damages rule is not limited to product liability claims.

One comment stated that the 2019 FTC proposed regulations could be interpreted to require a double allocation of deductions to royalty income, for example, if a taxpayer incurs damages from a patent infringement lawsuit and also indemnifies its CFC for damages paid in a separate lawsuit filed against the CFC. The Treasury Department and the IRS have determined that indemnification payments, to the extent deductible, are governed by the generally-applicable rules for allocating and apportioning expenses based on the factual relationship between the deduction and the class of gross income to which the deduction relates. The allocation of separate deductions that are both related to the same class of gross income does not constitute a double allocation. Accordingly, no changes are made in

the final regulations in response to this comment.

The 2019 FTC proposed regulations contained an explicit apportionment rule for damages awards in response to industrial accidents and investor lawsuits, but not for product liability and similar claims. The final regulations add a sentence at § 1.861–8(e)(5)(ii) to clarify that deductions relating to product liability and similar claims are apportioned among the statutory and residual groupings based on the relative amounts of gross income in the relevant class in the groupings in the year the deductions are allowed.

Finally, several comments disagreed with the approach in the 2019 FTC proposed regulations regarding lawsuits filed by investors against a corporation. These comments argued that it is inappropriate to allocate deductions for such payments to income produced by all of the taxpayer's assets, because these expenses can have a closer factual connection to the jurisdiction where the litigation occurs or where the events (for example, any negligence, fraud, or malfeasance) at issue in the lawsuit occurred. Some comments advocated for a more flexible rule, noting that certain shareholder claims may have a very narrow geographic scope, whereas other claims may relate to a broader range of activities.

The Treasury Department and the IRS have determined that it is inappropriate to allocate deductions for payments with respect to investor lawsuits on the basis of the situs of the underlying events or the location of the lawsuit. The purpose of direct investor lawsuits against a company is generally to compensate investors for damages to their investment in the entire company. Even where the underlying misconduct directly relates to only a portion of the taxpayer's business activities, the harm to the investor is generally attributable to the taxpayer's business more generally and, therefore, any damages payment is related to all of the taxpayer's income-producing activities. Moreover, any rule that attempted to quantify the portion of damages or settlements that relate to specific business activities and the portion that relates to more general reputational loss would by its nature be difficult for taxpayers to comply with and for the IRS to administer. Furthermore, the Treasury Department and the IRS disagree with the comments suggesting that award payments should be allocated based on the geographic location in which the lawsuit is filed, which could be governed by contractual terms or choice-of-law rules that have little to no factual relationship to the

underlying activities to which the lawsuit relates. Accordingly, the comments are not adopted.

### 3. Net Operating Loss Deductions

The 2019 FTC proposed regulations clarified the treatment of net operating losses (NOLs) by specifying how the statutory and residual grouping components of an NOL are determined in the taxable year of the loss and by clarifying the manner in which the net operating loss deduction allowed under section 172 is allocated and apportioned in the taxable year in which the deduction is allowed. Comments requested that for purposes of applying § 1.861–8(e)(8) to section 250 as the operative section, NOLs arising in taxable years before the TCJA's enactment of section 250 should not be allocated and apportioned to gross FDDEI. On July 15, 2020, the Treasury Department and the IRS finalized regulations under section 250, which provide that the deduction under section 172(a) is not taken into account in computing FDDEI. See § 1.250(b)–1(d)(2)(ii). Therefore, the comment is moot. However, a sentence is added to the final regulations at § 1.861–8(e)(8)(i) to clarify that in determining the component parts of an NOL, deductions that are considered absorbed in the year the loss arose for purposes of an operative section may differ from the deductions that are considered absorbed for purposes of another provision of the Code that requires determining the components of an NOL. Therefore, for example, a taxpayer's NOL may comprise excess deductions allocated to foreign source general category income for purposes of section 904, even though for purposes of section 172(b)(1)(B)(ii) the NOL is a farming loss comprising excess deductions allocated to U.S. source income from farming.

### 4. Application of the Exempt Income/Asset Rule to Insurance Companies in Connection With Certain Dividends and Tax-Exempt Interest

The 2019 FTC proposed regulations clarified in proposed § 1.861–8(d)(2)(ii)(B), (d)(2)(v), and (e)(16) the effect of certain deduction limitations on the treatment of income and assets generating dividends-received deductions and tax-exempt interest held by insurance companies for purposes of allocating and apportioning deductions to such income and assets. Specifically, the 2019 FTC proposed regulations provided that in the case of insurance companies, exempt income includes dividends for which a deduction is provided by sections 243(a)(1) and (2) and 245, without regard to the proration

rules under section 805(a)(4)(A)(ii) disallowing a portion of the deduction attributable to the policyholder's share of the dividends or any similar disallowance under section 805(a)(4)(D). Similarly, the regulations provided that the term exempt income includes tax-exempt interest without regard to the proration rules.

One comment requested that the final regulations modify § 1.861–8T(d)(2) to permit insurance companies to adjust the amount of income and assets that are exempted in apportioning deductions. The comment asserted that such adjustment is required in order to reflect the addition of section 864(e)(7)(E) and relied on legislative history to a provision in proposed technical corrections legislation (Technical Corrections Act of 1987, H.R. 2636, 100th Cong., section 112(g)(6)(A)) (June 10, 1987) (the "1987 bill") to suggest that Congress intended to create a different result for insurance companies than for other companies.

The 1987 bill, however, was not enacted, and the language in section 864(e)(7)(E) is not the same as the language proposed in the bill. Section 864(e)(7)(E) provides regulatory authority for the Secretary to issue regulations regarding any adjustments that may be appropriate in applying section 864(e)(3) to insurance companies. The legislative history to section 864(e)(7)(E) (which was enacted in 1988) does not contain the same language as did the committee reports from the 1987 bill, and the rule that was proposed in the 1987 bill is contrary to subsequent case law. See *Travelers Insurance Company v. United States*, 303 F.3d 1373 (2002). Therefore, the Treasury Department and the IRS have concluded that although section 864(e)(7)(E) provides regulatory authority for a rule applying section 864(e)(3) to insurance companies, there is no indication that Congress intended for Treasury to adopt a rule mirroring the rule in the 1987 bill (which Congress did not enact).

Section 864(e)(3) is clear that exempt income includes income for which a deduction is allowed under sections 243 and 245, and no exception is provided in the statute for insurance companies. Furthermore, as explained in Part I.A.4 of the Explanation of Provisions in the 2019 FTC proposed regulations, a special rule for either tax-exempt interest of a life insurance company or dividends-received deductions and tax-exempt interest of a nonlife insurance company is not appropriate because when a policyholder's share or applicable percentage is accounted for as either a reserve adjustment or a

reduction to losses incurred, no further modification to the generally applicable rules is required to ensure that the appropriate amount of expenses are apportioned to U.S. source income. Instead, the rule suggested by the comment would inappropriately distort the allocation and apportionment of deductions to U.S. source income. Therefore, the comment is not adopted.

#### 5. Treatment of the Section 250 Deduction

One comment requested clarification on the allocation and apportionment of the deduction allowed under section 250 (“section 250 deduction”) with respect to members of a consolidated group. In general, under § 1.1502–50(b), a consolidated group member’s section 250 deduction is determined based on the member’s share of the sum of all members’ positive FDDEI or GILTI. Separate from this determination under § 1.1502–50(b), a taxpayer must also allocate and apportion the section 250 deduction to gross income for purposes of determining its foreign tax credit limitation. For this purpose, in allocating and apportioning the section 250 deduction to statutory and residual groupings, under § 1.861–8(e)(13) the portion of the section 250 deduction attributable to FDII is treated as definitely related and allocable to the specific class of gross income that is included in the taxpayer’s FDDEI and then apportioned between the statutory and residual groupings based on the relative amounts of FDDEI in each grouping. In the context of an affiliated group, under § 1.861–14T(c)(1) expenses are generally allocated and apportioned by treating all members of an affiliated group as if they were a single corporation.

In response to the comment requesting clarity on the allocation and apportionment of the section 250 deduction with respect to members of a consolidated group, the final regulations provide that the section 250 deduction is allocated and apportioned as if all members of the consolidated group are treated as a single corporation. See § 1.861–14(e)(4). However, in the case of an affiliated group that is not a consolidated group, the section 250 deduction of a member of an affiliated group is allocated and apportioned on a separate entity basis under the rules of § 1.861–8(e)(13) and (14).

#### 6. Other Requests for Comments on Expense Allocation

The preamble to the 2019 FTC proposed regulations requested comments on whether future regulations should allow taxpayers to capitalize and

amortize certain expenses solely for purposes of the rules in § 1.861–9 for allocating and apportioning interest expense in order to better reflect asset values under the tax book value method. One comment was received recommending that such a rule be included with respect to R&E and advertising expenditures. The Treasury Department and the IRS agree with this comment and, accordingly, this rule is included in a notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register** (the “2020 FTC proposed regulations”). See Part V.A of the Explanation of Provisions in the 2020 FTC proposed regulations.

One comment requested that a special rule be adopted in § 1.861–10T to directly allocate certain interest expense related to regulated utility companies. The Treasury Department and the IRS agree that a special rule is warranted, and have included a rule in the 2020 FTC proposed regulations. See Part V.B. of the Explanation of Provisions in the 2020 FTC proposed regulations.

Finally, the preamble to the 2019 FTC proposed regulations requested comments on whether the rules in § 1.861–8(e)(6) for allocating and apportioning state income taxes should be revised in light of changes made by the TCJA and changes to state rules for taxing foreign income. One comment was received requesting that the existing rules, which rely on state law to determine the income to which state taxes relate, be retained. The Treasury Department and the IRS agree that no changes to the rules in § 1.861–8(e)(6) are required at this time.

#### 7. Examples Illustrating Allocation and Apportionment of Certain Expenses of an Affiliated Group of Corporations

Examples 1 through 6 in § 1.861–14T(j) apply the temporary regulations to fact patterns involving affiliated groups of corporations. However, Examples 1 and 4 of § 1.861–14T(j) are no longer consistent with current law, and therefore the final regulations append an informational footnote to § 1.861–14T(j) to reflect this fact. The Treasury Department and the IRS are also studying whether the remaining examples should be modified and whether new examples should be included in future guidance.

##### *B. Partnership Transactions*

The 2019 FTC proposed regulations revised §§ 1.861–9(b) and 1.954–2(h)(2)(i) to provide that guaranteed payments for the use of capital described in section 707(c) are treated similarly to interest deductions for

purposes of allocating and apportioning deductions under §§ 1.861–8 through 1.861–14, and are treated as income equivalent to interest under section 954(c)(1)(E). These rules were intended to prevent the use of guaranteed payments to avoid the rules under §§ 1.861–9(e)(8) and 1.954–2(h) that apply to partnership debt.

One comment stated that while guaranteed payments for capital are economically similar to interest payments in some respects, guaranteed payments are, for Federal income tax purposes, payments with respect to equity, not debt, and regulations issued under section 707 narrowly circumscribe the situations in which a guaranteed payment is treated as something other than a distributive share of partnership income. The comment recommended that guaranteed payments for capital be treated as interest only in cases when the taxpayer harbors an abusive motive to circumvent the relevant rule.

The Treasury Department and the IRS have determined that guaranteed payments for the use of capital share many of the characteristics of interest payments that a partnership would make to a lender and, therefore, should be treated as interest equivalents for purposes of allocating and apportioning deductions under §§ 1.861–8 through 1.861–14 and as income equivalent to interest under section 954(c)(1)(E). This treatment is consistent with other sections of the Code in which guaranteed payments for the use of capital are treated similarly to interest. See, for example, §§ 1.469–2(e)(2)(ii) and 1.263A–9(c)(2)(iii). In addition, the fact that a guaranteed payment for the use of capital may be treated as a payment attributable to equity under section 707(c), or that a guaranteed payment for the use of capital is not explicitly included in the definition of interest in § 1.163(j)–1(b)(22), does not preclude applying the same allocation and apportionment rules that apply to interest expense attributable to debt, nor does it preclude treating such payments as “equivalent” to interest under section 954(c)(1)(E). Instead, the relevant statutory provisions under sections 861 and 864, and section 954(c)(1)(E), are clear that the rules can apply to amounts that are similar to interest.

Finally, a rule that would require determining whether the transaction had an abusive motive would be difficult to administer. Therefore, the comment is not adopted.

### C. Treatment of Section 818(f) Expenses for Consolidated Groups

Section 818(f)(1) provides that a life insurance company's deduction for life insurance reserves and certain other deductions ("section 818(f) expenses") are treated as items which cannot definitely be allocated to an item or class of gross income. When the life insurance company is a member of an affiliated group of corporations, proposed § 1.861-14(h)(1) provided that section 818(f) expenses are allocated and apportioned on a separate company basis.

One comment argued that the separate company approach was inconsistent with the general rule in section 864(e)(6) that expenses other than interest that are not directly allocable or apportioned to any specific income-producing activity are allocated and apportioned as if all members of the affiliated group were a single corporation. The comment also argued that the separate company approach would encourage consolidated groups to use intercompany transactions, such as related party reinsurance arrangements, to shift their section 818(f) expenses and achieve a more desirable foreign tax credit result. The comment advocated that the regulations instead adopt a single entity approach for life insurance companies that operate businesses and manage assets and liabilities on a group basis (a "life subgroup" approach).

In contrast, another comment argued that the separate company approach adopted in the proposed regulations was consistent with the fact that life insurance companies are regulated with respect to their reserves, investable assets, and capital. The comment, however, acknowledged that a life subgroup approach may be appropriate in certain cases, such as when an affiliated group of life insurance companies manages similar products on a cross-entity, product-line basis, rather than on an entity-by-entity basis. The comment recommended that final regulations provide a one-time election for taxpayers to choose either the separate company or life subgroup approach for allocating and apportioning section 818(f) expenses.

The Treasury Department and the IRS agree that there are merits and drawbacks to both the separate company and the life subgroup approaches and that a one-time election, as suggested by the comments, should be considered. Therefore, the final regulations at § 1.861-14(h) do not include the separate company rule for section 818(f) expenses. The 2020 FTC proposed regulations instead propose a life

subgroup approach as well as a one-time election for taxpayers to choose the separate company approach.

### D. Allocation and Apportionment of R&E Expenditures

The 2019 FTC proposed regulations proposed several changes to § 1.861-17, including eliminating the gross income method of apportionment, eliminating the legally-mandated R&E rule, and limiting the class of income to which R&E expenditures could be allocated to gross intangible income reasonably connected with a relevant Standard Industrial Code (SIC) category. In addition, the rule for exclusive apportionment of R&E expenditures was modified by eliminating the possibility of increased exclusive apportionment based on taxpayer-specific facts and circumstances, and by providing that exclusive apportionment applies solely for purposes of section 904.

#### 1. Scope of Gross Intangible Income

Before being revised, § 1.861-17(a) provided that R&E expenditures are related to all income reasonably connected to a broad line of business or SIC code category. The 2019 FTC proposed regulations narrowed and clarified the class of gross income to which R&E expenditures are considered to relate. The 2019 FTC proposed regulations defined the relevant class of gross income as gross intangible income ("GII"), which is defined as all income attributable, in whole or in part, to intangible property, including sales or leases of products or services derived, in whole or in part, from intangible property, income from sales of intangible property, income from platform contribution transactions, royalty income, and amounts taken into account under section 367(d) by reason of a transfer of intangible property. GII does not include dividends or any amounts included in income under section 951, 951A, or 1293.

One comment disagreed with the exclusion from GII of section 951A inclusions. According to this comment, R&E expenditures ultimately benefit foreign subsidiaries such that allocation to income described in section 904(d)(1)(A) (the "section 951A category") is appropriate and should not be treated differently from other taxpayer expenses that reduce income in the section 951A category. Other comments generally supported the exclusion of GILTI and other income inclusions from GII on the grounds that a taxpayer incurring R&E expenditures to develop intangible property should be fully compensated for the value of that intellectual property and,

conversely, the earnings of CFCs should not reflect returns on intellectual property owned by another person.

The Treasury Department and the IRS have determined that GII should continue to exclude GILTI or other inclusions attributable to ownership of stock in a CFC. As described in § 1.861-17(b), R&E expenditures, whether or not ultimately successful, are incurred to produce intangible property. Under the rules of sections 367(d) and 482, the person incurring the R&E expenditures must be compensated at arm's length when such intangible property is licensed, sold, or otherwise gives rise to income of controlled parties, and it is this income that gives rise to GII. In transactions not involving the direct transfer of intangible property to a related party, the section 482 regulations require compensation for the intangible property embedded in the underlying transaction. See generally § 1.482-1(d)(3)(v). For example, § 1.482-3(f) requires that intangible property embedded in tangible property be accounted for when determining the arm's length price for the transaction. Similarly, § 1.482-9(m) requires that intangible property used in a controlled services transaction be accounted for in determining the arm's length price for the transaction.

In contrast to R&E expenditures giving rise to income required by sections 367(d) and 482, subpart F or GILTI inclusions reflect income earned by a CFC and not the taxpayer incurring the R&E expenditures; the fact that such taxpayer is deemed under section 951 or 951A to have income through an inclusion from a CFC licensee does not mean that such income is a result of the R&E expenditures incurred by the taxpayer, assuming that the CFC pays the taxpayer an arm's length price for the transfer of the intangible property or, in the case of an exchange described in sections 351 or 361, the taxpayer reports the required annual income inclusion.<sup>2</sup> Therefore, including income in the section 951A category in GII would result in a mismatch between the R&E expenditures and the income

<sup>2</sup> To assist in determining an arm's length price in related party transactions, section 14221 of the TCJA and related technical corrections in the 2018 Consolidated Appropriations Act amended sections 482 and 367(d) to clarify the methods that may be applied to determine the value of intangible property and that the definition of intangible property includes workforce, goodwill and going concern value, or other items the value or potential value of which is not attributable to tangible property or the services of any individual. To the extent the comment reflects a concern that arm's length compensation for intangible property has not always been paid under sections 367(d) and 482, the comment raises issues beyond the scope of this rulemaking.



generated by such expenditures. Although (as noted in a comment) R&E expenditures that are ultimately unsuccessful could be viewed as intended to benefit a taxpayer's foreign subsidiaries more broadly, the Treasury Department and the IRS have determined that the GII earned by the taxpayer provides a reasonable proxy for how the taxpayer expects to recover its R&E costs, and providing separate rules for identifying and attributing unsuccessful R&E expenditures to a broader class of income would be unduly burdensome for taxpayers and difficult for the IRS to administer.

Several comments noted that while income in the section 951A category is excluded from GII, income giving rise to foreign-derived intangible income ("FDII") is included in GII. These comments generally argued that the exclusion from GII of income in the section 951A category and inclusion of amounts included in FDII created a lack of parity between the two provisions even though the methodology and calculations of both are meant to be similar.

The Treasury Department and the IRS disagree with these comments. The allocation and apportionment of R&E expenditures to separate categories for purposes of section 904 as the operative section and the allocation and apportionment of R&E expenditures to FDDEI for purposes of section 250 as the operative section both require identifying the class of income to which the R&E expenditures are attributable. R&E expenditures incurred by a United States shareholder ("U.S. shareholder") are not allocated and apportioned to income in the section 951A category because such income, which relates to an inclusion of income earned by the CFC, is not a return on the U.S. shareholder's R&E expenditures and, thus, is not included in gross intangible income. In contrast, income giving rise to FDII is earned directly by the same taxpayer that incurs R&E expenditures and may include a return on those R&E expenditures. Income that gives rise to FDII is reduced by "the deductions (including taxes) properly allocable to such gross income." See section 250(b)(3)(A)(ii) and § 1.250(b)-1(d)(2). There is no indication that Congress intended to exclude R&E expenditures from that calculation. Furthermore, because expenses incurred by a CFC are allocated and apportioned to income of the CFC for purposes of computing tested income under section 951A(c)(2)(A)(ii), contrary to the suggestion in the comments, R&E expenditures of the CFC are in fact allocated and apportioned to tested

income under § 1.861-17 and reduce the ultimate amount of the taxpayer's GILTI inclusion. Accordingly, the comment is not adopted.

One comment requested modifications to the definition of GII to exclude both acquired intangible property and income from certain platform contribution transactions described in § 1.482-7(b)(1)(ii). According to the comment, income from these items should be excluded from GII because a taxpayer's R&E expenditures could not relate to gross income from intangible property acquired from a different taxpayer (as opposed to developed by the taxpayer), or to gross income from certain platform contributions.

The Treasury Department and the IRS have determined that the comment does not accurately describe the premise on which the R&E allocation and apportionment rules are based. R&E expenditures are not reasonably expected to produce any current income in the taxable year in which the expenditures are incurred, and as the regulations explicitly recognize, the results of R&E expenditures are speculative. Accordingly, R&E expenditures are allocated to a class of currently recognized gross income only because it generally will be the best available proxy for the income that the current expense is reasonably expected to produce in the future. Specifically, although current R&E expense of a taxpayer likely does not directly contribute to gross intangible income currently recognized, it is reasonable to expect that R&E will contribute to GII earned by the taxpayer group in the future. The definition of GII is not intended to require a strict factual connection between the R&E expenditure and GII earned in the taxable year, but merely that the expenditures be "reasonably connected" with a class of income. The Treasury Department and the IRS have also determined that requiring the comment's suggested level of explicit factual connection between R&E expenditures and GII would outweigh the administrative benefit and ease of broadly defining GII. Moreover, in cases in which a taxpayer has a valid cost sharing agreement, even though R&E expenditures may be allocated to PCT payments, those expenses are generally apportioned based on sales by the taxpayer or other entities reasonably expected to benefit from current research and experimentation. This ensures that R&E expenditures offset the categories of income included in GII that are expected to benefit from those

expenditures. Accordingly, the comment is not adopted.

One comment requested clarification of the definition of GII and specifically that the final regulations provide that the services income included in GII does not include gross income allocated to or from a foreign branch under § 1.904-4(f)(2)(vi) by reason of a disregarded payment for services performed by or for the foreign branch that contribute to earning GII of the taxpayer.

Under § 1.904-4(f)(2)(vi)(B), a disregarded payment from a foreign branch owner to its foreign branch to compensate the foreign branch for the provision of contract R&E services that, if regarded, would be allocable to general category gross intangible income attributable to the foreign branch owner under the principles of §§ 1.861-8 through 1.861-17, would cause the general category GII attributable to the foreign branch owner to be adjusted downward and the GII attributable to the foreign branch and included in foreign branch category income to be adjusted upward. Although a disregarded payment for R&E services does not give rise to gross income for Federal income tax purposes and so does not in and of itself constitute GII, to the extent the disregarded payment results in the reattribution of regarded gross income that is GII from the general category to the foreign branch category (or vice versa), that income is treated as GII in the foreign branch category (or the general category). The final regulations at § 1.861-17(b)(2) clarify that although GII does not include disregarded payments, certain disregarded payments that would be allocable to GII if regarded may result in the reassignment of GII from the general category to the foreign branch category or vice versa. Part II.D.6 of this Summary of Comments and Explanation of Revisions further describes comments regarding R&E expenditures and foreign branches.

One comment sought clarification regarding the portion of product sales derived from intangible property that would be considered GII. The final regulations at § 1.861-17(b)(2) clarify that GII includes the full amount of gross income from sales or leases of products or services, if the income is derived in whole or in part from intangible property. Under the definition of GII, there is no bifurcation or splitting of sales income between a portion attributable to intangible property and other amounts such as distribution or marketing functions. Additionally, the definition of GII has been modified to more clearly delineate between amounts from sales or leases of

products derived from intangible property versus sales or licenses of intangible property itself.

## 2. Allocation of R&E Expenditures

One comment requested modifications to the general rule that allocates R&E expenditures to GII that is reasonably connected with one or more relevant SIC code categories. The comment noted that in some cases, taxpayers are restricted by law or contract from exploiting research, with the result that the research would only generate income in a particular statutory grouping after several years from the date of the contract. Accordingly, the comment requested that such R&E expenditures be allocated to the statutory or residual grouping of income within GII that corresponds to the market restrictions on the use of the R&E. Alternatively, the comment requested that taxpayers be provided with the option to allocate R&E expenditures in a manner consistent with the taxpayer's books and records to the extent there is a clear factual relationship between the expenditures and a particular category of income.

The Treasury Department and the IRS have determined that it is inappropriate to provide exceptions to the general rule that R&E expenditures are allocated to GII reasonably connected with one or more relevant SIC code categories. The two approaches suggested by the comment are premised on a goal of seeking to "trace" R&E expenditures to the actual income that they are expected to produce in the future. However, as discussed in Part II.D.1 of this Summary of Comments and Explanation of Revisions, R&E expenditures are not reasonably expected to produce any current income in the taxable year in which the expenditures are incurred, and the regulations recognize that the results of R&E expenditures are speculative. Instead, § 1.861-17 relies on the use of current year sales as a proxy for the income that the expenses are reasonably expected to produce in the future, in recognition of the fact that it is difficult to ascertain the composition of future income that would be generated from R&E expenditures. This approach generally already takes into account the types of market or legal restrictions described by the comment—to the extent that a taxpayer's sales of products in the same SIC code category are generally restricted to a particular market, these restrictions will be reflected in its sales and therefore are already taken into account under the sales method provided in proposed § 1.861-17. Moreover, rules that specially allocate

particular R&E expenditures based on the reasonableness of speculative expectations about sales that may or may not actually arise several years in the future would be very difficult for taxpayers to comply with and for the IRS to administer.

Finally, allowing taxpayers to elect the use of a books-and-records method to allocate R&E expenditures to less than all of a taxpayer's GII would lead to inappropriate results, as taxpayers would only elect such option if the additional information reflected in the taxpayer's books and records improved the tax result; in contrast, the IRS would not have any such information available to it if the taxpayer chose not to make the election. Since this information would generally be in the form of predictions about future income streams, an elective books-and-records rule would create administrability concerns for the IRS, which would have substantial difficulty verifying whether the predictions were reasonable. Accordingly, the comments are not adopted.

One comment recommended that the Treasury Department and the IRS reconsider the elimination of the "legally mandated R&E" rule from the 2019 FTC proposed regulations, noting that the rule seemed to be required by section 864(g)(1)(A). As explained in the preamble to the 2019 FTC proposed regulations, the legally mandated R&E rule was eliminated in light of changes to the international business environment and to simplify the regulations, and the comment does not argue the change is inappropriate. Additionally, the comment misstates the application of section 864(g)(1)(A), which is not applicable to the taxable years to which the final regulations apply. See section 864(g)(6). Accordingly, the comment is not adopted.

One comment sought clarification on the allocation of R&E expenditures where research is conducted with respect to more than one SIC code category. The comment noted that the current final regulations at § 1.861-17(a)(2)(iii) mention two digit SIC code categories, or Major Groups in the terminology of the SIC Manual, yet the 2019 FTC proposed regulations omitted references to two digit SIC codes.

The Treasury Department and the IRS have determined that it is appropriate to aggregate some or all three digit SIC categories within the same Major Group, but it is inappropriate to aggregate any three digit SIC categories within different Major Groups. While R&E expenditures are speculative, it is not reasonable to expect R&E conducted for

one broad line of business to benefit an unrelated line of business and, therefore, the allocation and apportionment of expenses should not be determined by aggregating different Major Groups. For example, if a taxpayer engages in both the manufacturing and assembling of cars and trucks (SIC code 371) it may aggregate that category with another three digit category in Major Group 37, which includes six other three digit categories (for example, aircraft and parts (SIC code 372) or railroad equipment (SIC code 374)), but taxpayers may not aggregate a three digit SIC code from a Major Group with another three digit SIC code from a different Major Group, except as provided in § 1.861-17(b)(3)(iv) (requiring aggregation of R&E expenditures related to sales-related activities with the most closely related three digit SIC code, other than those within the wholesale and retail trade divisions, if the taxpayer conducts material non-sales-related activities with respect to a particular SIC code). The final regulations are modified accordingly.

## 3. Exclusive Apportionment of R&E Expenditures

### i. Computation of FDII

Several comments argued that if the Treasury Department and the IRS determine that GII should include amounts giving rise to FDII, then the rule in the 2019 FTC proposed regulations in § 1.861-17(c), which limits exclusive apportionment of R&E expenditures solely for purposes of applying section 904 as the operative section, should be revised to also allow for exclusive apportionment for purposes of calculating a taxpayer's FDII deduction. The comments generally argued that the exclusive apportionment provision be applied such that 50 percent of a taxpayer's R&E expenditures should be apportioned to income that is not foreign derived deduction eligible income ("FDDEI") provided that at least 50 percent of the taxpayer's research activities are conducted in the United States. Comments argued that such an exclusive apportionment rule would encourage R&E activity in the United States, consistent with the general intent of the TCJA to eliminate tax incentives for shifting activity and intellectual property overseas. Additionally, comments asserted that R&E expenditures provide greater value to the location where R&E is performed and that there is a technology "lag"

before successful products are exported to foreign markets.

The Treasury Department and the IRS have determined that it is not appropriate to apply an exclusive apportionment rule for purposes of computing FDII. As discussed in Part II.D.1 of this Summary of Comments and Explanation of Revisions, R&E expenditures are not reasonably expected to produce any current income in the taxable year in which the expenditures are incurred, and the regulations explicitly recognize that the results of R&E expenditures are speculative. Furthermore, to the extent there is consistently a “lag” before a taxpayer’s successful products are exported to foreign markets, then such lag should generally be reflected in current year sales of newly successful products (which relate to R&E incurred in prior taxable years) being weighted towards domestic markets. Therefore, the rules’ use of current year sales as a proxy for the income that the expense is reasonably expected to produce in the future already takes into account to some extent the potential for a “lag” between exploiting intangible property in the domestic market versus foreign markets.

In addition, the Treasury Department and the IRS have determined that nothing in the text of the TCJA or its legislative history suggests that Congress intended that existing rules on allocation and apportionment of R&E expenditures be modified in a way to create particular incentives. Section 250(b)(3) requires determining the deductions that are “properly allocable” to deduction eligible income, and § 1.250(b)–1(d)(2) confirms that the general rules under § 1.861–17 apply for purposes of allocating and apportioning R&E expenditures to deduction eligible income and FDDEI. Nothing in the statute or legislative history suggests that any alternative allocation and apportionment rule should apply. Furthermore, adopting an R&E allocation and apportionment rule solely for purposes of increasing the amount of the FDII deduction to incentivize R&E activity (whether or not such expenditures were “properly” allocable to non-FDDEI income) would be inconsistent with the United States’ position, including as stated in forums such as the OECD’s Forum on Harmful Tax Practices, that the FDII regime is not intended to provide a tax inducement to shifting activities or income, but is intended to neutralize the effect of providing a lower U.S. effective tax rate with respect to the active earnings of a CFC of a domestic corporation (through a deduction for GILTI) by also providing

a lower effective U.S. tax rate with respect to FDII earned directly by the domestic corporation. Such parity is generally furthered by ensuring that R&E expenditures incurred by a domestic corporation are allocated and apportioned to FDII in the same manner as R&E expenditures incurred by a CFC are allocated and apportioned to tested income that gives rise to GILTI.

Therefore, the final regulations provide that the exclusive apportionment rule is limited to section 904 as the operative section.

#### ii. Increased Exclusive Apportionment

Two comments recommended reinstating the rule allowing for an increased exclusive apportionment of R&E expenditures. Under the increased exclusive apportionment rule, a taxpayer may establish to the satisfaction of the Commissioner that an even greater amount of R&E expenditures should be exclusively apportioned. One comment indicated that there may be circumstances where an even greater amount of R&E expenditures should be apportioned, such as following the termination of a cost sharing arrangement (“CSA”). Another comment pointed out that the 2019 FTC proposed regulations reduce taxpayer options by eliminating both increased exclusive apportionment and the gross income method.

The Treasury Department and the IRS have determined that a rule allowing for increased exclusive apportionment is not warranted. The facts and circumstances nature of the determination that would be required and the potential for disputes outweigh the benefits of affording taxpayers additional flexibility in rare or unusual cases. Additionally, to the extent that there is a tendency to exploit intellectual property in the same market where the taxpayer conducts R&E, this will already be reflected in current sales, as those in part reflect the results of recently-developed intellectual property. Accordingly, this comment is not adopted.

#### iii. Mandatory Application of Exclusive Apportionment

Two comments generally objected to the required application of exclusive apportionment for purposes of section 904. According to the comments, in certain situations where a taxpayer has insufficient domestic source gross income to absorb the apportioned R&E expenditures, the resulting overall domestic loss (“ODL”) would reduce foreign source income in each separate category described in § 1.904–5(a)(4)(v), including the section 951A and foreign

branch categories, reducing the taxpayer’s ability to claim foreign tax credits. The comments recommended that taxpayers either be allowed to elect out of exclusive apportionment or alternatively that it be applied in an amount less than 50 percent of the taxpayer’s R&E expenditures. One comment alternatively recommended a modification to the ODL and R&E expenditure rules such that the majority of the amounts otherwise subjected to exclusive apportionment would instead be allocated to income in the general category rather than the section 951A or foreign branch categories.

The TCJA did not modify the operation of section 904(f) or (g) with respect to the section 951A or foreign branch categories, nor is there any indication in the TCJA or legislative history that Congress intended the rules under section 904(f) and (g), or the allocation and apportionment rules under section 861, to apply differently in connection with section 951A or foreign branch category income. To the extent an ODL account is created as the result of a domestic loss offsetting foreign source income in the section 951A or foreign branch category under section 904(f)(5)(D), this reduction is reversed in later years through the recapture provisions in section 904(g)(3), when U.S. source income is recharacterized as foreign source income in the separate categories that were offset by the ODL. Additionally, the Treasury Department and the IRS have determined that the consistent application of the exclusive apportionment rule for purposes of section 904 promotes simplicity and certainty, whereas an optional rule would be more difficult to administer. Accordingly, these comments are not adopted.

#### 4. Elimination of the Gross Income Method

Several comments requested that the gross income method for apportioning R&E expenditures be retained. In general, these comments recommended allowing taxpayers to choose either the gross income method or the sales method rather than being required to utilize only the sales method, including by allowing taxpayers to choose one method for certain operative sections and another method for other operative sections. Some comments asserted that the mandatory use of the sales method would inappropriately allocate and apportion more R&E expenditures to FDDEI than under the gross income method in cases where U.S. taxpayers license their intellectual property for foreign use but sell products directly to

U.S. customers. One comment argued that the sales method could be distortive in certain situations where a taxpayer licenses its intellectual property to entities whose sales are at least partially attributable to self-developed intellectual property. Another comment argued that where a taxpayer's primary type of GII is royalty income, it will be difficult to apportion R&E based on sales numbers and that therefore the gross income method should be maintained.

The Treasury Department and the IRS have determined that, on balance, the sales method results in substantially fewer distortions than the gross income method. Before being modified by these final regulations, taxpayers were permitted to apportion R&E expenditures under either a gross income or sales method. The Explanation of Provisions in the 2019 FTC proposed regulations explained that the gross income method could produce inappropriate, distortive results in certain cases. In particular, distortions could arise because the gross income method looks only to gross income earned directly by the taxpayer. Gross income that is earned by the taxpayer and that is attributable to one grouping (such as U.S. source income) may reflect value unrelated to intangible property, for example gross income from sales that reflect value from marketing or distribution activities of the taxpayer, whereas gross income of such taxpayer that is attributable to another grouping (such as foreign source income) may exclude such non-IP related value due, for example, to the fact that such gross income is earned solely from licensing intangible property to a related party without the performance of any marketing or distribution activities. The distortions arise both because gross income reflects a reduction of gross receipts for cost of goods sold but not for related deductible expenses, and also because the gross income method does not distinguish between gross income earned from customers (for which the gross income generally captures all of the value related to the product or service arising from the IP) versus from related parties (for which gross income generally only captures an intermediate portion of the value of the relevant product or service, which will generally be enhanced by the related party).

In contrast, the sales method provides a consistent, reliable method with fewer distortions than the gross income method. In particular, the sales method focuses on the gross receipts from sales of a product to final customers. This approach is more likely to achieve

consistent results in the case of the same or similar final products, and thereby allows for a consistent comparison of value derived from intangible property with respect to each grouping. That is the case regardless of whether the taxpayer chooses to license its intangible property to other persons (including related parties) for purposes of manufacturing final products, or the taxpayer manufactures products itself, and regardless of whether other persons enhance the product with additional value attributable to other intangible property. Therefore, the sales method ensures that differences in supply chain structures do not alter the nature of how R&E expenditures are allocated and apportioned.

Alternatively, some comments recommended modifying the gross income method. One comment recommended modifying the gross income method to more accurately match income to related R&E expenditures by using only gross income that is attributable to the intangible property owned by the taxpayer. However, the Treasury Department and the IRS have determined that it would lead to complexity for taxpayers and administrative burdens for the IRS to seek to accurately determine the share of gross income that is attributable to intangible property when the intangible property is embedded in a final product. In addition, such a rule would be unlikely to result in significantly different results than under the sales method, because the ratio of gross income among groupings that is attributable solely to intangible property is likely to be broadly similar to the ratio of gross receipts from sales within those groupings, since the intangible component of gross income from sales is likely to be determined as a fraction of gross receipts, and such fraction would generally be the same for each grouping.

One comment argued that the gross income method must be included in the final regulations because it is statutorily required under section 864(g)(1). However, section 864(g) is not applicable to the taxable years covered by the final regulations. See section 864(g)(6). Therefore, the comment is not adopted.

Finally, one comment recommended allowing taxpayers to use the gross income method if using the sales method would otherwise cause the taxpayer to have an ODL. The Treasury Department and the IRS have determined that it would be inappropriate to allow for the targeted application of a method solely for the purpose of avoiding the ODL rules,

which are statutorily mandated. The regulations under section 861, including § 1.861-17, are premised on associating deductions in as accurate and reasonable a manner as possible with the income to which such deductions relate. It is inconsistent with this overall policy of relating deductions to the relevant income to revise the regulations under section 861 simply to achieve a specific result under an operative section. Accordingly, the final regulations eliminate the gross income method.

## 5. Application of Sales Method

The 2019 FTC proposed regulations retained the rule in the prior final regulations which provides that for apportionment purposes, the sales method includes certain gross receipts of related and unrelated entities that are reasonably expected to benefit from the taxpayer's R&E expenditures, but does not include the receipts of entities that have entered into a valid CSA with the taxpayer. The 2019 FTC proposed regulations made limited changes to the sales method as it existed under the prior final regulations.

One comment requested guidance on the application of the sales method in the context of foreign branch category income; this comment is discussed in Part II.D.6 of this Summary of Comments and Explanation of Revisions.

Two comments asked for a modification to the treatment of controlled entities that terminate an existing CSA with a taxpayer. Under the sales method, gross receipts from sales of products or the provision of services within a relevant SIC code category by controlled parties of the taxpayer are taken into account when apportioning the taxpayer's R&E expenditures if the controlled party is reasonably expected to benefit from the taxpayer's research and experimentation. Under proposed § 1.861-17(d)(4)(iv), the sales of controlled parties that enter into a valid CSA with a taxpayer are generally excluded from the apportionment formula because the controlled party is not expected to benefit from the taxpayer's R&E expenditures. The comments argued that when a CSA is terminated and a taxpayer licenses newly-developed intangibles to a controlled party, all gross receipts from the controlled party are included in the apportionment formula, even though for some post-termination period the controlled party may benefit more from intangibles created by its own R&E expenditures incurred under the previously-existing CSA rather than from the newly-developed and licensed

intangibles. The comments recommended varying adjustments, including rules specific to CSA terminations or alternatively more generalized adjustments such as the retention of the increased exclusive apportionment rule or the gross income method.

The Treasury Department and the IRS disagree with the comments' characterization of § 1.861–17 as seeking directly to match R&E expenditures with the income that such expenditures generate. According to the comments, following a CSA termination with a controlled party, a taxpayer's current R&E expenditures should not offset the controlled party's royalty payment to the taxpayer because the controlled party's gross receipts would be attributable to the intangibles funded by the controlled party during the period the CSA existed. This assertion assumes that current sales are used to apportion R&E expenditures because they result from a taxpayer's current or recent research and, therefore, it is inappropriate to include gross receipts attributable to the research of a different taxpayer. The regulations, however, are based in part on the acknowledgement that R&E is a speculative, forward-looking activity that often does not result in income or sales in the current year, or even in future years. As discussed in Part II.D.2 of this Summary of Comments and Explanation of Revisions, current sales are nevertheless used because they generally will be the best available proxy for the income R&E expenditures are expected to produce in future years. Accordingly, once a CSA is terminated, it is appropriate to include the sales of a controlled party that previously participated in a CSA if that controlled party is reasonably expected to benefit from the taxpayer's current R&E expenditures to generate future sales. Additionally, the Treasury Department and the IRS have determined that attempting to distinguish between the sales attributable to the controlled party's intangible property and those attributable to intangible property licensed from the taxpayer is generally difficult and uncertain and may often lead to disputes, making such a rule difficult for taxpayers to comply with and burdensome for the IRS to administer. Because those concerns also exist when a taxpayer and a controlled party enter into a CSA, the final regulations also do not adopt comments requesting such a rule in that context. Furthermore, the Treasury Department and the IRS have determined that the tax consequences of terminating a CSA

may vary depending on the facts and circumstances and are considering whether it would be appropriate to provide special rules for these transactions, and thus it would not be appropriate to provide special rules in connection with § 1.861–17 until these transactions have undergone further study. Therefore, the comments are not adopted.

Finally, several comments requested a modification to the rule in proposed § 1.861–17(d)(3) and (4) providing that if a taxpayer has previously licensed, sold, or transferred intangible property related to a SIC code category to a controlled or uncontrolled party, then the taxpayer is presumed to expect to do so with respect to all future intangible property related to the same SIC code category. The comments argued that the 2019 FTC proposed regulations' use of the term "presumption" suggested that taxpayers would be unable to rebut the presumption in appropriate cases. In response to the comments, the final regulations clarify that taxpayers may rebut the presumption by demonstrating that prior exploitation of the taxpayer's intangible property is inconsistent with reasonable future expectations.

In addition, the final regulations make other revisions to the sales method. First, the final regulations specify under what circumstances the sales or services of uncontrolled or controlled parties are taken into account. In particular, the final regulations specify that the gross receipts are taken into account if the uncontrolled or controlled party is expected to acquire (through license, sale, or transfer) intangible property arising from the taxpayer's current R&E expenditures, products in which such intangible property is embedded or used in connection with the manufacture or sale of such products, or services that incorporate or benefit from such intangible property. Second, the final regulations revise § 1.861–17(d)(4) to refer to sales by controlled parties (which is defined as any person that is related to the taxpayer), rather than controlled corporations, to clarify that, for example, sales made by a controlled partnership that is reasonably expected to license intangible property from the taxpayer are fully taken into account under the sales method. Finally, the final regulations revise § 1.861–17(f)(3) to provide that if a partnership incurs R&E expenditures (and is not also an uncontrolled party or controlled party described in § 1.861–17(d)(3) or (4)) and makes related sales, then those sales are considered made by the partners in proportion to their distributive shares of gross income attributable to the sales.

## 6. Foreign Branch Category Income and R&E Expenditures

Two comments addressed the interaction of § 1.861–17 and foreign branch category income. One comment requested that a portion of sales earned by a foreign branch should be attributed to the general category for purposes of apportioning R&E expenditures in circumstances where a foreign branch utilizes intellectual property of the foreign branch owner to earn GII and pays a disregarded royalty to its U.S. owner. Under § 1.904–4(f)(2)(vi)(A), the amount of foreign branch category income would be adjusted downward and the foreign branch owner's general category income would be adjusted upward by the amount of the disregarded royalty. According to the comment, after exclusive apportionment (as applicable), the 2019 FTC proposed regulations would apportion entirely to foreign branch category income the remaining R&E expense, which should instead be apportioned to the general category income originally attributable to the GII of the foreign branch that was reassigned by reason of the disregarded royalty.

The Treasury Department and the IRS have determined that the 2019 FTC proposed regulations, in combination with § 1.904–4(f)(2)(vi), already operate in the manner requested by the comment. Under proposed § 1.861–17(d)(1)(iii), gross receipts are assigned to the statutory grouping (or groupings) or residual grouping to which the GII related to the sale, lease, or service is assigned. Adjustments to the amounts of gross income attributable to a foreign branch by reason of disregarded payments change the separate category grouping to which the gross income is assigned, but do not change the total amount, character, or source of a United States person's gross income. See § 1.904–4(f)(2)(vi)(A). After application of § 1.904–4(f)(2)(vi), GII related to the foreign branch's sales is assigned to the general category in the amount of the disregarded royalty payment, and only the balance of the GII is assigned to the foreign branch category. Accordingly, a proportionate amount of the gross receipts from sales made by the foreign branch to which a disregarded royalty payment would be allocable is assigned to the general and foreign branch categories in the same ratio as the disregarded royalty payment bears to the gross income attributable to the sales. The final regulations in § 1.861–17(d)(1)(iii) clarify that the assignment of gross receipts occurs after gross income in the separate categories is adjusted under § 1.904–4(f)(2)(vi) and

clarify through an example the formula used to reassign gross receipts as a result of a disregarded reallocation transaction. See § 1.861–17(g)(6) (*Example 6*).

The second comment requested changes to the treatment of foreign branches that provide contract R&E services for the benefit of the foreign branch owner. According to the comment, when disregarded payments made by the foreign branch owner in respect of the provision of contract R&E services by a foreign branch cause GII to be reallocated to the foreign branch, R&E expenditures incurred by the foreign branch owner may be apportioned to foreign branch category income in a manner inconsistent with the economics of the branch's activities as a services provider, creating disparate tax results compared to those that would obtain if the services were performed by a CFC. The comment suggested that the foreign branch's regarded costs of providing the research services that give rise to the disregarded payment from the foreign branch owner should reduce the amount of GII that was assigned to the foreign branch category, or more generally that GII should not be assigned to the foreign branch category by reason of disregarded payments for research services.

The Treasury Department and the IRS agree that R&E expenditures, including deductible expenses for the foreign branch's costs in providing research services to the foreign branch owner, may be apportioned to foreign branch category income that is GII, including GII that is treated as attributable to the foreign branch category under § 1.904–4(f)(2)(vi) by reason of disregarded payments from the foreign branch owner compensating the foreign branch for its research services that will generate GII for the foreign branch owner, and that the apportionment is based upon gross receipts assigned to the statutory groupings. However, as noted in § 1.904–4(f)(2)(vi)(A), the reattribution of gross income between the general and foreign branch categories by reason of disregarded payments cannot change the character of a taxpayer's realized gross income. The Treasury Department and the IRS have determined that the different characterization of services income earned by a CFC, which may not be GII, and sales income reflecting GII that is attributed to a foreign branch by reason of disregarded payments for services, results from the Federal income tax treatment of disregarded payments, which do not give rise to gross income, and that it is not appropriate effectively

to override the characterization of gross income by modifying the rules for allocating and apportioning recognized R&E expenditures. Accordingly, the comment is not adopted.

#### 7. Contract Research Arrangements

In the Explanation of Provisions in the 2019 FTC proposed regulations, the Treasury Department and the IRS requested comments on whether contract research arrangements involving expenditures that are reimbursed by a foreign affiliate are generally paid or incurred by a U.S. taxpayer such that a deduction under section 174 would be allowable for such expenditures, and whether any special rules for such arrangements should be considered. Generally, the comments received stated that where contract research is performed in the United States and is connected with a U.S.-based multinational's trade or business, a deduction under section 174, rather than section 162, may be appropriate.

The Treasury Department and the IRS have determined that it is beyond the scope of the final regulations to determine whether contract research expenses are, or are not, eligible to be deducted under either section 162 or 174.

#### 8. Amended Returns and Applicability Dates

One comment requested clarification of the applicability date provisions of the § 1.861–17 portion of the 2019 FTC proposed regulations. The comment noted that it was unclear whether a taxpayer that originally elected to apply the gross income method on its 2018 tax return would be eligible to amend its 2018 tax return to apply the sales method. The 2019 FTC final regulations included a provision addressing the binding election contained in former § 1.861–17(e)(1). Under this provision, as modified in the 2019 FTC final regulations at § 1.861–17(e)(3), taxpayers otherwise subject to the binding election were permitted to change their election. On May 15, 2020, correcting amendments to the 2019 FTC final regulations were issued in 85 FR 29323. These amendments make clear that the change in method can occur on an original or an amended return. See also Part VII of this Summary of Comments and Explanation of Revisions for a discussion of the ability for taxpayers to rely on the proposed or final versions of § 1.861–17 for taxable years before the years in which the final regulations are applicable. Accordingly, changes to the applicability date provisions are not necessary in response to this comment.

Finally, one comment requested that the applicability of the regulations under section 250 be deferred until after § 1.861–17 is finalized. Because the applicability of the regulations under section 250 has been deferred until taxable years beginning on or after January 1, 2021, which is consistent with the applicability date of § 1.861–17, the comment is moot. See § 1.250–1(b).

#### E. Application of Section 904(b) to Net Operating Losses

Proposed § 1.904(b)–3(d)(2) contained a coordination rule providing that for purposes of determining the source and separate category of a net operating loss, the separate limitation loss and overall foreign loss rules of section 904(f) and the overall domestic loss rules of section 904(g) are applied without taking into account the adjustments required under section 904(b). No comments were received on this provision, which is finalized without change.

One comment requested that the final regulations include a rule switching off the application of section 904(b)(4) with respect to pre-2018 U.S. source NOLs that offset foreign source income and created ODL accounts in pre-2018 taxable years, because in certain cases the increase in the denominator of the foreign tax credit limitation fraction required by section 904(b)(4) could limit the utilization of foreign tax credits that would otherwise be allowed by reason of the recapture of the ODL.

Nothing in section 904(b)(4) allows for the rule to be applied differently in cases when a taxpayer recaptures a pre-2018 ODL versus a post-2017 ODL or has no ODL recapture at all. Instead, the adjustments required by section 904(b)(4) apply in all taxable years beginning after 2017. Therefore, the comment is not adopted.

### III. Conduit Financing Rules Under § 1.881–3 To Address Hybrid Instruments

#### A. Overview

The conduit financing regulations in § 1.881–3 allow the IRS to disregard the participation of one or more intermediate entities in a “financing arrangement” where such entities are acting as conduit entities, and to recharacterize the financing arrangement as a transaction directly between the remaining parties for purposes of imposing tax under sections 871, 881, 1441 and 1442. In general, a financing arrangement exists when through a series of transactions one person advances money or other property (the financing entity), another

person receives money or other property (the financed entity), the advance and receipt are effected through one or more other persons (intermediate entities), and there are “financing transactions” linking each of those parties. See § 1.881–3(a)(2)(i). An instrument that for U.S. tax purposes is stock (or a similar interest, such as an interest in a partnership) is not a financing transaction under the existing conduit financing regulations, unless it is “redeemable equity” or is otherwise described in § 1.881–3(a)(2)(ii)(B)(1).

The 2020 hybrids proposed regulations expanded the definition of a financing transaction, such that an instrument that for U.S. tax purposes is stock or a similar interest is a financing transaction if: (i) Under the tax law of a foreign country where the issuer is a tax resident or has a taxable presence, such as a permanent establishment, the issuer is allowed a deduction or another tax benefit, including a deduction with respect to equity, for an amount paid, accrued, or distributed with respect to the instrument; or (ii) under the issuer’s tax laws, a person related to the issuer is entitled to a refund, including a credit, or similar tax benefit for taxes paid by the issuer upon a payment, accrual, or distribution with respect to the equity interest and without regard to the related person’s tax liability in the issuer’s jurisdiction. See proposed § 1.881–3(a)(2)(ii)(B)(1)(iv) and (v). The 2020 hybrids proposed regulations relating to conduit financing arrangements were proposed to apply to payments made on or after the date that final regulations are published in the **Federal Register**.

#### *B. Scope of Instruments Treated as Financing Transactions*

A comment agreed that a financing transaction should include an instrument that is stock or a similar interest for U.S. tax purposes but debt under the tax law of the issuer’s country because, according to the comment, cases of potential conduit abuse are likely to involve “classic” hybrid instruments not covered by the types of equity described in § 1.881–3(a)(2)(ii)(B)(1). However, the comment recommended that an instrument that is equity for purposes of both U.S. tax law and the issuer’s tax law not be treated as a financing transaction, except in limited circumstances, such as if the instrument is issued by a special purpose company formed to facilitate the avoidance of tax under section 881 and the instrument gives rise to a notional deduction or a refund or credit to a related person. According to the comment, the proposed rule that treated

an instrument that is equity for both U.S. and foreign tax purposes as a financing transaction was overbroad—as it could deem an operating company to have entered into a financing transaction simply because foreign tax law provides for notional interest deductions or a similar regime of general applicability—or was unclear or vague in certain cases.

If the final regulations were to retain the proposed rules treating other types of equity instruments as financing transactions, the comment requested several clarifications, modifications, and limitations with respect to the rules. These included: (i) Treating an instrument that is equity in a partnership for U.S. tax purposes and under the issuer’s tax law as a financing transaction only if the partnership is a hybrid entity that claims treaty benefits; (ii) either eliminating or clarifying the rule providing that an instrument can be a financing transaction by reason of generating tax benefits in a jurisdiction where the issuer has a permanent establishment; and (iii) modifying the applicability date for payments under existing financing arrangements.

Consistent with the comment, the final regulations adopt without substantive change the rule that included as a financing transaction an instrument that is stock or a similar interest (including an interest in a partnership) for U.S. tax purposes but debt under the tax law of the country of which the issuer is a tax resident. See § 1.881–3(a)(2)(ii)(B)(1)(iv). In addition, the final regulations provide that if the issuer is not a tax resident of any country, such as an entity treated as a partnership under foreign tax law, the instrument is a financing transaction if the instrument is debt under the tax law of the country where the issuer is created, organized, or otherwise established. See id.

The final regulations do not include the rules under the 2020 hybrids proposed regulations that treated as a financing transaction an instrument that is stock or a similar interest for U.S. tax purposes but gives rise to notional interest deductions or other tax benefits (such as a deduction or credit allowed to a related person) under foreign tax law. The Treasury Department and the IRS plan to finalize those rules separately, in order to allow additional time to consider the comments received. In addition, the Treasury Department and the IRS are continuing to study instruments that generate tax benefits in the jurisdiction where the issuer has a permanent establishment and may address these instruments in future guidance.

## **IV. Foreign Tax Credit Limitation Under Section 904**

### *A. Definition of Financial Services Entity*

In order to promote simplification and greater consistency with other Code provisions that have complementary policy objectives, § 1.904–4(e)(2) of the 2019 FTC proposed regulations proposed to define a financial services entity as an individual or a corporation “predominantly engaged in the active conduct of a banking, insurance, financing, or similar business,” and proposed to define financial services income as “income derived in the active conduct of a banking, insurance, financing, or similar business.” These modified definitions are generally consistent with sections 954(h), 1297(b)(2)(B), and 953(e); the 2019 FTC proposed regulations also included conforming changes to the rules for affiliated groups in proposed § 1.904–4(e)(2)(ii) and partnerships in proposed § 1.904–4(e)(2)(i)(C).

Comments stated that the 2019 FTC proposed regulations increased uncertainty and resulted in the disqualification of certain banks or insurance companies that would qualify as financial services entities under the existing final regulations. Comments also suggested that it was inappropriate to seek to align the relevant definitions in section 904 with those in section 954 because of the differing policies and scope of the two rules. Comments suggested various modifications to more closely align the revisions with the existing approach under § 1.904–4(e), or in the alternative, withdrawing the proposed rules entirely.

The Treasury Department and the IRS have determined that revisions to the financial services entity rules in § 1.904–4(e) continue to be necessary in light of statutory changes made in 2004 (under the American Jobs Creation Act of 2004, Pub. L. 108–357) and the changes to the look-through rules in § 1.904–5 in the 2019 FTC final regulations, which were precipitated by the revisions to section 904(d) under the TCJA. However, the Treasury Department and the IRS have determined the changes to § 1.904–4(e) should be repropoed to allow further opportunity for comment. Therefore, the 2020 FTC proposed regulations contain new proposed regulations under § 1.904–4(e), as well as a delayed applicability date. See Part IX.B. of the Explanation of Provisions in the 2020 FTC proposed regulations.

### *B. Allocation and Apportionment of Foreign Income Taxes*

Proposed § 1.861–20 provided detailed guidance on how to match foreign income taxes with income, particularly in the case of differences in how U.S. and foreign law compute taxable income with respect to the same transactions. Proposed § 1.861–20(c) provided that foreign tax expense is allocated and apportioned among the statutory and residual groupings by first assigning the items of gross income under foreign law (“foreign gross income”) on which a foreign tax is imposed to a grouping, then allocating and apportioning deductions under foreign law to that income, and finally allocating and apportioning the foreign tax among the groupings. See proposed § 1.861–20(c).

Proposed § 1.861–20(d)(2)(ii)(B) provided that if a taxpayer recognizes an item of foreign gross income that is attributable to a base difference, then the item of foreign gross income is assigned to the residual grouping, with the result that no credit is allowed if the tax on that item is paid by a CFC. The proposed regulations provided an exclusive list of items that are excluded from U.S. gross income and that, if taxable under foreign law, are treated as base differences.

Several comments requested that distributions described in sections 301(c)(2) and 733, representing nontaxable returns of capital, be removed from the list of base differences on the grounds that foreign tax on such distributions is more likely to result from timing differences. Some comments argued that the foreign law characterization of the distribution should govern the determination of the income group to which the foreign tax is allocated. Other comments suggested that foreign tax on return of capital distributions should be associated with passive category capital gains, because by reducing basis such distributions may increase the amount of capital gain recognized for U.S. tax purposes in the future.

The purpose of the rules in § 1.861–20, as well as § 1.904–6, is to allocate and apportion foreign income taxes to groupings of income determined under Federal income tax law, and the final regulations at § 1.861–20(d)(1), consistent with the approach in former § 1.904–6, provide that Federal income tax law applies to characterize foreign gross income and assign it to a grouping. Characterizing items solely based on foreign law, with no comparison to the U.S. tax base, would altogether eliminate base differences, which are

expressly referenced in section 904(d)(2)(H)(i).

However, the Treasury Department and the IRS have determined that in most cases, a foreign tax imposed on distributions described in sections 301(c)(2) and 733 is likely to represent tax on earnings and profits of the distributing entity that are accounted for at different times under U.S. and foreign tax law, such as earnings of a hybrid partnership, earnings that are accelerated and subsequently eliminated for U.S. tax purposes by reason of a section 338 election, or earnings and profits of lower-tier entities, rather than tax on amounts that are permanently excluded from the U.S. tax base. Although in some cases involving net basis foreign income taxes imposed at the shareholder level, distributions described in sections 301(c)(2) and 733 may reflect a timing difference in the recognition of unrealized gain with respect to the equity of the distributing entity, the Treasury Department and the IRS have determined that these situations are less likely to occur than timing differences in the recognition of earnings subject to withholding taxes because of the prevalence of foreign participation exemption regimes. Moreover, treating the foreign tax on distributions as representing a timing difference on earnings and profits of the distributing entity is more consistent with the general approach in the Code and regulations to the treatment of distributions as representing a tax on the earnings (see, for example, sections 904(d)(3) and (4), and 960(b)) and with treating gain on stock sales as related in part to earnings and profits (see section 1248(a)).

Therefore, these distributions are removed from the list of base differences, and the final regulations at § 1.861–20(d)(3)(ii)(B)(2) generally associate a foreign law dividend that gives rise to a return of capital distribution under section 301(c)(2) with hypothetical earnings of the distributing corporation, measured based on the groupings to which the tax book value of the corporation’s stock is assigned under the asset method in § 1.861–9. Similar rules are included in the 2020 FTC proposed regulations for partnership distributions described in section 733.

The Treasury Department and the IRS have determined that similar rules should apply in appropriate cases to associate a portion of foreign tax imposed on an item of foreign gross income constituting gain recognized on the sale or other disposition of stock in a corporation or a partnership interest

with amounts that constitute nontaxable basis recovery for U.S. tax purposes. Such similar treatment is appropriate to minimize differences in the foreign tax credit consequences of a sale or a distribution in redemption of the taxpayer’s interest. Proposed rules on the allocation of foreign income tax on such dispositions are included in the 2020 FTC proposed regulations.

Proposed § 1.861–20 addressed the assignment to statutory and residual groupings of foreign gross income arising from disregarded payments between a foreign branch (as defined in § 1.904–4(f)(3)) and its owner. If the foreign gross income item arises from a payment made by a foreign branch to its owner, proposed § 1.861–20(d)(3)(ii)(A) generally assigned the item by deeming the payment to be made ratably out of the foreign branch’s accumulated after-tax income, calculated based on the tax book value of the branch’s assets in each grouping. If the item of foreign gross income arises from a disregarded payment to a foreign branch from its owner, proposed § 1.861–20(d)(3)(ii)(B) generally assigned the item to the residual grouping, with the result that any taxes imposed on the disregarded payment would be allocated and apportioned to the residual grouping as well. In addition, proposed § 1.904–6(b)(2) included special rules assigning foreign gross income items arising from certain disregarded payments for purposes of applying section 904 as the operative section.

Several comments asserted that foreign tax on disregarded payments from a foreign branch owner to a foreign branch should not be allocated and apportioned to the residual grouping, which results in an effective denial of foreign tax credits in the case of a branch of a CFC, because items of foreign gross income that arise from disregarded payments of items such as interest or royalties should give rise to creditable foreign income taxes despite being nontaxable for Federal income tax purposes. Some comments recommended adopting a tracing regime similar to the rules in § 1.904–4(f) to trace foreign gross income that a taxpayer includes by reason of a disregarded payment to current year income of the payor for purposes of determining the grouping to which tax on the disregarded payment is allocated and apportioned. Comments also requested that the final regulations clarify whether the rule for remittances or contributions applies in the case of payments between two foreign branches.

The Treasury Department and the IRS generally agree with the comments that



rules similar to the rules in § 1.904–4(f) should apply under § 1.861–20 to trace foreign gross income that a taxpayer includes by reason of a disregarded payment to the current year income of the payor to which the disregarded payment would be allocable if regarded for U.S. tax purposes. However, in order to provide taxpayers additional opportunity to comment, the final regulations reserve on the allocation and apportionment of foreign tax on disregarded payments, and new proposed rules are contained in the 2020 FTC proposed regulations. See Part V.F.4 of the Explanation of Provisions in the 2020 FTC proposed regulations. Similarly, the special rules in proposed § 1.904–6(b)(2) for assigning foreign gross income items arising from certain disregarded payments for purposes of applying section 904 as the operative section are repropoed in the 2020 FTC proposed regulations. The other special rules in proposed § 1.861–20(d)(3) for allocating foreign tax in connection with a taxpayer’s investment in a corporation or a disregarded entity are reorganized, and some of the definitions in proposed § 1.861–20(b) are correspondingly revised, in the final regulations to group the rules on the basis of how the entity is classified, and whether the transaction giving rise to the item of foreign gross income results in the recognition of gross income or loss, for U.S. tax purposes. The rule in proposed § 1.904–6(b)(3) relating to dispositions of property resulting in certain disregarded reallocation transactions is removed and repropoed as part of proposed § 1.861–20 as contained in the 2020 FTC proposed regulations.

Finally, one comment requested that §§ 1.904–1 and 1.904–6 clarify that the tax allocation rules apply to taxes paid to United States territories, which are generally treated as foreign countries for purposes of the foreign tax credit. The final regulations clarify this point by including a cross reference to § 1.901–2(g), which defines a foreign country to include the territories. See § 1.861–20(b)(6).

#### **V. Foreign Tax Redeterminations Under Section 905(c) and Penalty Provisions Under Section 6689**

Portions of the temporary regulations relating to sections 905(c), 986(a), and 6689 (TD 9362) (the “2007 temporary regulations”) were repropoed in order to provide taxpayers an additional opportunity to comment on those rules in light of the changes made by the TCJA. In particular, the rules in the 2007 temporary regulations that were repropoed in the 2019 FTC proposed regulations were: (1) Proposed § 1.905–

3(b)(2), which addressed foreign taxes deemed paid under section 960, (2) proposed § 1.905–4, which in general provided the procedural rules for how to notify the IRS of a foreign tax redetermination, and (3) proposed § 301.6689–1, which provided rules for the penalty for failure to notify the IRS of a foreign tax redetermination. In addition, the 2019 FTC proposed regulations contained a transition rule in proposed §§ 1.905–3(b)(2)(iv) and 1.905–5 to address foreign tax redeterminations of foreign corporations that relate to taxable years that predated the amendments made by the TCJA.

#### *A. Adjustments to Foreign Taxes Paid by Foreign Corporations*

One comment requested clarification on whether multiple payments to foreign tax authorities under a single assessment (for example, payments to stop the running of interest and penalties) each result in a foreign tax redetermination under section 905(c).

Under § 1.905–3(a) of the 2019 FTC final regulations, each payment of tax that has accrued in a later year in excess of the amount originally accrued results in a separate foreign tax redetermination. However, the 2019 FTC proposed regulations at § 1.905–4(b)(1)(iv), which is finalized without change, only required one amended return for each affected prior year to reflect all foreign tax redeterminations that occur in the same taxable year. In the case of payments that are made across multiple taxable years, § 1.905–4(b)(1)(iv) of the final regulations also provides that, if more than one foreign tax redetermination requires a redetermination of U.S. tax liability for the same affected year and those redeterminations occur within the same taxable year or within two consecutive taxable years, the taxpayer may file for the affected year one amended return and one statement under § 1.905–4(c) with respect to all of the redeterminations. Otherwise, separate amended returns for each affected year are required to reflect each foreign tax redetermination. Accordingly, no changes are made in response to this comment.

The comment also requested that the Treasury Department and the IRS clarify whether contested taxes that are paid before the contest is resolved are considered to accrue for foreign tax credit purposes when paid or whether they represent an advance payment against a future liability that does not accrue until the final liability is determined. Proposed rules addressing this issue are included in the 2020 FTC proposed regulations. See Part X.D.3 of

the Explanation of Provisions in the 2020 FTC proposed regulations.

#### *B. Deductions for Foreign Income Taxes*

One comment requested clarification on whether the general rules under section 905(c) apply to taxpayers who elect to take a deduction, rather than a credit, for creditable foreign taxes in the prior year to which the adjusted taxes relate. Additionally, the comment requested that the Treasury Department and the IRS clarify whether the ten-year statute of limitations under section 6511(d)(3)(A) applies to refund claims based on such deductions.

In the case of a U.S. taxpayer that directly pays or accrues foreign income taxes, no U.S. tax redetermination is required in the case of a foreign tax redetermination of such taxes if the taxpayer did not claim a foreign tax credit in the taxable year to which such taxes relate. See § 1.905–3(b)(1) (a redetermination of U.S. tax liability is required with respect to foreign income tax claimed as a credit under section 901). However, in the case of a U.S. shareholder of a CFC that pays or accrues foreign income tax, proposed § 1.905–3(b)(2)(i) and (ii), which are finalized without substantive change, provided that a redetermination of U.S. tax liability is required to account for the effect of a foreign tax redetermination even in situations in which the foreign tax credit is not changed, such as for purposes of computing earnings and profits or applying the high-tax exception described in section 954(b)(4), including in the case of a U.S. shareholder that chooses to deduct foreign income taxes rather than to claim a foreign tax credit. Additional guidance addressing the accrual rules for creditable foreign taxes that are deducted or claimed as a credit is included in § 1.461–4(g)(6)(B)(iii) and in the 2020 FTC proposed regulations.

The question of whether section 6511(d)(3)(A) applies to refunds relating to foreign taxes that are deducted, instead of taken as a foreign tax credit, is beyond the scope of this rulemaking. See, however, *Trusted Media Brands, Inc. v. United States*, 899 F.3d 175 (2d. Cir. 2018) (holding that section 6511(d)(3)(A) only applies to refund claims based on foreign tax credits). In addition, the 2020 FTC proposed regulations include proposed amendments to the regulations under section 901(a), which provides that an election to claim foreign income taxes as a credit for a particular taxable year may be made or changed at any time before the expiration of the period prescribed for claiming a refund of U.S. tax for that year. See Part X.B.2 of the Explanation

of Provisions in the 2020 FTC proposed regulations.

### C. Application to GILTI High-Tax Exclusion

Proposed § 1.905–3(b)(2)(ii) provided that the required adjustments to U.S. tax liability by reason of a foreign tax redetermination of a foreign corporation include not only adjustments to the amount of foreign taxes deemed paid and related section 78 dividend, but also adjustments to the foreign corporation's income and earnings and profits and the amount of the U.S. shareholder's inclusions under sections 951 and 951A in the year to which the redetermined foreign tax relates.

One comment requested that final regulations clarify whether a U.S. tax redetermination is required when the foreign tax redetermination affects whether the taxpayer is eligible for the GILTI high-tax exclusion. Specifically, the comment stated that because a redetermination of U.S. tax liability is required when the foreign tax redetermination affects whether a taxpayer is eligible for the subpart F high-tax election under section 954(b)(4), a similar result should apply for taxpayers that make (or seek to make) the GILTI high-tax exclusion election, and that taxpayers should be allowed to make the election on an annual basis. Further, the comment suggested that if taxpayers are allowed to make an annual election under the final GILTI high-tax exclusion regulations, then taxpayers should be permitted to make or revoke the election on an amended return following a foreign tax redetermination.

Proposed § 1.905–3(b)(2)(ii) provided that the required U.S. tax redetermination applies for purposes of determining amounts excluded from a CFC's gross tested income under section 951A(c)(2)(A)(i)(III), and this provision is retained in the final regulations with minor modifications. Furthermore, under final regulations issued on July 23, 2020 (TD 9902, 85 FR 44620), taxpayers may make the GILTI high-tax exclusion election on an annual basis and may do so on an amended return filed within 24 months of the unextended due date of the original income tax return. See § 1.951A–2(c)(7)(viii)(A)(1)(i).

### D. Foreign Tax Redeterminations of Successor Entities

Proposed § 1.905–3(b)(3) provided that if at the time of a foreign tax redetermination the person with legal liability for the tax (the "successor") is a different person than the person that had legal liability for the tax in the year

to which the redetermined tax relates (the "original taxpayer"), the required redetermination of U.S. tax liability is made as if the foreign tax redetermination occurred in the hands of the original taxpayer. The proposed regulations further provided that Federal income tax principles apply to determine the tax consequences if the successor remits, or receives a refund of, a tax that in the year to which the redetermined tax relates was the legal liability of, and thus considered paid by, the original taxpayer.

One comment suggested that proposed § 1.905–3(b)(3), as drafted, did not clearly address cases where the ownership of a disregarded entity changes. The comment recommended clarifying that in the case of a disregarded entity, the owner of the disregarded entity is treated as the person with legal liability for the tax or the person with the legal right to a refund, as applicable.

The Treasury Department and the IRS have determined that no clarification is necessary. Existing regulations make clear that the owner of a disregarded entity is considered to be legally liable for the tax. See § 1.901–2(f)(4)(ii) (legal liability for income taxes imposed on a disregarded entity).

The same comment stated that the preamble to the proposed regulations incorrectly suggested that under U.S. tax principles the payment of tax by a successor entity owned by the original taxpayer (for example, by a CFC that was formerly a disregarded entity) is treated as a distribution. The comment further recommended addressing the issue of contingent liabilities in future guidance. The Treasury Department and the IRS agree that there may be multiple ways to characterize the tax consequences of tax paid by a successor in the example described in the preamble to the proposed regulations. Furthermore, the Treasury Department and the IRS have determined that the issue of contingent foreign tax liabilities in connection with foreign tax redeterminations under section 905(c) requires further study and may be considered as part of future guidance.

### E. Notification to the IRS of Foreign Tax Redeterminations and Related Penalty Provisions

#### 1. Notification Through Amended Returns

In general, proposed § 1.905–4(b)(1)(i) provided that any taxpayer for which a redetermination of U.S. tax liability is required must notify the IRS of the foreign tax redetermination by filing an amended return.

Several comments suggested that taxpayers should be allowed to report adjustments to U.S. tax liability in prior years by reason of foreign tax redeterminations on an attachment to their Federal income tax return for the taxable year in which the redetermination occurs, instead of requiring taxpayers to file amended tax returns for the taxable year in which the adjusted foreign tax was claimed as a credit and any intervening years in which the foreign tax redetermination affected U.S. tax liability. Specifically, comments suggested that taxpayers could be allowed to file a statement with their return for the taxable year in which the foreign tax redetermination occurs notifying the IRS of overpayments or underpayments of U.S. tax and applicable interest due for prior taxable years that resulted from the foreign tax redetermination. One comment suggested that taxpayers could be required to maintain books and records reflecting all the adjustments that would normally accompany an amended return, without actually being required to prepare and file such a return. Another comment suggested that the IRS could amend Schedule E on Form 5471 to include this type of information about the changes to prior year U.S. tax liabilities that result from foreign tax redeterminations. Comments noted that providing an alternative to filing amended Federal income tax returns would relieve taxpayers from having to file amended state tax returns.

The Treasury Department and the IRS have determined that, based on existing processes, the only manner in which taxpayers can properly notify the IRS of a change in U.S. tax liability for a prior taxable year that results from a foreign tax redetermination is by filing an amended return reflecting all the necessary U.S. tax adjustments. In addition, the Treasury Department and the IRS have determined that the type of statement suggested by the comments, reflecting a recomputation of Federal income tax liability for a prior year, could be viewed by state tax authorities as the functional equivalent of an amended Federal income tax return that may not necessarily operate to relieve taxpayers of their obligations to file amended state tax returns. In any event, taxpayer requests for relief from state tax filing obligations are properly directed to state tax authorities, rather than to the Treasury Department and the IRS. Therefore, the comments are not adopted. However, the Treasury Department and the IRS continue to study whether new processes or forms can be developed to streamline the

filing requirements while ensuring that the IRS receives the necessary information to verify that taxpayers have made the required adjustments to their U.S. tax liability. Under § 1.905–4(b)(3) of the final regulations, the IRS may prescribe alternative notification requirements through forms, instructions, publications, or other guidance.

Comments also suggested that the notification due date should be extended (for example, to up to three years from the due date of the original return for the taxable year in which the foreign tax redetermination occurred).

The Treasury Department and the IRS have determined that deferring the due date of the required amended returns beyond the due date (with extensions) of the return for the year in which the foreign tax redetermination occurs would not substantially reduce compliance burdens and could be more difficult for the IRS to administer, because the same filing obligations would be required, though with respect to foreign tax redeterminations that occurred three years earlier rather than in the current taxable year. In addition, taxpayers have an economic incentive to promptly file amended returns claiming a refund of U.S. tax in cases where a foreign tax redetermination reduces, rather than increases, U.S. tax liability; the Treasury Department and the IRS have determined that it is appropriate to require comparable promptness when a foreign tax redetermination increases U.S. tax due in order to permit timely verification of the required U.S. tax adjustments when the relevant documentation and personnel are more readily available. Accordingly, the comments are not adopted. However, a transition rule is added at § 1.905–4(b)(6) to give taxpayers an additional year to file required notifications with respect to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019, and before November 12, 2020.

Comments also requested that the final regulations provide that for foreign tax redeterminations below a certain de minimis threshold (for example, 10 percent of foreign taxes as originally accrued, or \$5 million), taxpayers should be allowed to account for the foreign tax redeterminations by making adjustments to current year taxes and foreign tax credits claimed in the taxable year in which the foreign tax redetermination occurs, rather than by adjusting U.S. tax liability in the prior year or years in which the adjusted foreign taxes were claimed as a credit. Alternatively, some comments requested that for foreign tax

redeterminations below a de minimis or materiality threshold, taxpayers should be completely relieved of adjusting U.S. tax liability and from all notification and amended return requirements.

The Treasury Department and the IRS have determined that, as amended by the TCJA, section 905(c) mandates retroactive adjustments to U.S. tax liability when foreign taxes claimed as credits are redetermined. The TCJA repealed section 902 and the regulatory authority at the end of section 905(c)(1) to prescribe alternative adjustments to multi-year pools of earnings and taxes of foreign corporations in lieu of the required adjustments to U.S. tax liability for the affected years. Recharacterizing prior year taxes as current year taxes would have substantive effects on the amounts of a taxpayer's GILTI and subpart F inclusions, the applicable carryover periods for excess credits, the applicable currency translation conventions, the amounts of interest owed by or due to the taxpayer, and the applicable statutes of limitation for refund or assessment. Therefore, the comments are not adopted.

Finally, a comment requested that § 1.905–4(b)(1)(ii) be amended to allow a taxpayer that avails itself of special procedures under Revenue Procedure 94–69 to notify the IRS of a foreign tax redetermination when the taxpayer makes a Revenue Procedure 94–69 disclosure during an audit for the taxable year for which U.S. tax liability is increased by reason of the foreign tax redetermination.

In relevant part, Revenue Procedure 94–69 provides special procedures for a taxpayer in the Large Corporate Compliance program (formerly the Coordinated Examination Program or Coordinated Industry Case program) to avoid the potential application of the accuracy-related penalty currently described in section 6662. Under Revenue Procedure 94–69, a taxpayer may file a written statement that is treated as a qualified amended return within 15 days after the IRS requests it. However, Revenue Procedure 94–69 does not provide any protection for penalties under section 6689 for failure to file a notice of a foreign tax redetermination, and it requires a statement that is less detailed than the notification statement required under § 1.905–4(b)(1)(ii). Further, section 905(c) contemplates that the burden is on the taxpayer to notify the IRS of a foreign tax redetermination, whereas Revenue Procedure 94–69 places the burden on the IRS to request information. Finally, the notification requirement under § 1.905–4(b)(1)(ii) affords a taxpayer more time to satisfy

its reporting obligation as opposed to the 15-day notification requirement in Revenue Procedure 94–69. Therefore, the comment is not adopted.

## 2. Foreign Tax Redeterminations of Pass-Through Entities

Proposed § 1.905–4(b)(2) generally provided that a pass-through entity that reports creditable foreign income tax to its partners, shareholders, or beneficiaries is required to notify the IRS and its partners, shareholders, or beneficiaries if there is a foreign tax redetermination with respect to such foreign income tax. See proposed § 1.905–4(c) for the information required to be provided with the notification. Additionally, proposed § 1.905–4(b)(2)(ii) provided that if a redetermination of U.S. tax liability would require a partnership adjustment as defined in § 301.6241–1(a)(6), the partnership must file an administrative adjustment request (“AAR”) under section 6227 without regard to the time restrictions on filing an AAR in section 6227(c). See also § 1.6227–1(g).

One comment suggested that S corporations should be allowed to follow similar notification procedures as partnerships that are subject to sections 6221 through 6241 (enacted in § 1101 of the Bipartisan Budget Act of 2015, Pub. L. 114–74 (“BBA”) and as amended by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114–113, div Q, and by sections 201 through 207 of the Tax Technical Corrections Act of 2018, contained in Title II of Division U of the Consolidated Appropriations Act of 2018, Pub. L. 115–141).

By their terms, the BBA rules only apply to partnerships and not S corporations, except in the limited circumstance in which an S corporation is a partner in a partnership subject to the BBA rules. See sections 6226(b)(4) and 6227(b). But in cases where the S corporation is not a partner in a BBA partnership that made the election, there is no provision under BBA or any other provision of the Code to allow the S corporation to pay the imputed underpayment on behalf of its shareholders. Because the statute does not generally allow for S corporations to pay imputed underpayments on behalf of its shareholders, the approach suggested by the comment is not viable and therefore the comment is not adopted. However, as described in Part V.E.1 of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS continue to study whether new processes or forms can be developed to streamline the amended return requirements, including in the case of S corporations that report

foreign tax redeterminations to their shareholders.

### 3. Foreign Tax Redeterminations of LB&I Taxpayers

Proposed § 1.905–4(b)(4) provided a limited alternative notification requirement for U.S. taxpayers that are under the jurisdiction of the IRS's Large Business & International ("LB&I") Division. Under proposed § 1.905–4(b)(4)(i)(B), the alternative notification requirement is available only if certain conditions are met, including that an amended return reflecting a foreign tax redetermination would otherwise be due while the return for the affected taxable year is under examination, and that the foreign tax redetermination results in a downward adjustment to the amount of foreign tax paid or accrued, or included in the computation of foreign taxes deemed paid.

Several comments suggested broadening the scope of proposed § 1.905–4(b)(4) to include upward adjustments to foreign taxes paid or accrued. The comments also recommended that the special notification rules apply when multiple foreign tax redeterminations involving different foreign jurisdictions occur in the same taxable year and result in offsetting adjustments, for example, if there is an additional payment of foreign tax in one jurisdiction and a refund of a comparable amount in another jurisdiction.

The proposed regulations limited the alternative notification requirement to cases where the foreign tax redetermination results in a downward adjustment to the amount of foreign taxes paid or accrued because failure to comply with the notification requirements exposes taxpayers to penalties under section 6689 only if the foreign tax redetermination results in an underpayment of U.S. tax. As provided in § 1.905–4(b)(1)(iii), if a foreign tax redetermination results in an overpayment of U.S. tax, in order to claim a refund of U.S. tax the taxpayer must file an amended return within the period specified in section 6511. See section 6511(d)(3)(A), providing a special 10-year period of limitations for refund claims based on foreign tax credits. However, in unusual circumstances, an increase in foreign tax liability for a prior year may result in an underpayment (rather than an overpayment) of U.S. tax (for example, if an increase in foreign income tax liability causes a CFC to have a tested loss or to qualify for the high-tax exclusion of section 954(b)(4), reducing the amount of foreign taxes deemed paid).

In addition, in some cases the complexity of the required computations may make it difficult for taxpayers to identify easily which particular foreign tax redeterminations will ultimately result in an underpayment of U.S. tax. Accordingly, the final regulations extend the alternative notification procedures to cover the case of any adjustment (whether upward or downward) of foreign taxes by reason of a foreign tax redetermination that increases U.S. tax liability, and so would otherwise require the filing of an amended return while the affected year of the LB&I taxpayer is under examination. In addition, the final regulations provide that an LB&I taxpayer that has a foreign tax redetermination that decreases U.S. tax liability for an affected year that is under examination may (but is not required to) notify the examiner of the adjustment in lieu of filing an amended return to claim a refund (within the time period provided in section 6511). However, because section 6511(d)(3) generally allows taxpayers 10 years to seek a U.S. tax refund attributable to foreign tax credits and the regulations do not preclude taxpayers from filing such an amended return before the audit of an affected year is completed, the IRS may either accept the alternative notification or require the taxpayer to file an amended return. The additional flexibility added to the final regulations will assure timely notification of, and penalty protection for taxpayers with respect to, all foreign tax redeterminations that may increase or decrease U.S. tax liability for an affected taxable year, including in the case of offsetting foreign tax redeterminations that occur in the same taxable year.

Finally, comments recommended that examiners should be granted authority to accept notifications of foreign tax redeterminations outside the periods specified in § 1.905–4(b)(4)(ii)(A) through (C) and for affected taxable years that are not currently under examination. For example, the comments suggested that the notification deadline for an LB&I taxpayer should be extended upon the taxpayer's request and at the examiner's discretion.

The Treasury Department and the IRS have determined that amended returns reflecting additional U.S. tax due should be timely filed in order to ensure examiners have sufficient time to take into account any redetermination of U.S. tax liability without prolonging the audit. In addition, the special notification rules are not extended to taxpayers that are not currently under examination. The alternative

notification rules in § 1.905–4(b)(4) are predicated on the fact that the examiner is in the process of determining whether to propose adjustments to the items included on the taxpayer's return for the taxable year under examination, and it is appropriate to defer the requirement to file an amended return reflecting the effect of a foreign tax redetermination on the taxpayer's U.S. tax liability for that taxable year until the examination has concluded. These considerations do not apply to affected taxable years that are not currently under examination when an amended return would otherwise be due. Accordingly, these comments are not adopted.

### F. Transition Rule Relating to the TCJA

Proposed §§ 1.905–3(b)(2)(iv) and 1.905–5 provided a transition rule providing that post-2017 redeterminations of pre-2018 foreign income taxes of foreign corporations must be accounted for by adjusting the foreign corporation's taxable income and earnings and profits, post-1986 undistributed earnings, and post-1986 foreign income taxes (or pre-1987 accumulated profits and pre-1987 foreign income taxes, as applicable) in the pre-2018 year to which the redetermined foreign taxes relate.

The preamble to the 2019 FTC proposed regulations requested comments on whether an alternative adjustment to account for post-2017 foreign tax redeterminations with respect to pre-2018 taxable years of foreign corporations, such as an adjustment to the foreign corporation's taxable income and earnings and profits, post-1986 undistributed earnings, and post-1986 foreign income taxes as of the foreign corporation's last taxable year beginning before January 1, 2018, may provide for a simplified and reasonably accurate alternative.

Several comments supported this suggestion. A comment further noted that certain taxpayers should be excluded from any alternative rule where it would be distortive. For example, the comment suggested excluding taxpayers that distributed material amounts of earnings and profits, as well as taxpayers who took advantage of the subpart F high-tax exception in the foreign corporation's final pre-TCJA taxable year. Another comment noted that taxpayers should be allowed to adjust the foreign corporation's final pre-2018 year only if the adjustments would not cause a deficit in the foreign corporation's tax pool in that final year. A comment also suggested that the alternative rule should provide that in case of foreign corporations that ceased to be subject to

the pooling regime before 2018 (for example, due to a liquidation or sale to a foreign acquiror), the required adjustments should be made in the foreign corporation's last year in which the pooling rules are relevant). Additionally, several comments suggested that foreign tax redeterminations of foreign corporations below a certain threshold should not require a redetermination or adjustment of a taxpayer's section 965(a) inclusion or the amount of foreign taxes deemed paid with respect to such section 965(a) inclusion. Instead, some comments suggested that the redetermination be taken into account in the post-2017 year of the redetermination.

In response to comments, the final regulations under § 1.905-5(e) provide an irrevocable election for a foreign corporation's controlling domestic shareholders to account for all foreign tax redeterminations that occur in taxable years ending on or after November 2, 2020, with respect to pre-2018 taxable years of foreign corporations as if they occurred in the foreign corporation's last taxable year beginning before January 1, 2018 (the "last pooling year"). The rules in §§ 1.905-3T and 1.905-5T (as contained in 26 CFR part 1 revised as of April 1, 2019) will apply for purposes of determining whether a particular foreign tax redetermination must instead be accounted for in the year to which the redetermined foreign tax relates, instead of in the last pooling year. The election is made by the foreign corporation's controlling domestic shareholders, and is binding on all persons who are, or were in a prior year to which the election applies, U.S. shareholders of the foreign corporation with respect to which the election is made for all of its subsequent foreign tax redeterminations, as well as foreign tax redeterminations of other members of the same CFC group as the foreign corporation for which the election is made. For this purpose, the definition of a CFC group in § 1.905-5(e)(2)(iv)(B) is modeled off the definition contained in § 1.951A-2(c)(7)(viii)(E)(2).

No exception is provided that would allow taxpayers to avoid redetermination or adjustment of the amount of a taxpayer's section 965(a) inclusion or foreign income taxes deemed paid with respect to such section 965(a) inclusion if under section 905(c) a foreign tax redetermination with respect to a foreign corporation's pre-2018 year requires such an adjustment to the taxpayer's U.S. tax liability. As discussed in Part V.E.1 of this Summary of Comments and Explanation of Revisions, section 905(c)

mandates retroactive adjustments to U.S. tax liability when foreign taxes claimed as credits are redetermined, and there is no technical or policy basis on which to exclude such adjustments when the U.S. tax liability arises as a result of section 965 as opposed to another section of the Code.

### G. Protective Claims

One comment requested guidance on how to file protective refund claims to account for contested foreign taxes that may result in foreign tax redeterminations after the expiration of the applicable statute of limitations. Providing guidance on the procedures for filing protective claims is beyond the scope of this rulemaking.

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

The 2019 FTC proposed regulations included a clarification relating to schemes involving jurisdictions that do not impose corporate income tax on a CFC until its earnings are distributed. The proposed regulations clarified that foreign income taxes that have not accrued because they are contingent on a future distribution are not taken into account for purposes of determining the amount of foreign income taxes paid or accrued with respect to an item of income.

No comments were received with respect to this provision, and the rules are finalized without change. In addition, proposed § 1.905-1(d)(1) in the 2020 FTC proposed regulations further clarifies that taxes contingent on a future distribution are not treated as accrued.

## VII. Applicability Dates

### A. Regulations Relating to Foreign Tax Credits

The 2019 FTC proposed regulations provided that the rules in proposed §§ 1.861-8, 1.861-9, 1.861-12, 1.861-14, 1.904-4(c)(7) and (8), 1.904(b)-3, 1.905-3, 1.905-4, 1.905-5, 1.954-1, 1.954-2, 1.965-5(b)(2), and 301.6689-1 are applicable to taxable years that end on or after December 16, 2019. Certain provisions, such as §§ 1.704-1(b)(4)(viii)(d)(1), 1.861-17, 1.861-20, 1.904-6, and 1.960-1, were proposed to be applicable to taxable years beginning after December 31, 2019, while proposed §§ 1.904-4(e) and 1.904(g)-3 were proposed to be applicable to taxable years ending on or after the date the final regulations are filed. Proposed § 1.1502-4 was proposed to be applicable to taxable years for which the original consolidated Federal income

tax return is due (without extensions) after December 17, 2019.

Several comments requested that the applicability dates to the 2019 FTC proposed regulations generally be delayed to taxable years beginning on or after the final regulations are published to allow more time for taxpayers to adapt to the new rules, and also requested that the regulations allow taxpayers the flexibility to rely on either the 2019 FTC proposed regulations or the final regulations for any preceding taxable years.

The Treasury Department and the IRS agree that the applicability date of the expense allocation rules in §§ 1.861-8 and 1.861-14, which particularly in the case of stewardship expenses contain significant changes relative to the 2019 FTC proposed regulations, should be delayed to allow taxpayers more time to comply with the revisions made in the final regulations. Therefore, the applicability dates of §§ 1.861-8 and 1.861-14 are revised to apply to taxable years beginning after December 31, 2019 (consistent with the later applicability date provided for §§ 1.861-17, 1.861-20, 1.904-6, and 1.960-1). In addition, although the applicability date of the notification requirements for foreign tax redeterminations in § 1.905-4 is adopted as proposed to apply to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019, a transition rule is added to the final regulations to provide taxpayers an additional year to file required notifications with respect to foreign tax redeterminations occurring in taxable years ending before November 12, 2020. Also, because section 1503(a) provides that regulations under section 1502 only apply to consolidated tax returns if they are prescribed before the last day prescribed by law for the filing of such return, the applicability date of § 1.1502-4 is revised to apply to taxable years for which the original consolidated Federal income tax return is due (without extensions) after November 12, 2020. However, the other provisions in the 2019 FTC proposed regulations which were proposed to apply to taxable years ending on or after December 16, 2019 (§§ 1.861-9, 1.861-12, 1.904-4(c)(7) and (8), 1.904(b)-3, 1.905-3, 1.905-5, 1.954-1, 1.954-2, 1.965-5(b)(2), and 301.6689-1), generally received minimal or no comments and have been adopted with no or minimal changes. Therefore, the Treasury Department and the IRS have determined that taxpayers with 2019 calendar years have been sufficiently on notice of these rules and little benefit would be afforded by providing a delayed applicability date or an election

to apply either the proposed or final regulations to preceding years, given that these rules have not significantly changed between the proposed and final regulations.

The 2019 FTC proposed regulations provided that, with respect to § 1.861–17, taxpayers that use the sales method for taxable years beginning after December 31, 2017, and before January 1, 2020 (or taxpayers that use the sales method only for their last taxable year that begins before January 1, 2020), may rely on proposed § 1.861–17 if they apply it consistently with respect to such taxable year and any subsequent year. Therefore, a taxpayer using the sales method for its taxable year beginning in 2018 may rely on proposed § 1.861–17 but must also apply the sales method (relying on proposed § 1.861–17) for its taxable year beginning in 2019.

These final regulations provide that a taxpayer may choose to apply § 1.861–17 (as contained in these final regulations) to taxable years beginning before January 1, 2020, provided that it applies the final regulations in their entirety, and provided that if a taxpayer applies the final regulations to the taxable year beginning in 2018, the taxpayer must also apply the final regulations for the subsequent taxable year beginning in 2019. Alternatively, and consistent with the 2019 FTC proposed regulations, a taxpayer may rely on proposed § 1.861–17 in its entirety for taxable years beginning after December 31, 2017, and beginning before January 1, 2020. A taxpayer that applies either the proposed or final version of § 1.861–17 to a taxable year beginning on or after January 1, 2018, and beginning before January 1, 2020, must apply it with respect to all operative sections (including both section 250 and 904). See § 1.861–8(f).

#### *B. Rules Relating to Hybrid Arrangements and Section 951A*

Under the 2020 hybrids proposed regulations, the rules under section 245A(e) relating to hybrid deduction accounts were proposed to be applicable to taxable years ending on or after the date that final regulations are published in the **Federal Register**, although a taxpayer could choose to consistently apply those final regulations to earlier taxable years. See proposed § 1.245A(e)–1(h)(2). In addition, the 2020 hybrids proposed regulations provided that a taxpayer could consistently rely on the proposed rules with respect to earlier taxable years.

Further, under the 2020 hybrids proposed regulations, the rules under section 881 relating to conduit financing

arrangements were proposed to be applicable to payments made on or after the date that final regulations are published in the **Federal Register**. See proposed § 1.881–3(f). Finally, the rules under section 951A relating to disqualified payments were proposed to be applicable to taxable years of foreign corporations ending on or after April 7, 2020, and to taxable years of United States shareholders in which or with which such taxable years end. See proposed § 1.951A–7(d).

As discussed in Part III.B of this Summary of Comments and Explanation of Revisions, a comment recommended modifying the applicability date for the rules under section 881 if the final regulations were to include some of the proposed rules, such as the rule that treated as a financing transaction an instrument that is equity for both U.S. and foreign tax purposes and that gives rise to notional interest deductions. The final regulations do not include those rules. In addition, no comments suggested a modification to the applicability dates for the other rules under the 2020 hybrids proposed regulations. Therefore, the final regulations adopt applicability dates consistent with the proposed applicability dates under the 2020 hybrids proposed regulations. See §§ 1.245A(e)–1(h)(2); 1.881–3(f); and 1.951A–7(d). The final regulations also clarify that for a taxpayer to apply the final rules under section 245A(e) to a taxable year ending before November 12, 2020, the taxpayer must consistently apply those rules to that taxable year and any subsequent taxable year ending before November 12, 2020. See § 1.245A(e)–1(h)(2).

### **Special Analyses**

#### **I. Regulatory Planning and Review**

Executive Orders 13771, 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. For purposes of Executive Order 13771, this final rule is regulatory.

These final regulations have been designated 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 (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these regulations as economically significant under section 1(c) of the MOA. Accordingly, the OMB has reviewed these regulations.

#### *A. Background and Need for the Final Regulations*

##### **1. Regulations Relating to Foreign Tax Credits**

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

The FTC calculation operates by defining different categories of foreign source income (a “separate category”) based on the type of income.<sup>3</sup> Foreign taxes paid or accrued as well as deductions for expenses borne by U.S. parents and domestic affiliates that support foreign operations are also allocated to the separate categories under similar principles. The taxpayer can then use foreign tax credits allocated to each category against the U.S. tax owed on income in that category. This approach means that taxpayers who pay foreign taxes on income in one category cannot claim a credit against U.S. taxes owed on income in a different category, an important feature of the FTC regime. For example, suppose a domestic corporate taxpayer has \$100 of active foreign source income in the “general category” and \$100 of passive foreign source income, such as interest income, in the “passive category.” It also has \$50 of foreign taxes associated with the

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

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

The final regulations are needed to address changes introduced by the TCJA and to respond to outstanding issues raised in comments to foreign tax credit regulations issued in 2018. In particular, the comments highlighted the following areas of concern: (a) Uncertainty concerning appropriate allocation of R&E expenditures across FTC categories, and (b) the need to treat loans from partnerships to partners the same as loans from partners to partnerships with respect to aligning interest income to interest expense. In addition, the final regulations are needed to expand the application of section 905(c) to cases where a foreign tax redetermination changes a taxpayer’s eligibility for the high-taxed exception under subpart F and GILTI.

In addition to the 2018 FTC final regulations, the Treasury Department and the IRS also issued final regulations in 2019 (84 FR 69022) (2019 FTC final regulations) and proposed regulations (84 FR 69124) (2019 FTC proposed regulations), which are being finalized in this document, and are issuing additional proposed regulations simultaneously with these final regulations.

## 2. Regulations Relating to Hybrid Arrangements and to Section 951A

The TCJA introduced two new provisions, sections 245A(e) and 267A, that affect the treatment of hybrid arrangements, and a new section 951A, which imposes tax on United States shareholders with respect to certain earnings of their CFCs.<sup>4</sup> The Treasury

Department and the IRS previously issued final regulations under sections 245A(e) and 267A (2020 hybrids final regulations) as well as proposed regulations under sections 245A(e), 881, and 951A (2020 hybrids proposed regulations). See TD 9896, 85 FR 19802; REG–106013–19, 85 FR 19858. The Treasury Department and the IRS are issuing additional final regulations relating to finalize the 2020 hybrids proposed regulations.

Section 245A(e) disallows the dividends received deduction (DRD) for any dividend received by a U.S. shareholder from a CFC if the dividend is a hybrid dividend. In addition, section 245A(e) treats hybrid dividends between CFCs with a common U.S. shareholder as subpart F income. The statute defines a hybrid dividend as an amount received from a CFC for which a deduction would be allowed under section 245A(a) and for which the CFC received a deduction or other tax benefit in a foreign country. This disallowance of the DRD for hybrid dividends and the treatment of hybrid dividends as subpart F income neutralizes the double non-taxation that might otherwise be produced by these dividends.<sup>5</sup> The 2020 hybrids final regulations require that taxpayers maintain “hybrid deduction accounts” to track a CFC’s (or a person related to a CFC’s) hybrid deductions allowed in foreign jurisdictions across sources and years. The 2020 hybrids final regulations then provide that a dividend received by a U.S. shareholder from the CFC is a hybrid dividend to the extent of the sum of those accounts.

These final regulations also include rules regarding conduit financing arrangements.<sup>6</sup> Under the regulations in

that have operations both in the U.S. and a foreign country. These hybrid arrangements use differences in tax treatment by the U.S. and a foreign country to reduce taxes in one or both jurisdictions. Hybrid arrangements can be “hybrid entities,” in which a taxpayer is treated as a flow-through or disregarded entity in one country but as a corporation in another, or “hybrid instruments,” which are financial transactions that are treated as debt in one country and as equity in another.

<sup>5</sup> The tax treatment under which certain payments are deductible in one jurisdiction and not included in income in a second jurisdiction is referred to as a deduction/no-inclusion outcome (“D/NI outcome”).

<sup>6</sup> On December 22, 2008, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–113462–08) that proposed adding § 1.881–3(a)(2)(i)(C) to the conduit financing regulations. The preamble to the proposed regulations provides that the Treasury Department and the IRS are also studying transactions where a financing entity advances cash or other property to an intermediate entity in exchange for a hybrid instrument (that is, an instrument treated as debt under the tax laws of the foreign country in which the intermediary is resident and equity for U.S. tax purposes), and states that they may issue separate guidance to address the treatment under § 1.881–3 of certain hybrid instruments.

§ 1.881–3 (the “conduit financing regulations”), a “financing arrangement” means a series of transactions by which one entity (the financing entity) advances money or other property to another entity (the financed entity) through one or more intermediaries, and there are “financing transactions” linking each of those parties. If the IRS determines that a principal purpose of such an arrangement is to avoid U.S. tax, the IRS may disregard the participation of intermediate entities. As a result, U.S.-source payments from the financed entity are, for U.S. withholding tax purposes, treated as being made directly to the financing entity.

For example, consider a foreign entity that is seeking to finance its U.S. subsidiary but is not entitled to U.S. tax treaty benefits; thus, U.S.-source payments made to this entity are not entitled to reduced withholding tax rates. Instead of lending money directly to the U.S. subsidiary, the foreign entity might loan money to an affiliate residing in a treaty jurisdiction and have the affiliate lend on to the U.S. subsidiary in order to access U.S. tax treaty benefits.

Under the conduit financing regulations, if the IRS determines that a principal purpose of such an arrangement is to avoid U.S. tax, the IRS may disregard the participation of the affiliate. As a result, U.S.-source interest payments from the U.S. subsidiary are, for U.S. withholding tax purposes, treated as being made directly to the foreign entity.

In general, the conduit financing regulations apply only if “financing transactions,” as defined under the regulations, link the financing entity, the intermediate entities, and the financed entity. Under the prior conduit financing regulations, before the finalization of these regulations, an instrument that is equity for U.S. tax purposes generally will not be treated as a “financing transaction” unless it provides the holder significant redemption rights or the issuer has a right to redeem that likely will be exercised. This is the case even if the instrument is treated as debt under the laws of the foreign jurisdiction (for example, perpetual debt). As a result, the prior conduit financing regulations would not apply to an equity instrument in the absence of such attributes, and the U.S.-source payment might be entitled to a lower rate of U.S. withholding tax.

These final regulations also implement items in section 951A of the TCJA. Section 951A provides for the taxation of global intangible low-taxed

<sup>4</sup> Hybrid arrangements are tax-avoidance tools used by certain multinational corporations (MNCs)

income (GILTI), effective beginning with the first taxable year of a CFC that begins after December 31, 2017. The existing final regulations under section 951A address the treatment of a deduction or loss attributable to basis created by certain transfers of property from one CFC to a related CFC after December 31, 2017, but before the date on which section 951A first applies to the transferring CFC's income. Those regulations state that such a deduction or loss is allocated to residual CFC gross income; that is, income that is not attributable to tested income, subpart F income, or income effectively connected with a trade or business in the United States.

## B. Overview of the Final Regulations

### 1. Regulations Relating to Foreign Tax Credits

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

### 2. Regulations Relating to Hybrid Arrangements and to Section 951A

These final regulations address three main issues. First, these final regulations address adjustments to hybrid deduction accounts under section 245A(e) and the 2020 hybrids final regulations. The 2020 hybrids final regulations stipulate that hybrid deduction accounts should generally be reduced to the extent that earnings and profits of the CFC that have not been subject to foreign tax as a result of certain hybrid arrangements are included in income in the United States by some provision other than section 245A(e). These final regulations provide

new rules for reducing hybrid deduction accounts by reason of income inclusions attributable to subpart F, GILTI, and sections 951(a)(1)(B) and 956. An inclusion due to subpart F or GILTI reduces a hybrid deduction account only to the extent that the inclusion is not offset by a deduction or credit, such as a foreign tax credit, that likely will be afforded to the inclusion. Because deductions and credits are not available to offset income inclusions under section 951(a)(1)(B) and 956, these inclusions reduce a hybrid deduction account dollar-for-dollar.

Second, these final regulations address conduit financing arrangements under § 1.881-3 by expanding the types of transactions classified as financing transactions. These final regulations state that if a financial instrument is debt under the tax law of the foreign jurisdiction where the issuer is a resident, or, if the issuer is not a tax resident of any country, where it is created, organized, or otherwise established, then it may now be characterized as a financing transaction even though the instrument is equity for U.S. tax purposes. Accordingly, the conduit financing regulations would apply to multiple-party financing arrangements using these types of instruments. This change is consistent with the policy of § 1.881-3 and also helps to align the conduit regulations with the policy of section 267A by discouraging the exploitation of differences in treatment of financial instruments across jurisdictions. While section 267A and the 2020 hybrids final regulations apply only if the D/NI outcome is a result of the use of a hybrid entity or instrument, the conduit financing regulations apply regardless of causation and instead look to whether there is a tax avoidance plan. Thus, this new rule, to a limited extent, will address economically similar transactions that section 267A and the 2020 hybrids final regulations do not cover.

Finally, these final regulations address certain payments made after December 31, 2017, but before the date of the start of the first fiscal year for the transferor CFC for which 951A applies (the "disqualified period") in which payments, such as pre-payments of royalties, create income during the disqualified period and a corresponding deduction or loss claimed in taxable years after the disqualified period. Absent these final regulations, those deductions or losses could have been used to reduce tested income or increase tested losses, among other benefits. However, under these final regulations, these deductions will no longer provide

such a tax benefit, and will instead be allocated to residual CFC income, similar to deductions or losses from certain property transfers in the disqualified period under the existing final regulations under section 951A.

## C. Economic Analysis

### 1. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of these final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these regulations.

### 2. Summary of Economic Effects

#### i. Regulations Relating to Foreign Tax Credits

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

To the extent that taxpayers would generally, in the absence of this final guidance, have interpreted the foreign tax credit rules as being less favorable to the taxpayer than the final regulations provide, the final regulations may result in additional international activity by these taxpayers relative to the no-action baseline. This additional activity may include both activities that are beneficial to the U.S. economy (perhaps because they represent enhanced international opportunities for businesses with U.S. owners) and activities that are not beneficial



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

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

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

#### ii. Regulations Relating to Hybrid Arrangements and Section 951A

These provisions of the final regulations provide certainty and clarity to taxpayers regarding (i) adjustments to hybrid deduction accounts under section 245A(e) and the 2020 hybrids final regulations; (ii) the determination of withholding taxes on payments made pursuant to conduit financing arrangements under § 1.881-3; and (iii) the allocation of deductions for certain payments between related CFCs for purposes of section 951A and the final regulations under section 951A.

In the absence of this clarity, the likelihood that different taxpayers would interpret the rules regarding hybrid arrangements and certain deductible payments under the final regulations under section 951A differently would be exacerbated. In general, overall economic performance is enhanced when businesses face more uniform signals about tax treatment. Certainty and clarity over tax treatment generally also reduce compliance costs for taxpayers.

For those statutory provisions for which similar taxpayers would generally adopt similar interpretations of the statute even in the absence of guidance, the final regulations provide value by helping to ensure that those interpretations are consistent with the intent and purpose of the statute. Because the tax treatment in these final regulations advances the intent and purpose of the statute, this guidance enhances U.S. economic performance, relative to the no-action baseline or alternative regulatory approaches, within the context of Congressional intent.

These provisions of the final regulations will further enhance U.S. economic performance by helping to ensure that similar economic arrangements face similar tax treatments. Disparate tax treatment of similar economic transactions may create economic inefficiencies by leading taxpayers to undertake less productive economic activities.

The Treasury Department and the IRS have not undertaken quantitative estimates of the economic effects of these provisions of the final regulations because they do not have readily available data or models to estimate with reasonable precision (i) the types or volume of hybrid arrangements or certain disqualified payments between related CFCs that would likely be covered under these regulations, under the no-action baseline, or under alternative regulatory approaches; or (ii) the effects of those hybrid arrangements or disqualified payments on businesses' overall economic performance, including possible differences in compliance costs.

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

#### iii. Summary of Economic Effects of All Provisions

The Treasury Department and the IRS project that the final regulations will have economic effects greater than \$100 million per year (\$2020) relative to the no-action baseline. This determination is based on the substantial size of many of the businesses potentially affected by these regulations and the general responsiveness of business activity to effective tax rates,<sup>7</sup> one component of

which is the creditability of foreign taxes. Based on these two magnitudes, even modest changes in the treatment of foreign taxes or the allocation of deductions between related CFCs provided by the final regulations, relative to the no-action baseline, can be expected to have annual effects greater than \$100 million (\$2020).

### 3. Economic Effects of Specific Provisions

#### i. Rules for Allocating R&E Expenditures Under the Sales Method

##### a. Background

Under long-standing foreign tax credit rules, taxpayers must allocate expenditures to income categories. In the case of research and experimentation (R&E) expenditures, taxpayers can elect between a "sales method" and a "gross income method" to allocate the R&E expenses.<sup>8</sup>

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

The gross income method is based on a different apportionment factor (gross income) as compared to the sales method (gross receipts). However, the gross income method is subject to certain conditions that require the result to be within a certain band around the result under the sales method, because historically the Treasury Department and the IRS have considered that the gross income method could lead to anomalous results and could be more easily manipulated than the sales

*Economic Review* 2017, 107(1): 217–48 and articles cited therein.

<sup>8</sup> If the taxpayer chooses the gross income method, 25 percent of the R&E expenditures are exclusively apportioned to the source where more than 50 percent of the taxpayer's R&E activities occur (generally the United States), and the other 75 percent is apportioned ratably. If a taxpayer chooses the sales method then 50 percent of the R&E expenditures are exclusively apportioned on the same basis, and the other 50 percent is apportioned ratably.

<sup>7</sup> See E. Zwick and J. Mahon, "Tax Policy and Heterogeneous Investment Behavior," at *American*

method.<sup>9</sup> The uncertainty with respect to R&E expense allocation under the sales method needed resolution, and because the gross income method is tied to the sales method, any changes to the sales method required consideration of the gross income method.

#### b. Options Considered for the Final Regulations

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

The final regulations adopt the third option. This option allows for the provision of an allocation and apportionment method for R&E expenditures that generally matches the expense reasonably with the income it generates. The matching of income and expenses generally produces a more efficient tax system contingent on the overall Code relative to the alternative options. Additionally, because this option results in no R&E expense being allocated to section 951A category income, it does not incentivize taxpayers with excess credits (which cannot be carried over to prior or future taxable years and therefore become unusable) in the section 951A category to perform R&E through foreign subsidiaries; instead, the chosen option generally incentivizes choosing the location of R&E based on economic considerations rather than tax-related reasons, contingent on the overall Code. Finally, because the final regulations

<sup>9</sup>The gross income method is more susceptible to manipulation because taxpayers can manage the type and amount of their foreign gross income by, for example, not paying a dividend and because presuming a factual relationship between the R&E expenditure and the related class of income based on the relative amounts of a taxpayer's gross income was more attenuated than a factual relationship based on sales.

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

#### c. Number of Affected Taxpayers

The Treasury Department and the IRS have determined that the population of affected taxpayers consists of any U.S. taxpayer with R&E expenditures and foreign operations. There are around 2,500 such taxpayers in currently available tax filings from tax year 2018. Based on Statistics of Income data, approximately \$40 billion of R&E expenses of such taxpayers were allocated to foreign source income, out of a total of \$190 billion in qualified research expenses reported by such taxpayers.<sup>10</sup>

#### ii. Application of Section 905(c) to Changes Affecting the High-Tax Exception

##### a. Background

Section 905(c) provides special rules for a foreign tax redetermination (FTR), which is when the amount of foreign tax paid in an earlier year (origin year) is changed in a later year (FTR year). This redetermination may be necessary, for example, because the taxpayer gets a refund or because a foreign audit determines that the taxpayer owes additional foreign tax. Since these additional taxes (or refunds) relate to the origin year, an FTR affects a taxpayer's origin year tax position (as well as FTC carryovers from that year). Before the TCJA, FTRs of foreign corporations generally resulted in prospective "pooling adjustments" to foreign tax credits. Under this approach, taxpayers simply added to or reduced the amount of foreign taxes in their foreign subsidiary's FTC "pool" going forward rather than amend the deemed paid taxes claimed on their origin year return. TCJA eliminated the pooling mechanism for taxes (because the adoption of a participation exemption system along with the elimination of deferral made it unnecessary) and replaced it with a system where taxes are deemed paid each year with an inclusion or distribution of previously taxed earnings and profits ("PTEP").

The 2019 FTC final regulations make clear that an FTR of a United States

<sup>10</sup>Note, however, that these taxpayers might have additional R&E expenses which are not qualified R&E expenses. The tax data do not separately identify such expenses.

taxpayer must always be accounted for in the origin year, and that the taxpayer must file an amended return reflecting any resulting change in the taxpayer's U.S. tax liability.

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

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

#### b. Options Considered for the Final Regulations

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

The final regulations adopt the second option. The first option would lead to frequent occurrences of inaccurate results with respect to the GILTI and subpart F high-tax exceptions because it is common for foreign audits to change the amount of tax paid in a prior

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

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

#### c. Number of Affected Taxpayers

The Treasury Department and the IRS determined that the final regulations potentially affect those U.S. taxpayers that pay foreign taxes and have a redetermination of that tax. Although data reporting the number of taxpayers subject to an FTR in a given year are not readily available, some taxpayers currently subject to FTRs will file amended returns. The Treasury Department and the IRS estimate that there were between 8,900 and 13,500 taxpayers with foreign affiliates that filed amended returns in 2018. However, the elimination of the pooling mechanism and the expanded incidence of deemed paid taxes in connection with the GILTI regime may significantly increase the number of taxpayers filing amended returns, and the expansion of the section 905(c) requirement to file an amended return to instances where a FTR changes eligibility for the high-tax exception under GILTI or subpart F (but does not affect the taxpayer's foreign tax credit) has the potential to modestly increase that number. The Treasury Department and the IRS have determined that a high upper bound for the number of taxpayers subject to a FTR that will be required to file amended returns (that is, taxpayers

affected by this provision) can be derived by estimating the number of taxpayers with a potential GILTI or subpart F inclusion. Based on currently available tax filings for taxable year 2018, there were about 16,500 C corporations with CFCs that filed at least one Form 5471 with their Form 1120 return. In addition, for the same year, there were about 41,000 individuals with CFCs that e-filed at least one Form 5471 with their Form 1040 return.

In 2018, there were about 3,250 S corporations with CFCs that filed at least one Form 5471 with their 1120S return. The identified S corporations had an estimated 23,000 shareholders. Finally, the Treasury Department and the IRS estimate that there were approximately 7,500 U.S. partnerships with CFCs that e-filed at least one Form 5471 as Category 4 or 5 filers in 2018. The identified partnerships had approximately 1.7 million partners, as indicated by the number of Schedules K-1 filed by the partnerships. This number includes both domestic and foreign partners, so it substantially overstates the number of partners that would actually be affected by the final regulations because it includes foreign partners.

#### iii. Extension of the Partnership Loan Rule to Loans From the Partnership to a U.S. Partner

##### a. Background

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

##### b. Options Considered for the Final Regulations

The Treasury Department and the IRS considered two options with respect to this rule. The first option was to not provide a rule, because the abuse the Treasury Department and the IRS were concerned about was not relevant with respect to loans from the partnership to the partner. In the absence of a matching

rule, the U.S. partner's U.S. source taxable income would be artificially increased but this income is not eligible to be sheltered by FTCs. The second option was to provide an identical rule for loans from the partnership to the partner as was provided in the 2019 FTC final regulations for loans from the partner to the partnership. The final regulations adopt the second option. This symmetry helps to ensure that similar economic transactions are treated similarly.

##### c. Number of Affected Taxpayers

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

#### iv. Section 245A(e)—Adjustment of Hybrid Deduction Account

##### a. Background

Under the 2020 hybrids final regulations, taxpayers must maintain hybrid deduction accounts to track income of a CFC that was sheltered from foreign tax due to hybrid arrangements, so that it may be included in U.S. income under section 245A(e) when paid as a dividend. The final regulations address how hybrid deduction accounts should be adjusted to account for earnings and profits of a CFC included in U.S. income due to certain provisions other than section 245A(e). The final regulations provide rules reducing a hybrid deduction account for three categories of inclusions: subpart F inclusions, GILTI inclusions, and inclusions under sections 951(a)(1)(B) and 956.

##### b. Options Considered for the Final Regulations

One option for addressing the treatment of earnings and profits included in U.S. income due to provisions other than section 245A(e) would be to not issue additional guidance beyond current tax rules and thus not to adjust hybrid deduction accounts to account for such inclusions. This would be the simplest approach among those considered, but under this approach, some income could be subject to double taxation in the United States. For example, if no adjustment is made, to the extent that a CFC's earnings and profits were sheltered from foreign tax as a result of certain hybrid arrangements, the section 245A DRD would be disallowed for an amount of

dividends equal to the amount of the sheltered earnings and profits, even if some of the sheltered earnings and profits were included in the income of a U.S. shareholder under the subpart F rules. The U.S. shareholder would be subject to tax on both the dividends and on the subpart F inclusion. Owing to this double taxation, the final regulations do not adopt this approach.

A second option would be to reduce hybrid deduction accounts by amounts included in gross income under the three categories; that is, without regard to deductions or credits that may offset the inclusion. While this option is also relatively simple, it could lead to double non-taxation and thus would give rise to results not intended by the statute. Subpart F and GILTI inclusions may be offset by—and thus may not be fully taxed in the United States as a result of—foreign tax credits and, in the case of GILTI, the section 250 deduction.<sup>11</sup> Therefore, this option for reducing hybrid deduction accounts may result in some income that was sheltered from foreign tax due to hybrid arrangements also escaping full U.S. taxation. This double non-taxation is economically inefficient because otherwise similar activities are taxed differently, potentially leading to inefficient business decisions.

A third option, which is the option finalized by the Treasury Department and the IRS, is to reduce hybrid deduction accounts by the amount of the inclusions from the three categories, but only to the extent that the inclusions are likely not offset by foreign tax credits or, in the case of GILTI, the section 250 deduction. For subpart F and GILTI inclusions, the final regulations stipulate adjustments to be made to account for the foreign tax credits and the section 250 deduction available for GILTI inclusions. These adjustments are intended to provide a precise, administrable manner for measuring the extent to which a subpart F or GILTI inclusion is included in U.S. income and not shielded by foreign tax credits or deductions. This option results in an outcome aligned with statutory intent, as it generally ensures that the section 245A DRD is disallowed (and thus a dividend is included in U.S. income without any regard for foreign tax credits) only for amounts that were sheltered from foreign tax by reason of a hybrid arrangement but that have not yet been subject to U.S. tax.

Relative to a no-action baseline, these final regulations provide taxpayers with new instructions regarding how to adjust hybrid deduction accounts to account for earnings and profits that are included in U.S. income by reason of certain provisions other than section 245A(e). This new instruction avoids possible double taxation. Double taxation is inconsistent with the intent and purpose of the statute and is economically inefficient because it may result in otherwise similar income streams facing different tax treatment, incentivizing taxpayers to finance operations with specific income streams and activities that may not be the most economically productive.

The Treasury Department and the IRS have not estimated the difference in compliance costs under each of the three options for the treatment of earnings and profits included in U.S. income due to provisions other than section 245A(e) because they do not have readily available data or models that can provide such estimates.

#### c. Number of Affected Taxpayers

The Treasury Department and IRS estimate that this provision will impact an upper bound of approximately 2,000 taxpayers. This estimate is based on the top 10 percent of taxpayers (by gross receipts) that filed a domestic corporate income tax return for tax year 2017 with a Form 5471 attached, because only domestic corporations that are U.S. shareholders of CFCs are potentially affected by section 245A(e).<sup>12</sup>

This estimate is an upper bound on the number of large corporations affected because it is based on all transactions, even though only a portion of such transactions involve hybrid arrangements. The tax data do not report whether these reported dividends were part of a hybrid arrangement because such information was not relevant for calculating tax before the TCJA. In addition, this estimate is an upper bound because the Treasury Department and the IRS anticipate that fewer taxpayers would engage in hybrid arrangements going forward as the statute and § 1.245A(e)-1 would make such arrangements less beneficial to taxpayers. Further, it is anticipated that the final regulations will result in only a small increase in compliance costs for those taxpayers who do engage in hybrid arrangements (relative to the

baseline) because a reduction to hybrid deduction accounts under these final regulations generally uses information required to be computed under other provisions of the Code.

#### v. Conduit Financing Regulations To Address Hybrid Instruments

##### a. Background

The conduit financing regulations allow the IRS to disregard intermediate entities in a multiple-party financing arrangement for the purposes of determining withholding tax rates if the instruments used in the arrangement are considered “financing transactions.” Financing transactions generally exclude instruments that are treated as equity for U.S. tax purposes unless they have significant redemption-type features. Thus, in the absence of further guidance, the conduit financing regulations would not apply to an equity instrument in the absence of such features. This would allow payments made under these arrangements to continue to be eligible for reduced withholding tax rates through a conduit structure.

##### b. Options Considered for the Final Regulations

One option for addressing the current disparate treatment would be to not change the conduit financing regulations, which currently treat equity as a financing transaction only if it has specific redemption-type features; this is the no-action baseline. This option is not adopted by the Treasury Department and the IRS, since it is inconsistent with the Treasury Department’s and the IRS’s ongoing efforts to address financing transactions that use hybrid instruments, as discussed in the 2008 proposed regulations.

A second option, which is adopted in the final regulations, is to treat as a financing transaction an instrument that is equity for U.S. tax purposes but debt under the tax law of the issuer’s jurisdiction of residence or, if the issuer is not a tax resident of any country, the tax law of the country in which the issuer is created, organized or otherwise established. This approach will prevent taxpayers from using this type of hybrid instrument to engage in treaty shopping through a conduit jurisdiction. However, this approach does not cover certain cases, such as if a jurisdiction offers a tax benefit to non-debt instruments (for example, a notional interest deduction with respect to equity). The Treasury Department and the IRS adopt this second option in these final regulations because it will, in a manner that is clear and

<sup>11</sup> Deductions or credits are not available to offset income inclusions under sections 951(a)(1)(B) and 956, the third category of income inclusions that reduce hybrid deduction accounts addressed by these final regulations.

<sup>12</sup> Because of the complexities involved, primarily only large taxpayers engage in hybrid arrangements. The estimate that the top 10 percent of otherwise-relevant taxpayers (by gross receipts) are likely to engage in hybrid arrangements is based on the judgment of the Treasury Department and IRS.

administrable, prevent a basic form of inappropriate avoidance of the conduit financing regulations.

A third option considered, which was proposed in the 2020 hybrids proposed regulations, would be to treat as a financing transaction any instrument that is equity for U.S. tax purposes and which entitles its issuer or its shareholder a deduction or similar tax benefit in the issuer's resident jurisdiction or in the jurisdiction where the resident has a permanent establishment. This rule would be broader than the second option. It would cover all instruments that give rise to deductions or similar tax benefits, such as credits, rather than only those instruments that are treated as debt under foreign law. This rule would also cover instruments where a financing payment is attributable to a permanent establishment of the issuer, and the tax law of the permanent establishment's jurisdiction allows a deduction or similar treatment for the instrument. This approach would prevent issuers from routing transactions through their permanent establishments to avoid the anti-conduit rules. The Treasury Department and the IRS did not adopt this third option in these final regulations. As discussed in Part III.B of the Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS plan to finalize this rule separately to allow additional time to consider the comments received.

Relative to a no-action baseline, the final regulations are likely to incentivize some taxpayers to shift away from conduit financing arrangements and hybrid arrangements, a shift that is likely to result in little to no overall economic loss, or even an economic gain, because conduit arrangements are generally not economically productive arrangements and are typically pursued only for tax-related reasons. The Treasury Department and the IRS recognize, however, that as a result of these provisions, some taxpayers may face a higher effective tax rate, which may lower their economic activity.

The Treasury Department and the IRS have not undertaken more precise quantitative estimates of either of these economic effects because they do not have readily available data or models to estimate with reasonable precision: (i) The types or volume of conduit arrangements that taxpayers would likely use under the final regulations or under the no-action baseline; or (ii) the effects of those arrangements on businesses' overall economic performance, including possible differences in compliance costs.

#### c. Number of Affected Taxpayers

The Treasury Department and the IRS estimate that the number of taxpayers potentially affected by the final conduit financing regulations will be an upper bound of approximately 7,000 taxpayers. This estimate is based on the top 10 percent of taxpayers (by gross receipts) that filed a domestic corporate income tax return with a Form 5472, "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business," attached because primarily foreign entities that advance money or other property to a related U.S. entity through one or more foreign intermediaries are potentially affected by the conduit financing regulations.<sup>13</sup>

This estimate is an upper bound on the number of large corporations affected because it is based on all domestic corporate arrangements involving foreign related parties, even though only a portion of such arrangements are conduit financing arrangements that use hybrid instruments. The tax data do not report whether these arrangements were part of a conduit financing arrangement because such information is not provided on tax forms. In addition, this estimate is an upper bound because the Treasury Department and the IRS anticipate that fewer taxpayers would engage in conduit financing arrangements that use hybrid instruments going forward as the proposed conduit financing regulations would make such arrangements less beneficial to taxpayers.

#### vi. Rules Under Section 951A To Address Certain Disqualified Payments Made During the Disqualified Period

##### a. Background

The final section 951A regulations include a rule that addresses certain transactions involving disqualified transfers of property between related CFCs during the disqualified period that may have the effect of reducing GILTI inclusions due to timing differences between when income is included and when resulting deductions, such as depreciation expenses, are claimed. The disqualified period of a CFC is the period between December 31, 2017, which is the last earnings and profits measurement date under section 965, and the beginning of the CFC's first

taxable year that begins after December 31, 2017, which is the first taxable year with respect to which section 951A is effective. The final regulations refine this rule to extend its applicability to other transactions for which similar timing differences can arise.

##### b. Options Considered for the Final Regulations

The Treasury Department and the IRS considered two options with respect to providing a rule that would apply to certain transactions during the disqualified period in addition to disqualified transfers. The first option was to not provide a rule that would apply to additional transactions. This option was not adopted in the final regulations, since it would result in certain transactions involving payments during the disqualified period giving rise to reduced GILTI inclusions simply due to timing differences. In addition, this option would not provide a similar tax treatment for transactions involving payments as for disqualified transfers of property occurring during the disqualified period.

The second option, which is the option adopted in the final regulations, is to provide an identical rule for disqualified payments between related CFCs as was provided in the section 951A final regulations for disqualified transfers of property between related CFCs during the disqualified period. This symmetry helps to ensure that similar economic transactions are treated similarly.

In the absence of such a rule, certain payments between related CFCs made during the disqualified period may give rise to lower income inclusions for their U.S. shareholders. For example, suppose that a CFC licensed property to a related CFC for ten years and received pre-payments of royalties during the disqualified period from the related CFC. Since these prepayments were received by the licensor CFC during the disqualified period, they would not have affected amounts included under section 965 nor given rise to GILTI tested income. However, the licensee CFC that made the payments would not have claimed the total of the corresponding deductions during the disqualified period, since the timing of deductions are generally tied to economic performance over the period of use. The licensee CFC would claim deductions over the ten years of the contract, and since these deductions would be claimed during taxable years when section 951A is in effect, these deductions would reduce GILTI tested income or increase GILTI tested loss. Thus, this type of transaction could

<sup>13</sup> Because of the complexities involved, primarily only large taxpayers engage in conduit financing arrangements. The estimate that the top 10 percent of otherwise-relevant taxpayers (by gross receipts) are likely to engage in conduit financing arrangements is based on the judgment of the Treasury Department and IRS.

lower overall income inclusions for the U.S. shareholder of these CFCs in a manner that does not accurately reflect the earnings of the CFCs over time.

Under the final regulations, all deductions attributable to disqualified payments to a related CFC during the disqualified period are allocated and apportioned to residual CFC gross income. These deductions will not thereby reduce tested, subpart F or effectively connected income. This rule provides similar treatment to transactions involving payments as the rule in the section 951A final regulations provides to property transfers between related CFCs during the disqualified period.

Relative to a no-action baseline, the final regulations harmonize the treatment of similar transactions. Since this rule applies to deductions resulting from transactions that occurred during the disqualified period and not to any new transactions, the Treasury Department and the IRS do not expect changes in taxpayer behavior under the final regulations, relative to the no-action baseline.

#### c. Number of Affected Taxpayers

The Treasury Department and the IRS estimate that the number of taxpayers potentially affected by this rule will be an upper bound of approximately 25,000 to 35,000 taxpayers. This estimate is based on filers of income tax returns with a Form 5471 attached because only filers that are U.S. shareholders of CFCs or that have at least a 10 percent ownership in a foreign corporation would be subject to section 951A. This estimate is an upper bound because it is based on all filers subject to section 951A, even though only a portion of such taxpayers may have engaged in the pre-payment transactions during the disqualified period described in the proposed regulations. Therefore, the Treasury Department and the IRS estimate that the number of taxpayers potentially affected by this rule will be substantially less than 25,000 to 35,000 taxpayers.

## II. Paperwork Reduction Act

### A. Regulations Relating to Foreign Tax Credits

For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (“PRA”), there is a collection of information in §§ 1.905–4 and 1.905–5(b) and (e). When a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination (FTR), the final regulations generally require the taxpayer to notify the IRS of the FTR and provide certain information

necessary to redetermine the U.S. tax due for the year or years affected by the FTR. If there is no change in the U.S. tax liability as a result of the FTR or if the FTR is caused by certain de minimis fluctuations in foreign currency rates, the taxpayer may simply attach the notification to their next filed tax return and make any appropriate adjustments in that year. However, taxpayers are generally required to file an amended return (or an administrative adjustment request in the case of certain partnerships) for the year or years affected by the FTR along with an updated Form 1116 Foreign Tax Credit (Individual, Estate, or Trust) (covered under OMB Control Number 1545–0074 individual, or 1545–0121 and 1545–0092 estate and trust) or Form 1118 Foreign Tax Credit-Corporations (OMB Control Number 1545–0123), and a written statement providing specific information relating to the FTR (covered under OMB Control Number 1545–1056). Since the burden for filing amended income tax returns and the Forms 1116 and 1118 is covered under the OMB Control Numbers listed in the prior sentence, the burden estimates for OMB Control Number 1545–1056 only cover the burden for the written statements. Sections 1.905–5(b) and 1.905–5(e) only apply to foreign tax redeterminations of foreign corporations that relate to a taxable year of the foreign corporation beginning before January 1, 2018. Section 1.905–4 applies to all other foreign tax redeterminations. Section 1.905–5(b) and (e) reference the same notification and information requirements as § 1.905–4, subject to certain modifications.

For purposes of the PRA, the reporting burden associated with §§ 1.905–4 and 1.905–5(b) and (e) will be reflected in the PRA submission associated with OMB control number 1545–1056, which is set to expire on December 31, 2020. The number of respondents to this collection was estimated to be in a range from 8,900 to 13,500 and the total estimated burden time was estimated to be 56,000 hours and total estimated monetized costs of \$2,583,840 (\$2017). The IRS will be requesting a revision of the paperwork burden under OMB control number 1545–1056 prior to its expiration date.

For taxpayers who are required to file an amended return (along with related Form 1116 or Form 1118) in order to report an FTR, and for purposes of the PRA, the reporting burden for filing the amended return will be reflected in OMB control numbers 1545–0123 (relating to business filers, which represents a total estimated burden time, including all related forms and

schedules, of 3.344 billion hours and total estimated monetized costs of \$61.558 billion (\$2019)), 1545–0074 (relating to individual filers, which represents a total estimated burden time, including all related forms and schedules, of 1.717 billion hours and total estimated monetized costs of \$33.267 billion (\$2019)), 1545–0092 (relating to estate and trust filers with respect to all related forms and schedules except Form 1116, which represents a total estimated burden time, including all related forms and schedules except Form 1116, of 307,844,800 hours and total estimated monetized costs of \$14.077 billion (\$2018)), and 1545–0121 (relating to estate and trust filers but solely with respect to Form 1116, which represents a total estimated burden time related solely to Form 1116 of 25,066,693 hours and total estimated monetized costs of \$1.744 billion (\$2018)). In general, burden estimates for OMB control numbers 1545–0123 and 1545–0074 include, and therefore do not isolate, the estimated burden of the foreign tax credit-related forms. These reported burdens are therefore insufficient for future calculations of the burden imposed by the final regulations. However, with respect to estate and trust filers (OMB control numbers 1545–0121 and 1545–0092) the burdens with respect to foreign tax credit-related forms are isolated in OMB control number 1545–0121 which relates solely to Form 1116, and, therefore may be sufficient to determine future burdens imposed by the final regulations. These particular burden estimates, except OMB control number 1545–0121, have also been reported for other regulations related to the taxation of cross-border income and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burden that international tax provisions imposed prior to the TCJA.

As a result of the changes made in the TCJA to the foreign tax credit rules generally, and to section 905(c) specifically, the Treasury Department and the IRS anticipate that the number of respondents may increase among taxpayers who file Form 1120 series returns. The possible increase in the number of respondents is due to the increase in foreign tax credits claimed by taxpayers in connection with the new GILTI regime and the elimination of adjustments to pools of post-1986 earnings and profits and post-1986 foreign income taxes as an alternative to filing an amended return following the changes made in the TCJA. These

changes to the burden estimate will be reflected in the PRA submission for the renewal of OMB control number 1545-1056 as well as in the OMB control numbers 1545-0074 (for individuals) and 1545-0123 (for business taxpayers).

The estimates for the number of impacted filers with respect to the collections of information described in this Part II of the Special Analyses are based on filers of income tax returns that file a Form 1065, Form 1040, or

Form 1120 series for years 2015 through 2017 because only filers of these forms are generally subject to the collection of information requirement. The IRS estimates the number of impacted filers to be the following:

TAX FORMS IMPACTED

Collection of information	Number of respondents (estimated)	Forms to which the information may be attached
§ 1.905-4 .....	8,900—13,500	Form 1065 series, Form 1040 series, and Form 1120 series.
§ 1.905-5(b) .....	8,900—13,500	Form 1065 series, Form 1040 series, and Form 1120 series.
§ 1.905-5(e) .....	8,900—13,500	Form 1065 series, Form 1040 series, and Form 1120 series.

Source: IRS data (MeF, DCS, and Compliance Data Warehouse).

No burden estimates specific to the final regulations are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the final regulations. Those estimates would capture both changes made by the TCJA and those that arise out of discretionary authority exercised in the final regulations.

The Treasury Department and the IRS request comments on all aspects of the forms that reflect the information collection burdens related to the final regulations, including estimates for how much time it would take to comply with the paperwork burdens related to the forms described and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collections related to the final regulations will be made available for public comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.html> and will not be finalized until after these forms have been approved by OMB under the PRA.

*B. Regulations Relating to Hybrid Arrangements and Section 951A*

Pursuant to § 1.6038-2(f)(14), certain U.S. shareholders of a CFC must provide information relating to the CFC and the rules of section 245A(e) on Form 5471, “Information Return of U.S. Persons With Respect to Certain Foreign Corporations,” (OMB control number 1545-0123), as the form or other

guidance may prescribe. The final regulations do not impose any additional information collection requirements relating to section 245A(e). However, the final regulations provide guidance regarding certain computations required under section 245A(e), and such could affect the information required to be reported on Form 5471. For purposes of the PRA, the reporting burden associated with § 1.6038-2(f)(14) is reflected in the PRA submission for Form 5471. See the chart at the end of this Part II.B of this Special Analyses section for the status of the PRA submission for Form 5471. As described in the Special Analyses section in the 2020 hybrids final regulations, and as set forth in the chart below, the Treasury Department and the IRS estimate the number of affected filers to be 2,000.

Pursuant to § 1.6038-5, certain U.S. shareholders of a CFC must provide information relating to the CFC and the U.S. shareholder’s GILTI inclusion under section 951A on new Form 8992, “U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI),” (OMB control number 1545-0123), as the form or other guidance may prescribe. The final regulations do not impose any additional information collection requirements relating to section 951A. However, the final regulations provide guidance regarding computations required under section 951A for taxpayers who engaged in certain transactions during the disqualified period, and such guidance

could affect the information required to be reported by these taxpayers on Form 8992. For purposes of the PRA, the reporting burden associated with the collection of information under § 1.6038-5 is reflected in the PRA submission for Form 8992. See the chart at the end of this Part II.B of the Special Analyses for the status of the PRA submission for Form 8992. As discussed in the Special Analyses of the preamble to the proposed regulations under section 951A (REG-104390-18, 83 FR 51072), and as set forth in the chart below, the Treasury Department and the IRS estimate the number of filers subject to § 1.6038-5 to be 25,000 to 35,000. Since the final regulations only apply to taxpayers who engaged in certain transactions during the disqualified period, the Treasury Department and the IRS estimate that the number of filers affected by the final regulations and subject to the collection of information in § 1.6038-5 will be significantly less than 25,000 to 35,000.

There is no existing collection of information relating to conduit financing arrangements, and the final regulations do not impose any new information collection requirements relating to conduit financing arrangements. Therefore, a PRA analysis is not required with respect to the final regulations relating to conduit financing arrangements. As a result, the Treasury Department and the IRS estimate the number of filers affected by the final regulations for hybrid arrangements and section 951A to be the following.

TAX FORMS IMPACTED

Collection of information	Number of respondents (estimated, rounded to nearest 1,000)	Forms in which information may be collected
§ 1.6038-2(f)(14) .....	2,000	Form 5471 (Schedule I).
§ 1.6038-5 .....	25,000—35,000	Form 8992.

Source: IRS data (MeF, DCS, and Compliance Data Warehouse).

The current status of the PRA submissions related to the tax forms associated with the information collections in §§ 1.6038–2(f)(14) and 1.6038–5 is provided in the accompanying table. The reporting burdens associated with the information collections in §§ 1.6038–2(f)(14) and 1.6038–5 are included in the aggregated burden estimates for OMB control number 1545–0123, which represents a total estimated burden time for all forms and schedules for corporations of 3.157 billion hours and total estimated monetized costs of \$58.148 billion (\$2017). The overall burden estimates provided in 1545–0123 are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and are therefore not

suitable for future calculations needed to assess the burden specific to certain regulations, such as the information collections under § 1.6038–2(f)(14) or § 1.6038–5.

No burden estimates specific to the final regulations are currently available. The Treasury Department and the IRS have not identified any burden estimates, including those for new information collections, related to the requirements under the final regulations. The Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Changes in those estimates from the estimates reported here will capture both changes made by the TCJA and those that arise

out of discretionary authority exercised in the final regulations.

The Treasury Department and the IRS request comments on the forms that reflect the information collection burdens related to the final regulations, including estimates for how much time it would take to comply with the paperwork burdens related to the forms described and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collections related to the final regulations will be made available for public comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.html> and will not be finalized until after these forms have been approved by OMB under the PRA.

Form	Type of filer	OMB No.(s)	Status
Form 5471 .....	Business (NEW Model) .....	1545–0123	Approved by OIRA 1/30/2020 until 1/31/2021.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001</a>		
Form 8992 .....	Individual (NEW Model) .....	1545–0074	Approved by OIRA 1/30/2020 until 1/31/2021.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021</a>		
Form 8992 .....	Business (NEW Model) .....	1545–0123	Approved by OIRA 1/30/2020 until 1/31/2021.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001</a>		

**III. Regulatory Flexibility Act**

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

*A. Regulations Relating to Foreign Tax Credits*

These final regulations provide guidance needed to comply with statutory changes and affect individuals and corporations claiming foreign tax credits. The domestic small business entities that are subject to the foreign tax credit rules in the Code and in these final regulations are generally those domestic small business entities that are at least 10 percent corporate shareholders of foreign corporations, and so are eligible to claim dividends-received deductions or compute foreign taxes deemed paid under section 960 with respect to inclusions under subpart F and section 951A from CFCs. Other aspects of these final regulations also affect domestic small business entities that operate in foreign jurisdictions or

that have income from sources outside of the United States. Based on 2017 Statistics of Income data, the Treasury Department and the IRS computed the fraction of taxpayers owning a CFC by gross receipts size class. The smaller size classes have a relatively small fraction of taxpayers that own CFCs, which suggests that many domestic small business entities would be unaffected by these regulations.

Many of the important aspects of these final regulations, including all of the rules in §§ 1.861–8(d)(2)(ii)(B), 1.904–4(c)(7), 1.904–6(f), 1.905–3(b)(2), 1.905–5, 1.954–1, 1.954–2, and 1.965–5(b)(2) apply only to U.S. persons that operate a foreign business in corporate form, and, in most cases, only if the foreign corporation is a CFC. Other provisions in these final regulations, including the rules in §§ 1.861–8(d)(2)(v) and (e)(16), 1.861–14, 1.1502–4, and 1.1502–21, generally apply only to members of a consolidated group and insurance companies or other members of the financial services industry earning income from sources outside of the United States. It is infrequent for domestic small entities to operate as

part of an affiliated group, to be taxed as an insurance company, or to constitute a financial services entity, and also earn income from sources outside of the United States. Consequently, the Treasury Department and the IRS expect that these final regulations are unlikely to affect a substantial number of domestic small business entities; however, adequate data are not available at this time to certify that a substantial number of small entities would be unaffected.

The Treasury Department and the IRS have determined that these final regulations will not have a significant economic impact on domestic small business entities. Based on published information from 2017, 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 for businesses in all categories of business receipts. The amount of foreign tax credits in 2017 is an upper bound on the change in foreign tax credits resulting from these final 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 .....	0.12%	0.00%	0.00%	0.01%	0.01%	0.01%	0.02%	0.28%
FTC/(Total Receipts-Total Deductions) .....	0.61%	0.03%	0.09%	0.05%	0.35%	0.71%	1.38%	9.89%
FTC/Business Receipts ...	0.84%	0.00%	0.00%	0.00%	0.01%	0.01%	0.02%	0.05%

Source: RAAS: KDA: (Tax Year 2017 SOI Data).

Although § 1.905-4 contains a collection of information requirement, the small businesses that are subject to the requirements of § 1.905-4 are domestic small entities with significant foreign operations. The data to assess precise counts of small entities affected by § 1.905-4 are not readily available. However, as demonstrated in the accompanying Table in this Part III, foreign tax credits do not have a significant economic impact for any gross-receipts class of business entities. Accordingly, it is hereby certified that the requirements of § 1.905-4 will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), the proposed regulations preceding these final regulations (REG-105495-19) were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses and no comments were received.

*B. Regulations Relating to Hybrid Arrangements and Section 951A*

The final regulations amend certain computations required under section 245A(e) or section 951A. As discussed in the Special Analyses accompanying the preambles to the 2020 hybrids final regulations and the proposed regulations under section 951A (REG-104390-18, 83 FR 51072), as well as in Part II.B of the Special Analyses, the Treasury Department and the IRS project that a substantial number of domestic small business entities will not be subject to sections 245A(e) and 951A, and therefore, the existing requirements in §§ 1.6038-2(f)(14) and 1.6038-5 will not have a significant economic impact on a substantial number of small entities.

The small entities that are subject to section 245A(e) and § 1.6038-2(f)(14) are controlling U.S. shareholders of a CFC that engage in a hybrid arrangement, and the small entities that are subject to section 951A and § 1.6038-5 are U.S. shareholders of a CFC. A CFC is a foreign corporation in which more than 50 percent of its stock is owned by U.S. shareholders, measured either by value or voting power. A U.S. shareholder is any U.S.

person that owns 10 percent or more of a foreign corporation’s stock, measured either by value or voting power, and a controlling U.S. shareholder of a CFC is a U.S. person that owns more than 50 percent of the CFC’s stock.

The Treasury Department and the IRS estimate that there are only a small number of taxpayers having gross receipts below either \$25 million (or \$41.5 million for financial entities) who would potentially be affected by these regulations.<sup>14</sup> The Treasury Department and the IRS’s estimate of those entities who could potentially be affected is based on their review of those taxpayers who filed a domestic corporate income tax return in 2016 with gross receipts below either \$25 million (or \$41.5 million for financial institutions) who also reported dividends on a Form 5471. The Treasury Department and the IRS estimate that this number is between 1 and 6 percent of all affected entities regardless of size.

The Treasury Department and the IRS cannot readily identify from these data amounts that are received pursuant to hybrid arrangements because those amounts are not separately reported on tax forms. Thus, dividends received as reported on Form 5471 are an upper bound on the amount of hybrid arrangements by these taxpayers.

The Treasury Department and the IRS estimated the upper bound of the relative cost of the statutory and regulatory hybrids provisions, as a percentage of revenue, for these taxpayers as (i) the statutory tax rate of 21 percent multiplied by dividends received as reported on Form 5471, divided by (ii) the taxpayer’s gross receipts. Based on this calculation, the Treasury Department and the IRS estimate that the upper bound of the relative cost of these statutory and regulatory provisions is above 3 percent for more than half of the small entities described in the preceding paragraph. Because this estimate is an upper bound, a smaller subset of these taxpayers (including potentially zero taxpayers) is likely to have a cost above three percent of gross receipts.

<sup>14</sup> This estimate is limited to those taxpayers who report gross receipts above \$0.

Pursuant to section 7805(f), the proposed regulations preceding these final regulations (REG-106013-19) were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses and no comments were received.

**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. 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 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.

**VI. Congressional Review Act**

The Administrator of the Office of Information and Regulatory Affairs of the OMB has determined that this Treasury decision is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 *et seq.*) (“CRA”). Under section 801(3) of the CRA, a major rule takes effect 60 days after the rule is published in the **Federal Register**. Accordingly, the Treasury Department and IRS are adopting these final regulations with the delayed

effective date generally prescribed under the Congressional Review Act.

**Drafting Information**

The principal authors of the final regulations are Corina Braun, Karen J. Cate, Jeffrey P. Cowan, Jorge M. Oben, Richard F. Owens, Jeffrey L. Parry, Tracy M. Vilecco, Suzanne M. Walsh, and Andrew L. Wigmore of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

**List of Subjects**

*26 CFR Part 1*

Income taxes, Reporting and recordkeeping requirements.

*26 CFR Part 301*

Income taxes, Penalties, Reporting and recordkeeping requirements.

**Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

**PART 1—INCOME TAXES**

■ **Paragraph 1.** The authority citation for part 1 is amended by revising the entry for § 1.861–14 and adding an entry for § 1.905–4 in numerical order to read in part as follows:

**Authority:** 26 U.S.C. 7805.

\* \* \* \* \*

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

\* \* \* \* \*

Section 1.905–4 also issued under 26 U.S.C. 989(c)(4), 26 U.S.C. 6227(d), 26 U.S.C. 6241(11), and 26 U.S.C. 6689(a).

\* \* \* \* \*

■ **Par. 2.** Section 1.245A(e)–1 is amended by:

- 1. Adding paragraphs (d)(4)(i)(B) and (d)(4)(ii).
- 2. Adding a sentence at the end of the introductory text of paragraph (g).
- 3. Adding paragraphs (g)(1)(v) and (h)(2).

The additions read as follows:

**§ 1.245A(e)–1 Special rules for hybrid dividends.**

\* \* \* \* \*

- (d) \* \* \*
- (4) \* \* \*
- (i) \* \* \*

(B) Second, the account is decreased (but not below zero) pursuant to the rules of paragraphs (d)(4)(i)(B)(1) through (3) of this section, in the order set forth in this paragraph (d)(4)(i)(B).

(1) *Adjusted subpart F inclusions—(i) In general.* Subject to the limitation in paragraph (d)(4)(i)(B)(1)(ii) of this section, the account is reduced by an

adjusted subpart F inclusion with respect to the share for the taxable year, as determined pursuant to the rules of paragraph (d)(4)(ii) of this section.

(ii) *Limitation.* The reduction pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section cannot exceed the hybrid deductions of the CFC allocated to the share for the taxable year multiplied by a fraction, the numerator of which is the sum of the items of gross income of the CFC that give rise to subpart F income (determined without regard to an amount treated as subpart F income by reason of section 964(e)(4)(A)(i), to the extent that a deduction under section 245A(a) is allowed for a portion of the amount included under section 964(e)(4)(A)(ii) in the gross income of a domestic corporation) of the CFC for the taxable year and the denominator of which is the sum of all the items of gross income of the CFC for the taxable year.

(iii) *Special rule allocating otherwise unused adjusted subpart F inclusions across accounts in certain cases.* This paragraph (d)(4)(i)(B)(1)(iii) applies after each of the specified owner’s hybrid deduction accounts with respect to its shares of stock of the CFC are adjusted pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section but before the accounts are adjusted pursuant to paragraph (d)(4)(i)(B)(2) of this section, to the extent that one or more of the hybrid deduction accounts would have been reduced by an amount pursuant to paragraph (d)(4)(i)(B)(1)(i) of this section but for the limitation in paragraph (d)(4)(i)(B)(1)(ii) of this section (the aggregate of the amounts that would have been reduced but for the limitation, the *unused reduction amount*, and the accounts that would have been reduced by the unused reduction amount, the *unused reduction amount accounts*). When this paragraph (d)(4)(i)(B)(1)(iii) applies, the specified owner’s hybrid deduction accounts other than the unused reduction amount accounts (if any) are ratably reduced by the lesser of the unused reduction amount and the difference of the following two amounts: The hybrid deductions of the CFC allocated to the specified owner’s shares of stock of the CFC for the taxable year multiplied by the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section; and the reductions pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section with respect to the specified owner’s shares of stock of the CFC.

(2) *Adjusted GILTI inclusions—(i) In general.* Subject to the limitation in paragraph (d)(4)(i)(B)(2)(ii) of this section, the account is reduced by an adjusted GILTI inclusion with respect to

the share for the taxable year, as determined pursuant to the rules of paragraph (d)(4)(ii) of this section.

(ii) *Limitation.* The reduction pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section cannot exceed the hybrid deductions of the CFC allocated to the share for the taxable year multiplied by a fraction, the numerator of which is the sum of the items of gross tested income of the CFC for the taxable year and the denominator of which is the sum of all the items of gross income of the CFC for the taxable year.

(iii) *Special rule allocating otherwise unused adjusted GILTI inclusions across accounts in certain cases.* This paragraph (d)(4)(i)(B)(2)(iii) applies after each of the specified owner’s hybrid deduction accounts with respect to its shares of stock of the CFC are adjusted pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section but before the accounts are adjusted pursuant to paragraph (d)(4)(i)(B)(3) of this section, to the extent that one or more of the hybrid deduction accounts would have been reduced by an amount pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section but for the limitation in paragraph (d)(4)(i)(B)(2)(ii) of this section (the aggregate of the amounts that would have been reduced but for the limitation, the *unused reduction amount*, and the accounts that would have been reduced by the unused reduction amount, the *unused reduction amount accounts*). When this paragraph (d)(4)(i)(B)(2)(iii) applies, the specified owner’s hybrid deduction accounts other than the unused reduction amount accounts (if any) are ratably reduced by the lesser of the unused reduction amount and the difference of the following two amounts: The hybrid deductions of the CFC allocated to the specified owner’s shares of stock of the CFC for the taxable year multiplied by the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section; and the reductions pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section with respect to the specified owner’s shares of stock of the CFC. See paragraph (g)(1)(v)(C) of this section for an illustration of the application of this paragraph (d)(4)(i)(B)(2)(iii).

(3) *Certain section 956 inclusions.* The account is reduced by an amount included in the gross income of a domestic corporation under sections 951(a)(1)(B) and 956 with respect to the share for the taxable year of the domestic corporation in which or with which the CFC’s taxable year ends, to the extent so included by reason of the application of section 245A(e) and this

section to the hypothetical distribution described in § 1.956-1(a)(2).

\* \* \* \* \*

(ii) *Rules regarding adjusted subpart F and GILTI inclusions.* (A) The term *adjusted subpart F inclusion* means, with respect to a share of stock of a CFC for a taxable year of the CFC, a domestic corporation's pro rata share of the CFC's subpart F income included in gross income under section 951(a)(1)(A) (determined without regard to an amount included in gross income by the domestic corporation by reason of section 964(e)(4)(A)(ii), to the extent a deduction under section 245A(a) is allowed for the amount) for the taxable year of the domestic corporation in which or with which the CFC's taxable year ends, to the extent attributable to the share (as determined under the principles of section 951(a)(2) and § 1.951-1(b) and (e)), adjusted (but not below zero) by—

(1) Adding to the amount the associated foreign income taxes with respect to the amount; and

(2) Subtracting from such sum the quotient of the associated foreign income taxes divided by the percentage described in section 11(b).

(B) The term *adjusted GILTI inclusion* means, with respect to a share of stock of a CFC for a taxable year of the CFC, a domestic corporation's GILTI inclusion amount (within the meaning of § 1.951A-1(c)(1)) for the U.S. shareholder inclusion year (within the meaning of § 1.951A-1(f)(7)), to the extent attributable to the share (as determined under paragraph (d)(4)(ii)(C) of this section), adjusted (but not below zero) by—

(1) Adding to the amount the associated foreign income taxes with respect to the amount;

(2) Multiplying such sum by the difference of 100 percent and the section 250(a)(1)(B)(i) deduction percentage; and

(3) Subtracting from such product the quotient of 80 percent of the associated foreign income taxes divided by the percentage described in section 11(b).

(C) A domestic corporation's GILTI inclusion amount for a U.S. shareholder inclusion year is attributable to a share of stock of the CFC based on a fraction—

(1) The numerator of which is the domestic corporation's pro rata share of the tested income of the CFC for the U.S. shareholder inclusion year, to the extent attributable to the share (as determined under the principles of § 1.951A-1(d)(2)); and

(2) The denominator of which is the aggregate of the domestic corporation's pro rata share of the tested income of

each tested income CFC (as defined in § 1.951A-2(b)(1)) for the U.S. shareholder inclusion year.

(D) The term *associated foreign income taxes* means—

(1) With respect to a domestic corporation's pro rata share of the subpart F income of the CFC included in gross income under section 951(a)(1)(A) and attributable to a share of stock of a CFC for a taxable year of the CFC, current year tax (as described in § 1.960-1(b)(4)) allocated and apportioned under § 1.960-1(d)(3)(ii) to the subpart F income groups (as described in § 1.960-1(b)(30)) of the CFC for the taxable year, to the extent allocated to the share under paragraph (d)(4)(ii)(E) of this section; and

(2) With respect to a domestic corporation's GILTI inclusion amount under section 951A attributable to a share of stock of a CFC for a taxable year of the CFC, the product of—

(i) Current year tax (as described in § 1.960-1(b)(4)) allocated and apportioned under § 1.960-1(d)(3)(ii) to the tested income groups (as described in § 1.960-1(b)(33)) of the CFC for the taxable year, to the extent allocated to the share under paragraph (d)(4)(ii)(F) of this section;

(ii) The domestic corporation's inclusion percentage (as described in § 1.960-2(c)(2)); and

(iii) The section 904 limitation fraction with respect to the domestic corporation for the U.S. shareholder inclusion year.

(E) Current year tax allocated and apportioned to a subpart F income group of a CFC for a taxable year is allocated to a share of stock of the CFC by multiplying the foreign income tax by a fraction—

(1) The numerator of which is the domestic corporation's pro rata share of the subpart F income of the CFC for the taxable year, to the extent attributable to the share (as determined under the principles of section 951(a)(2) and § 1.951-1(b) and (e)); and

(2) The denominator of which is the subpart F income of the CFC for the taxable year.

(F) Current year tax allocated and apportioned to a tested income group of a CFC for a taxable year is allocated to a share of stock of the CFC by multiplying the foreign income tax by a fraction—

(1) The numerator of which is the domestic corporation's pro rata share of tested income of the CFC for the taxable year, to the extent attributable to the share (as determined under the principles of § 1.951A-1(d)(2)); and

(2) The denominator of which is the tested income of the CFC for the taxable year.

(G) The term *section 904 limitation fraction* means, with respect to a domestic corporation for a U.S. shareholder inclusion year, a fraction—

(1) The numerator of which is the amount of foreign tax credits for the U.S. shareholder inclusion year that, by reason of sections 901 and 960(d) and taking into account section 904, the domestic corporation is allowed for the separate category set forth in section 904(d)(1)(A) (amounts includible in gross income under section 951A); and

(2) The denominator of which is the amount of foreign tax credits for the U.S. shareholder inclusion year that, by reason of sections 901 and 960(d) and without regard to section 904, the domestic corporation would be allowed for the separate category set forth in section 904(d)(1)(A) (amounts includible in gross income under section 951A).

(H) The term *section 250(a)(1)(B)(i) deduction percentage* means, with respect to a domestic corporation for a U.S. shareholder inclusion year, a fraction—

(1) The numerator of which is the amount of the deduction under section 250 allowed to the domestic corporation for the U.S. shareholder inclusion year by reason of section 250(a)(1)(B)(i) (taking into account section 250(a)(2)(B)); and

(2) The denominator of which is the domestic corporation's GILTI inclusion amount for the U.S. shareholder inclusion year.

\* \* \* \* \*

(g) \* \* \* No amounts are included in the gross income of US1 under section 951(a)(1)(A), 951A(a), or 951(a)(1)(B) and section 956.

(1) \* \* \*

(v) *Alternative facts—account reduced by adjusted GILTI inclusion.* The facts are the same as in paragraph (g)(1)(i) of this section, except that for taxable year 1 FX has \$130x of gross tested income and \$10.5x of current year tax (as described in § 1.960-1(b)(4)) that is allocated and apportioned under § 1.960-1(d)(3)(ii) to the tested income groups of FX. US1's ability to credit the \$10.5x of current year tax is not limited under section 904(a). In addition, FX has \$119.5x of tested income (\$130x of gross tested income, less the \$10.5x of current year tax deductions properly allocable to the gross tested income). Further, of US1's pro rata share of the tested income (\$119.5x), \$80x is attributable to Share A and \$39.5x is attributable to Share B (as determined under the principles of § 1.951A-1(d)(2)). Moreover, US1's net deemed tangible income return (as defined in § 1.951A-1(c)(3)) for taxable year 1 is \$71.7x, and US1 does not own any stock of a CFC

other than its stock of FX. Thus, US1's GILTI inclusion amount (within the meaning of § 1.951A-1(c)(1)) for taxable year 1, the U.S. shareholder inclusion year, is \$47.8x (net CFC tested income of \$119.5x, less net deemed tangible income return of \$71.7x) and US1's inclusion percentage (as described in § 1.960-2(c)(2)) is 40 (\$47.8x/\$119.5x). The deduction allowed to US1 under section 250 by reason of section 250(a)(1)(B)(i) is not limited as a result of section 250(a)(2)(B). At the end of year 1, US1's hybrid deduction account with respect to Share A is: First, increased by \$80x (the amount of hybrid deductions allocated to Share A); and second, decreased by \$10x (the sum of the adjusted GILTI inclusion with respect to Share A, and the adjusted GILTI inclusion with respect to Share B that is allocated to the hybrid deduction account with respect to Share A) to \$70x. See paragraphs (d)(4)(i)(A) and (B) of this section. In year 2, the entire \$30x of each dividend received by US1 from FX during year 2 is a hybrid dividend, because the sum of US1's hybrid deduction accounts with respect to each of its shares of FX stock at the end of year 2 (\$70x) is at least equal to the amount of the dividends (\$60x). See paragraph (b)(2) of this section. At the end of year 2, US1's hybrid deduction account with respect to Share A is decreased by \$60x (the amount of the hybrid deductions in the account that give rise to a hybrid dividend or tiered hybrid dividend during year 2) to \$10x. See paragraph (d)(4)(i)(C) of this section. Paragraphs (g)(1)(v)(A) through (C) of this section describe the computations pursuant to paragraph (d)(4)(i)(B)(2) of this section.

(A) To determine the adjusted GILTI inclusion with respect to Share A for taxable year 1, it must be determined to what extent US1's \$47.8x GILTI inclusion amount is attributable to Share A. See paragraph (d)(4)(ii)(B) of this section. Here, \$32x of the inclusion is attributable to Share A, calculated as \$47.8x multiplied by a fraction, the numerator of which is \$80x (US1's pro rata share of the tested income of FX attributable to Share A) and denominator of which is \$119.5x (US1's pro rata share of the tested income of FX, its only CFC). See paragraph (d)(4)(ii)(C) of this section. Next, the associated foreign income taxes with respect to the \$32x GILTI inclusion amount attributable to Share A must be determined. See paragraphs (d)(4)(ii)(B) and (D) of this section. Such associated foreign income taxes are \$2.8x, calculated as \$10.5x (the current year tax allocated and apportioned to the tested income groups of FX) multiplied by a fraction, the numerator of which is \$80x (US1's pro rata share of the tested income of FX attributable to Share A) and the denominator of which is \$119.5x (the tested income of FX), multiplied by 40% (US1's inclusion percentage), multiplied by 1 (the section 904 limitation fraction with respect to US1's GILTI inclusion amount). See paragraphs (d)(4)(ii)(D), (F), and (G) of this section. Thus, pursuant to paragraph (d)(4)(ii)(B) of this section, the adjusted GILTI inclusion with respect to Share A is \$6.7x, computed by—

(1) Adding \$2.8x (the associated foreign income taxes with respect to the \$32x GILTI

inclusion attributable to Share A) to \$32x, which is \$34.8x;

(2) Multiplying \$34.8x (the sum of the amounts in paragraph (g)(1)(v)(A)(1) of this section) by 50% (the difference of 100 percent and the section 250(a)(1)(B)(i) deduction percentage), which is \$17.4x; and

(3) Subtracting \$10.7x (calculated as \$2.24x (80% of the \$2.8x of associated foreign income taxes) divided by .21 (the percentage described in section 11(b)) from \$17.4x (the product of the amounts in paragraph (g)(1)(v)(A)(2) of this section), which is \$6.7x.

(B) Pursuant to computations similar to those discussed in paragraph (g)(1)(v)(A) of this section, the adjusted GILTI inclusion with respect to Share B is \$3.3x. However, the hybrid deduction account with respect to Share B is not reduced by such \$3.3x, because of the limitation in paragraph (d)(4)(i)(B)(2)(ii) of this section, which, with respect to Share B, limits the reduction pursuant to paragraph (d)(4)(i)(B)(2)(i) of this section to \$0 (calculated as \$0, the hybrid deductions allocated to the share for the taxable year, multiplied by 1, the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section (computed as \$130x, the sole item of gross tested income, divided by \$130x, the sole item of gross income)). See paragraphs (d)(4)(i)(B)(2)(i) and (ii) of this section.

(C) US1's hybrid deduction account with respect to Share A is reduced by the entire \$6.7x adjusted GILTI inclusion with respect to the share, as such \$6.7x does not exceed the limit in paragraph (d)(4)(i)(B)(2)(ii) of this section (\$80x, calculated as \$80x, the hybrid deductions allocated to the share for the taxable year, multiplied by 1, the fraction described in paragraph (d)(4)(i)(B)(2)(ii) of this section). See paragraphs (d)(4)(i)(B)(2)(i) and (ii) of this section. In addition, the hybrid deduction account is reduced by another \$3.3x, the amount of the adjusted GILTI inclusion with respect to Share B that is allocated to the hybrid deduction account with respect to Share A. See paragraph (d)(4)(i)(B)(2)(iii) of this section. As a result, pursuant to paragraph (d)(4)(i)(B)(2) of this section, US1's hybrid deduction account with respect to Share A is reduced by \$10x (\$6.7x plus \$3.3x).

\* \* \* \* \*

(h) \* \* \*

(2) *Special rules.* Paragraphs (d)(4)(i)(B) and (d)(4)(ii) of this section (decrease of hybrid deduction accounts; rules regarding adjusted subpart F and GILTI inclusions) apply to taxable years ending on or after November 12, 2020. However, a taxpayer may choose to apply paragraphs (d)(4)(i)(B) and (d)(4)(ii) of this section to a taxable year ending before November 12, 2020, so long as the taxpayer consistently applies paragraphs (d)(4)(i)(B) and (d)(4)(ii) of this section to that taxable year and any subsequent taxable year ending before November 12, 2020.

■ **Par. 3.** Section 1.704-1 is amended by:

■ 1. In paragraph (b)(1)(ii)(b)(1), revising the fourth sentence and adding a new fifth sentence.

■ 2. Revising paragraph (b)(4)(viii)(d)(1). The revisions and addition read as follows:

**§ 1.704-1 Partner's distributive share.**

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(ii) \* \* \*

(b) \* \* \*

(1) \* \* \*

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

\* \* \* \* \*

(4) \* \* \*

(viii) \* \* \*

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

\* \* \* \* \*

■ **Par. 4.** Section 1.861-8 is amended by:

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

■ 2. In paragraph (d)(1), removing the language “§ 1.1502-4(d)(1) and the last sentence of” in the fifth sentence and removing the last sentence.

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

- 4. Adding paragraph (d)(2)(v).
- 5. Revising paragraph (e)(4)(ii).
- 6. Redesignating paragraph (e)(5) as paragraph (e)(5)(i).
- 7. Adding a heading for paragraph (e)(5) and paragraphs (e)(5)(ii) and (iii).
- 8. Revising the first sentence of paragraph (e)(6)(i) and paragraphs (e)(7) and (8).
- 9. Adding paragraphs (e)(16) and (g)(15) through (18).
- 10. Revising paragraph (h).

The additions and revisions read as follows:

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

(a) \* \* \*

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

\* \* \* \* \*

(d) \* \* \*

(2) \* \* \*

(ii) \* \* \*

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

are eliminated from consideration in the apportionment of interest expense under the affiliated group rule set forth in § 1.861-11T(c), and in the apportionment of other expenses under the affiliated group rules set forth in § 1.861-14T.

\* \* \* \* \*

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

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

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

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

(1) *Example 1—(i) Facts.* U.S.C. is a domestic life insurance company that has \$300x of gross income, consisting of \$100x of foreign source general category income and \$200x of U.S. source passive category interest income,

\$100x; of the latter of which is tax-exempt interest income from municipal bonds under section 103. U.S.C.'s opening balance of its section 807(c) reserves is \$50,000x; and USP's closing balance of its section 807(c) reserves is \$50,130x. Under section 807(b)(1)(B), USP's closing balance of its section 807(c) reserves, \$50,130x, is reduced by the amount of the policyholder's share of tax-exempt interest. The policyholder's share of tax-exempt interest under section 812(b) is equal to 30 percent of the \$100x of tax-exempt interest (\$30x). Therefore, under sections 803(a)(2) and 807(b), USP's reserve deduction is \$100x (\$50,130x of reserve deduction minus \$30x (30 percent of \$100x of tax-exempt interest), minus \$50,000x). U.S.C. has no other income or deductions.

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

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

(2) *Example 2—(i) Facts.* U.S.C. is a domestic life insurance company that has \$300x of gross income consisting of \$10x of foreign source general category income and \$200x of U.S. source general category dividend income eligible for the 50% dividends received

deduction (DRD) under section 243(a)(1). Under section 805(a)(4)(A)(ii), U.S.C. is allowed a 50% DRD on the company's share of the dividend received. Under section 812(a), the company's share of the dividend is equal to 70% of the dividend income eligible for the DRD under section 243(a)(1), which results in a DRD of \$70x (50% × 70% × \$200), and under section 812(b), the policyholder's share of the dividend is equal to 30% of the dividend income eligible for the DRD under section 243(a)(1), which would result in a DRD of \$30x (50% × 30% × \$200x). U.S.C. is entitled to a \$130x deduction for an increase in its life insurance reserves under sections 803(a)(2) and 807(b). Unlike for tax-exempt interest income, there is no adjustment under section 807(b)(1)(B) to the reserve deduction for the policyholder's share of dividends that would be offset by the DRD under section 243(a)(1). U.S.C. has no other income or deductions.

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

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

deduction is \$100x of foreign source general category gross income and \$100x of U.S. source gross income. Of U.S.C.'s \$100x remaining reserve deduction, \$50x (\$100x × \$100x / \$200x) is apportioned to foreign source general category gross income and \$50x (\$100x × \$100x / \$200x) is apportioned to U.S. source gross income.

\* \* \* \* \*  
 (e) \* \* \*  
 (4) \* \* \*

(ii) *Stewardship expenses—(A) In general.* Stewardship expenses are those expenses resulting from “duplicative activities” (as defined in § 1.482-9(l)(3)(iii)) or “shareholder activities” (as defined in § 1.482-9(l)(3)(iv)) that are undertaken for a person's own benefit as an investor in a related entity, which for purposes of this paragraph (e)(4)(ii) includes a business entity as described in § 301.7701-2(a) of this chapter that is classified for Federal income tax purposes as either a corporation or a partnership, or is disregarded as an entity separate from its owner (“disregarded entity”). Thus, for example, stewardship expenses include expenses of an activity the sole effect of which is to protect the investor's capital investment in the entity or to facilitate compliance by the investor with reporting, legal, or regulatory requirements applicable specifically to the investor. If an investor has a foreign or international department which exercises oversight functions with respect to related entities and, in addition, the department performs other functions that generate other foreign-source income (such as fees for services rendered outside of the United States for the benefit of foreign related corporations or foreign-source royalties), some part of the deductions with respect to that department are considered definitely related to the other foreign-source income. In some instances, the operations of a foreign or international department will also generate U.S. source income (such as fees for services performed in the United States). Stewardship expenses are allocated and apportioned on a separate entity basis without regard to the affiliated group rules in § 1.861-14. See § 1.861-14(e)(1)(i).

(B) *Allocation.* In the case of stewardship expenses incurred to oversee a corporation, the expenses are considered definitely related and allocable to dividends received or amounts included, or to be received or included, under sections 78, 301, 951, 951A, 1291, 1293, and 1296, from the corporation. In the case of stewardship expenses incurred to oversee a

partnership, the expenses are considered definitely related and allocable to a partner's distributive share of partnership income. In the case of stewardship expenses incurred to oversee a disregarded entity, the expenses are considered definitely related and allocable to all gross income attributable to the disregarded entity. Stewardship expenses are allocated to income from a particular entity (or entities) related to the taxpayer if the expense is definitely related to the oversight of that entity or entities as provided in § 1.861-8(b)(1) under all the facts and circumstances.

(C) *Apportionment.* Stewardship expenses must be apportioned between the statutory and residual groupings based on the relative values of the entity or entities in each grouping that are owned by the investor taxpayer, and without regard to the relative amounts of gross income in the statutory and residual groupings to which the stewardship expense is allocated. In the case of stewardship expenses incurred to oversee a lower-tier entity owned indirectly by the taxpayer, the stewardship expenses must be apportioned based on the relative values of the owner or owners of the lower-tier entity that are owned directly by the taxpayer. In the case of stewardship expenses incurred to oversee a corporation, the corporation's value is the value of its stock as determined and characterized under the asset method in § 1.861-9 (and, as relevant, §§ 1.861-12 and 1.861-13) for purposes of allocating and apportioning the taxpayer's interest expense. For purposes of the preceding sentence, if the corporation is a member of the same affiliated group as the investor, the value of the corporation's stock is determined under the asset method in § 1.861-9 and is characterized by the investor in proportion to how the corporation's assets are characterized for purposes of apportioning the group's interest expense. In the case of stewardship expenses incurred to oversee a partnership, the partnership's value is determined and characterized under the asset method in § 1.861-9 (taking into account any adjustments under sections 734(b) and 743(b)). In the case of stewardship expenses incurred to oversee a disregarded entity, the disregarded entity's character and value is determined using the principles of the asset method in § 1.861-9 as if the disregarded entity were treated as a corporation for Federal income tax purposes. For purposes of determining the tax book value of assets under this

paragraph (e)(4)(ii)(C), section 864(e)(3) and § 1.861–8(d)(2) do not apply.

(5) *Legal and accounting fees and expenses; damages awards, prejudgment interest, and settlement payments—* \* \* \*

(ii) *Product liability and other claims for damages.* Except as otherwise provided in this paragraph (e)(5), awards for litigation or arbitral damages, prejudgment interest, and payments in settlement of or in anticipation of claims for damages, including punitive damages, arising from claims relating to sales, licenses, or leases of products or the provision of services, are definitely related and allocable to the class of gross income of the type produced by the specific sales or leases of the products or provision of services that gave rise to the claims for damage or injury. Such damages and payments may include, but are not limited to, product liability or patent infringement claims. The deductions are apportioned among the statutory and residual groupings on the basis of the relative amounts of gross income in the relevant class in each grouping in the year in which the deductions are allowed. If the claims arise from an event incident to the production or sale of products or provision of services (such as an industrial accident), the payments are definitely related and allocable to the class of gross income ordinarily produced by the assets that are involved in the event. The deductions are apportioned among the statutory and residual groupings on the basis of the relative values (as determined under the asset method in § 1.861–9 for purposes of allocating and apportioning the taxpayer's interest expense) of the assets that were involved in the event or that were used to produce or sell products or services in the relevant class in each grouping; such values are determined in the year the deductions are allowed.

(iii) *Investor lawsuits.* If the claims are made by investors in a corporation and arise from negligence, fraud, or other malfeasance of the corporation (or its representatives), then the damages, prejudgment interest, and settlement payments paid by the corporation are definitely related and allocable to all income of the corporation and are apportioned among the statutory and residual groupings based on the relative value of the corporation's assets in each grouping (as determined under the asset method in § 1.861–9 for purposes of allocating and apportioning the taxpayer's interest expense) in the year the deductions are allowed.

(6) \* \* \*

(i) \* \* \* The deduction for foreign income, war profits, and excess profits

taxes allowed by section 164 is allocated and apportioned among the applicable statutory and residual groupings under § 1.861–20. \* \* \*

\* \* \* \* \*

(7) *Losses on the sale, exchange, or other disposition of property.* See §§ 1.865–1 and 1.865–2 for rules regarding the allocation and apportionment of certain losses.

(8) *Net operating loss deduction—(i) Components of net operating loss.* A net operating loss is separated into components that are assigned to statutory or residual groupings by reference to the losses in each such statutory or residual grouping that are not allocated to reduce income in other groupings in the taxable year of the loss. For example, for purposes of applying this paragraph (e)(8)(i) with respect to section 904 as the operative section, the source and separate category components of a net operating loss are determined by reference to the amounts of separate limitation loss and U.S. source loss (determined without regard to adjustments required under section 904(b)) that are not allocated to reduce U.S. source income or income in other separate categories under the rules of sections 904(f) and 904(g) for the taxable year in which the net operating loss arose. See § 1.904(g)–3(d)(2). See § 1.1502–4 for rules applicable in computing the foreign tax credit limitation and determining the source and separate category of a net operating loss of a consolidated group. Similarly, for purposes of applying this paragraph (e)(8)(i) with respect to another operative section (as described in § 1.861–8(f)(1)), a net operating loss is divided into component parts based on the amounts of the deductions that are assigned to the relevant statutory and residual groupings and that are not absorbed in the taxable year in which the loss is incurred under the rules of that operative section. Deductions that are considered absorbed for purposes of an operative section may differ from the deductions that are considered absorbed for purposes of another provision of the Code that requires determining the components of a net operating loss.

(ii) *Allocation and apportionment of section 172 deduction.* A net operating loss deduction allowed under section 172 is allocated and apportioned to statutory and residual groupings by reference to the statutory and residual groupings of the components of the net operating loss (as determined under paragraph (e)(8)(i) of this section) that is deducted in the taxable year. Except as provided under the rules for an operative section, a partial net operating

loss deduction is treated as ratably comprising the components of a net operating loss. See, for example, § 1.904(g)–3, which is an exception to the general rule described in the previous sentence and provides rules for determining the source and separate category of a partial net operating loss deduction for purposes of section 904 as the operative section.

\* \* \* \* \*

(16) *Special rule for the allocation and apportionment of reserve expenses of a life insurance company.* An amount of reserve expenses of a life insurance company equal to the dividends received deduction that is disallowed because it is attributable to the policyholders' share of dividends received is treated as definitely related to such dividends. See paragraph (d)(2)(v)(B)(2) of this section (*Example 2*).

\* \* \* \* \*

(g) \* \* \*

(15) *Example 15: Payment in settlement of claim for damages allocated to specific class of gross income—(i) Facts.* USP, a domestic corporation, sells Product A in the United States. USP also owns and operates a disregarded entity (FDE) in Country X. FDE, which constitutes a foreign branch of USP within the meaning of § 1.904–4(f)(3)(vii), sells Product A inventory in Country X. FDE's functional currency is the U.S. dollar. In each of its taxable years from 2018 through 2020, USP earns \$2,000x of U.S. source gross income from sales of Product A to customers in the United States. USP also sells Product A to FDE for an arm's length price and FDE sells Product A to customers in Country X. After the application of section 862(a)(6), § 1.861–7(c), and the disregarded payment rules of § 1.904–4(f)(2)(vi), the sales of Product A in Country X result in \$1,500x of general category foreign source gross income and \$500x of foreign branch category foreign source gross income in each of 2018 and 2019 and \$2,500x of general category foreign source gross income and \$500x of foreign branch category foreign source gross income in 2020. FDE is sued for damages in 2019 after Product A harms a customer in Country X in 2018. In 2020, FDE makes a deductible payment of \$60x to the Country X customer in settlement of the legal claims for damages.

(ii) *Analysis.* Under paragraph (e)(5)(ii) of this section, the deductible settlement payment is definitely related and allocable to the class of gross income of the type produced by the specific sales of property that gave rise

to the damages claims, that is USP's gross income from sales of Product A in Country X. Claims that might arise from damages caused by Product A to customers in the United States are irrelevant in allocating the deduction for the settlement payments made to the customer in Country X. For purposes of determining USP's foreign tax credit limitation under section 904(d), because in 2020 that class of gross income consists of both foreign source foreign branch category income and foreign source general category income, the settlement payment of \$60x is apportioned between gross income in the two categories in proportion to the relative amounts of gross income in each category in 2020, the year the deduction is allowed. Therefore, \$10x ( $\$60x \times \$500x / \$3,000x$ ) is apportioned to foreign source foreign branch category income, and the remaining \$50x ( $\$60x \times \$2,500x / \$3,000x$ ) is apportioned to foreign source general category income.

(16) *Example 16: Legal damages payment arising from event incident to production and sale—(i) Facts—*The facts are the same as in paragraph (g)(15) of this section (the facts in *Example 15*) except that instead of a product liability lawsuit relating to a 2018 event, in 2019 there is a disaster at a warehouse owned by USP in the United States arising from the negligence of an employee. The warehouse is used to store Product A inventory intended for sale both by USP in the United States and by FDE in Country X. In 2020, the warehouse asset is characterized under § 1.861–9T(g)(3)(ii) as a multiple category asset that is assigned 10% to the foreign source foreign branch category, 50% to the foreign source general category, and 40% to the residual grouping of U.S. source income. The inventory of Product A in the warehouse is destroyed and USP employees as well as residents in the vicinity of the warehouse are injured. USP's reputation in the United States suffers such that USP expects to subsequently lose market share in the United States. In 2020, USP makes deductible damages payments totaling \$50x to injured employees and the nearby residents, all of whom are in the United States.

(ii) *Analysis.* USP's warehouse in the United States is used in connection with sales of Product A to customers in both the United States and Country X. Thus, under paragraph (e)(5)(ii) of this section, the \$50x damages payment arises from an event incident to the sales of Product A and is therefore definitely related and allocable to the class of gross income ordinarily produced by the asset (the warehouse) that is involved in the

event—that is, the gross income from sales of Product A by USP in the United States and by FDE in Country X. Under paragraph (e)(5)(ii) of this section, the \$50x deduction for the damages payment is apportioned for purposes of applying section 904(d) on the basis of the relative value in each grouping (as determined under § 1.861–9(g) for purposes of allocating and apportioning USP's interest expense) of USP's warehouse, the asset involved in the event, in 2020, the year the deduction is allowed. USP's warehouse is a multiple category asset as described in § 1.861–9T(g)(3)(ii) and 10% of the value of USP's warehouse is properly characterized as an asset generating foreign source foreign branch category income in 2020. Accordingly, \$5x ( $10\% \times \$50x$ ) of the deduction is apportioned to foreign source foreign branch category income. Additionally, 50% of the value of USP's warehouse is properly characterized as an asset generating foreign source general category income in 2020 and, accordingly, \$25x ( $50\% \times \$50x$ ) is apportioned to such grouping. The remaining \$20x ( $40\% \times \$50x$ ) is apportioned to U.S. source income.

(17) *Example 17: Payment following a change in law—(i) Facts.* The facts are the same as in paragraph (g)(16) of this section (the facts in *Example 16*), except that the disaster at USP's warehouse occurred not in 2019 but in 2016 and thus before the enactment of the section 904(d) separate category for foreign branch category income. The deductible damages payments are made in 2020.

(ii) *Analysis.* USP's U.S. warehouse was used in connection with making sales of Product A in both the United States and Country X. Under paragraph (e)(5)(ii) of this section, the 2020 damages payment arises from an event incident to the sales of Product A and is therefore definitely related and allocable to the class of gross income ordinarily produced by the asset (the warehouse) that is involved in the event, that is the gross income from sales of Product A by USP in the United States and by FDE in Country X. Under the law in effect in 2016, the income earned from the Product A sales in Country X was solely general category income. Under paragraph (e)(5)(ii) of this section, the damages payment is definitely related and allocable to the class of gross income consisting of sales of Product A by USP in the United States and by FDE in Country X, and apportioned to the statutory and residual groupings based on the relative value in each grouping (as determined under § 1.861–9(g) for purposes of allocating and apportioning USP's interest expense) of USP's warehouse,

the asset involved in the event, in 2020, the year in which the deduction is allowed. Accordingly, for purposes of determining USP's foreign tax credit limitation under section 904(d), the 2020 deductible damages payment of \$50x is allocated and apportioned in the same manner as in paragraph (g)(16)(ii) of this section (the analysis in *Example 16*).

(18) *Example 18: Stewardship and supportive expenses—(i) Facts—(A) Overview.* USP, a domestic corporation, manufactures and sells Product A in the United States. USP directly owns 100% of the stock of USSub, a domestic corporation, and each of CFC1, CFC2, and CFC3, which are all controlled foreign corporations. USP and USSub file separate returns for U.S. Federal income tax purposes but are members of the same affiliated group as defined in section 243(b)(2). USSub, CFC1, CFC2, and CFC3 perform similar functions in the United States and in the foreign countries T, U, and V, respectively. USP's tax book value in the stock of USSub is \$15,000x. USP's tax book value in the stock of each of CFC1, CFC2, and CFC3 is, respectively, \$5,000x, \$10,000x, and \$15,000x.

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



oversight activities are related to all the subsidiaries. The cost of the duplicative activities is \$540x.

(C) *USP's income.* USP earns the following items of income: First, under section 951(a), USP has \$2,000x of subpart F income that is passive category income. Second, USP has a GILTI inclusion amount of \$2,000x. Third, USP earns \$1,000x of royalties, paid by CFC1 and CFC2, that are foreign source general category income. Finally, USP receives a fee of \$1,000x from CFC2 that is foreign source general category income.

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

(B) *Allocation.* First, the deduction of \$900x for expenses related to services rendered for the benefit of CFC2 is definitely related (and therefore allocable) to the fees for services that USP receives from CFC2. Second, the \$60x of deductions attributable to USP's license agreements with CFC1 and CFC2 are definitely related (and therefore allocable) solely to royalties received from CFC1 and CFC2. Third, based on the relevant facts and circumstances and the Department's oversight activities, the stewardship deduction of \$540x is related to the oversight of all of USP's subsidiaries and therefore is definitely related (and therefore allocable) to dividends and inclusions received or included from all the subsidiaries.

(C) *Apportionment.* (1) No apportionment of USP's deduction of \$900x for expenses related to the services performed for CFC2 is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, foreign source general category income.

(2) No apportionment of USP's deduction of \$60x attributable to the services related to license agreements is necessary because the class of gross income to which the deduction is

allocated consists entirely of a single statutory grouping, foreign source general category income.

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

(4) USP's deduction of \$540x for the Department's stewardship expenses which are allocable to dividends and amounts included from the subsidiaries are apportioned using the same value of USP's stock in USSub, CFC1, CFC2, and CFC3 that is used for purposes of allocating and apportioning USP's interest expense. Pursuant to paragraph (e)(4)(ii)(A) of this section and § 1.861–14(e)(1)(i), the value of USP's stock in USSub is included for purposes of apportioning USP's stewardship expense. The value of USSub's stock is \$15,000x, and USSub only owns assets that generate income in the residual grouping of gross income from U.S. sources. Therefore, for purposes of apportioning USP's stewardship expense, all of the \$15,000x value of the USSub stock is characterized as an asset generating U.S. source income.

Although USSub stock would be eliminated from consideration as an asset under paragraph (d)(2)(ii)(B) of this section, for purposes of apportioning USP's stewardship expense section 864(e)(3) and paragraph (d)(2) of this section do not apply. USP uses the asset method described in § 1.861–12T(c)(3)(ii) to characterize the stock in its CFCs. After application of § 1.861–13(a), USP determines that with respect to its three CFCs in the aggregate it has \$15,000x of section 951A category stock in the non-section 245A subgroup, \$6,000x of general category stock in the section 245A subgroup, and \$9,000x of passive category stock in the non-section 245A subgroup. Although under paragraph (d)(2)(ii)(C)(2) of this section \$7,500x of the stock that is section 951A category stock is an exempt asset, for purposes of apportioning USP's stewardship expense section 864(e)(3) and paragraph (d)(2) of this section do not apply. Finally, even though USP may be allowed a section 245A deduction with respect to dividends from the CFCs, no portion of the value of the stock of the CFCs is eliminated, because the section 245A deduction does not create exempt income or result in the stock being treated as an exempt asset. See section 864(e)(3) and paragraph (d)(2)(iii)(C) of this section.

(5) Taking into account the characterization of USP's stock in USSub, CFC1, CFC2, and CFC3 with a total value of \$45,000x (\$15,000x + \$6,000x + \$9,000x + \$15,000x), the \$540x of Department expenses is apportioned as follows: \$180x (\$540x × \$15,000x/\$45,000x) to section 951A category income, \$72x (\$540x × \$6,000x/\$45,000x) to general category income, \$108x (\$540x × \$9,000x/\$45,000x) to passive category income, and \$180x (\$540x × \$15,000x/\$45,000x) to the residual grouping of U.S. source income. Section 904(b)(4)(B)(i) and § 1.904(b)–3 apply to \$72x of the stewardship expense apportioned to the CFCs' stock that is characterized as being in the section 245A subgroup in the general category.

\* \* \* \* \*

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

(2) Paragraphs (d)(2)(ii)(B), (d)(2)(v), (e)(4) and (5), (e)(6)(i), (e)(8) and (16), and (g)(15) through (18) of this section apply to taxable years that begin after December 31, 2019. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also begin on or before December 31, 2019, see § 1.861–8(d)(2)(ii)(B), (e)(4) and (5), (e)(6)(i), and (e)(8) as in effect on December 17, 2019.

(3) The last sentence of paragraph (d)(2)(ii)(C)(1) of this section and paragraph (f)(1)(vi)(N) of this section apply to taxable years beginning on or after January 1, 2021.

■ **Par. 5.** Section 1.861–8T is amended by revising paragraph (d)(2)(ii)(B) to read as follows:

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

\* \* \* \* \*

- (d) \* \* \*
- (2) \* \* \*
- (ii) \* \* \*

(B) *Certain stock and dividends.* For further guidance, see § 1.861–8(d)(2)(ii)(B).

\* \* \* \* \*

■ **Par. 6.** Section 1.861–9 is amended by:

- 1. Revising paragraph (a).
- 2. Adding paragraph (b).
- 3. Revising paragraphs (e)(8)(vi)(C) and (D).
- 4. Adding paragraph (e)(9).
- 5. Revising paragraph (k).

The revisions and additions read as follows:

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

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

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

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

(2) *Certain foreign currency borrowings.* For further guidance, see § 1.861-9T(b)(2) through (7).

(3) through (7) [Reserved]

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

\* \* \* \* \*

- (e) \* \* \*
- (8) \* \* \*
- (vi) \* \* \*

(C) *Downstream partnership loan.* The term *downstream partnership loan* means a loan to a partnership for which the loan receivable is held, directly or indirectly through one or more other partnerships or other pass-through entities (as defined in § 1.904-5(a)(4)), by a person (or any person in the same affiliated group as such person) that owns an interest, directly or indirectly through one or more other partnerships or other pass-through entities, in the partnership.

(D) *Downstream partnership loan interest expense (DPL interest expense).* The term *downstream partnership loan interest expense*, or *DPL interest expense*, means an item of interest expense paid or accrued with respect to a downstream partnership loan, without regard to whether the expense was currently deductible (for example, by reason of section 163(j) or the election to waive deductions pursuant to § 1.59A-3(c)(6)).

\* \* \* \* \*

(9) *Special rule for upstream partnership loans*—(i) *In general.* For

purposes of apportioning interest expense that is not directly allocable under paragraph (e)(4) of this section or § 1.861-10T, an upstream partnership loan debtor's (UPL debtor) pro rata share of the value of the upstream partnership loan (as determined under paragraph (h)(4)(i) of this section) is not considered an asset of the UPL debtor taken into account as described in paragraphs (e)(2) and (3) of this section.

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

(iii) *Anti-avoidance rule for third party back-to-back loans.* If, with a principal purpose of avoiding the rules in this paragraph (e)(9), a partnership makes a loan to a person that is not related (within the meaning of section 267(b) or 707) to the lender, the unrelated person makes a loan to a direct or indirect partner in the partnership (or any person in the same affiliated group as a direct or indirect partner), and the first loan would constitute an upstream partnership loan if made directly to the direct or indirect partner (or person in the same affiliated group as a direct or indirect partner), then the rules of this paragraph (e)(9) apply as if the first loan was made directly by the partnership to the partner (or affiliate of the partner), and the interest expense paid by the partner is treated as made with respect to the first loan. Such a series of loans will be subject to the recharacterization rule in this paragraph (e)(9)(iii) without regard

to whether there was a principal purpose of avoiding the rules in this paragraph (e)(9) if the loan to the unrelated person would not have been made or maintained on substantially the same terms but for the loan of funds by the unrelated person to the direct or indirect partner (or affiliate of the partner). The principles of this paragraph (e)(9)(iii) also apply to similar transactions that involve more than two loans and regardless of the order in which the loans are made.

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

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

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

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

(C) *Upstream partnership loan.* The term *upstream partnership loan* means a loan by a partnership to a person (or any person in the same affiliated group as such person) that 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)), in the partnership.

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

(E) *Upstream partnership loan interest expense (UPL interest expense).* The term *upstream partnership loan*

interest expense, or UPL interest expense, means an item of interest expense paid or accrued with respect to an upstream partnership loan, without regard to whether the expense was currently deductible (for example, by reason of section 163(j) or the election to waive deductions pursuant to § 1.59A-3(c)(6)).

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

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

(A) *Example 1—(1) Facts*. US1, a domestic corporation, directly owns 60% of PRS, a foreign partnership that is not engaged in a U.S. trade or business. The remaining 40% of PRS is directly owned by US2, a domestic corporation that is unrelated to US1. US1, US2, and PRS all use the calendar year as their taxable year. In Year 1, PRS loans \$1,000x to US1. For Year 1, US1 has \$100x of interest expense with respect to the loan and PRS has \$100x of interest income with respect to the loan. US1's distributive share of the interest income is \$60x. Under paragraph (e)(2) of this section, \$75x of US1's interest expense with respect to the loan is allocated and apportioned to U.S. source income and \$25x is allocated and apportioned to foreign source foreign branch category income. Under paragraph (h)(4)(i) of this section, US1's share of the total value of the loan between US1 and PRS is \$600x.

(2) *Analysis*. The loan by PRS to US1 is an upstream partnership loan and US1 is an UPL debtor. Under paragraph (e)(9)(iv)(B) of this section, the matching expense amount is \$60x, the lesser of the UPL interest expense taken into account by US1 with respect to the loan for the taxable year (\$100x) and US1's distributive share of the UPL interest income (\$60x). Under paragraph (e)(9)(ii) of this section, US1 assigns \$45x of the UPL interest income to U.S. source income (\$60x × 75x/\$100x) and \$15x of the UPL interest income to foreign source foreign branch category income (\$60x × 25x/\$100x). Under paragraph (e)(9)(i) of this section, the disregarded portion of the upstream partnership loan is \$600x, and is not taken into account as described in paragraphs (e)(2) and (3) of this section.

(B) *Example 2—(1) Facts*. The facts are the same as in paragraph (e)(9)(vi)(A)(1) of this section (the facts in *Example 1*), except that US1 and US2 are part of the same affiliated group

with the same ratio of U.S. and foreign assets that US1 had in paragraph (e)(9)(vi)(A)(1), US2's distributive share of the interest income is \$40x, and under paragraph (h)(4)(i) of this section US2's share of the total value of the loan between US1 and PRS is \$400x.

(2) *Analysis*. The loan by PRS to US1 is an upstream partnership loan and US1 is an UPL debtor. Under paragraph (e)(9)(iv)(B) of this section, the matching expense amount is \$100x, the lesser of the UPL interest expense taken into account by US1 with respect to the loan for the taxable year (\$100x) and the total amount of US1 and US2's distributive shares of the UPL interest income (\$100x). Under paragraph (e)(9)(ii) of this section, US1 and US2 assign \$75x of their total UPL interest income to U.S. source income (\$100x × 75x/\$100x) and \$25x of their total UPL interest income to foreign source foreign branch category income (\$100x × 25x/\$100x). Under paragraph (e)(9)(i) of this section, the disregarded portion of the upstream partnership loan is \$1,000x, the total amount of US1 and US2's share of the loan between US1 and PRS, and is not taken into account as described in paragraphs (e)(2) and (3) of this section.

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

(2) Paragraphs (b)(1)(i), (b)(8), and (e)(9) of this section apply to taxable years that end on or after December 16, 2019. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also end before December 16, 2019, see § 1.861-9T(b)(1)(i) as contained in 26 CFR part 1 revised as of April 1, 2019.

■ **Par. 7.** Section 1.861-9T is amended by revising paragraph (b)(1)(i) and adding paragraph (b)(8) to read as follows:

**§ 1.861-9T Allocation and apportionment of interest expense (temporary).**

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(i) *General rule*. For further guidance, see § 1.861-9(b)(1)(i).

\* \* \* \* \*

(8) *Guaranteed payments*. For further guidance, see § 1.861-9(b)(8).

\* \* \* \* \*

■ **Par. 8.** Section 1.861-12 is amended by revising paragraph (e), adding paragraphs (f) and (g), and revising paragraph (k) to read as follows:

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

\* \* \* \* \*

(e) *Portfolio securities that constitute inventory or generate primarily gains*. For further guidance, see § 1.861-12T(e).

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

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

(i) *Example 1: Capitalized interest under section 263A—(A) Facts*. X is a domestic corporation that uses the tax book value method of apportionment. X has \$1,000x of indebtedness and incurs \$100x of interest expense. Using \$800x of the \$1,000x debt proceeds to produce tangible property, X capitalizes \$80x of interest expense under the rules of section 263A. X deducts the remaining \$20x of interest expense.

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

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

(B) *Analysis*. Under section 163(l), Loan A is a disqualified debt instrument because interest on Loan A is payable at the option of Y in stock of a related party to Y. Because Loan A is a

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

(g) *Special rules for FSCs.* For further guidance, see § 1.861-12T(g) through (j).

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

(2) Paragraph (f) of this section applies to taxable years that end on or after December 16, 2019. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and before December 16, 2019, see § 1.861-12T(f) as contained in 26 CFR part 1 revised as of April 1, 2019.

■ **Par. 9.** Section 1.861-12T is amended by revising paragraph (f) to read as follows:

**§ 1.861-12T Characterization rules and adjustments or certain assets (temporary).**

(f) *Assets connected with capitalized, deferred, or disallowed interest.* For further guidance, see § 1.861-12(f).

**§ 1.861-13T [REMOVED]**

■ **Par. 10.** Section 1.861-13T is removed.

■ **Par. 11.** Section 1.861-14 is amended by:

- 1. Removing the last sentence in paragraph (d)(1) and paragraphs (d)(3) through (e)(5).
- 2. Adding paragraph (d)(3), reserved paragraph (d)(4), paragraph (e) heading, and paragraphs (e)(1) through (5).
- 3. Removing the heading for paragraph (e)(6).
- 4. Redesignating paragraph (e)(6)(i) as paragraph (e)(6).
- 5. Revising the heading for newly redesignated paragraph (e)(6).
- 6. Removing paragraphs (e)(6)(ii) and (f) through (j).
- 7. Adding paragraph (f), reserved paragraph (g), paragraph (h), reserved paragraphs (i) and (j), and paragraph (k).

The additions and revisions read as follows:

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

\* \* \* \* \*

(d) \* \* \*

(3) *Inclusion of financial corporations.* For further guidance, see § 1.861-14T(d)(3) through (4).

(4) [Reserved]

(e) *Expenses to be allocated and apportioned under this section—(1) Expenses not directly allocable to specific income-producing activities or property.* (i) The expenses that are required to be allocated and apportioned under the rules of this section are expenses that are not directly allocable to specific income-producing activities or property solely of the member of the affiliated group that incurred the expense, including (but not limited to) certain expenses related to research and experimental expenses, supportive functions, deductions under section 250, legal and accounting expenses, and litigation damages awards, prejudgment interest, and settlement payments. Interest expense of members of an affiliated group of corporations is allocated and apportioned under § 1.861-11T and not under the rules of this section. Expenses that are included in inventory costs or that are capitalized are not subject to allocation and apportionment under the rules of this section. In addition, stewardship expenses are not subject to allocation and apportionment under the rules of this section; instead, stewardship expenses of a taxpayer are allocated and apportioned on a separate entity basis without treating members of the affiliated group as a single taxpayer. See § 1.861-8(e)(4)(ii)(A).

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

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

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

(4) *Section 250 deduction.* Except as provided in this paragraph (e)(4), the deduction allowed under section 250(a) (the section 250 deduction) to a member of an affiliated group is allocated and apportioned on a separate entity basis under the rules of § 1.861-8(e)(13) and (14). However, the section 250 deduction of a member of a consolidated group is not directly allocable to specific income-producing activities or property solely of the member of the affiliated group that is allowed the deduction. See § 1.1502-50 for rules on applying section 250 and §§ 1.250-1 through 1.250(b)-6 to a member of a consolidated group. In such case, the section 250 deduction is allocated and apportioned as if all members of the consolidated group are treated as a single corporation.

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

(6) *Charitable contribution expenses.*

(f) *Computation of FSC or DISC combined taxable income.* For further guidance, see § 1.861-14T(f) and (g).

(g) [Reserved]

(h) *Special rule for the allocation and apportionment of reserve expenses of a life insurance company.* Section 1.861-

8(e)(16) applies for purposes of allocating and apportioning reserve expenses with respect to dividends received by a life insurance company. The remaining reserve expenses of such company are allocated and apportioned under the rules of § 1.861–8 and this section.

(i) through (j) [Reserved]

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

■ **Par. 12.** Section 1.861–14T is amended by:

- 1. Revising paragraphs (e)(1)(i) and (e)(2)(i).
- 2. Removing and reserving paragraph (e)(2)(ii).
- 3. Revising paragraphs (e)(4) and (5) and (h).
- 4. Adding footnote 1 at the end of paragraph (j) introductory text.

The revisions and additions read as follows:

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

\* \* \* \* \*

(e) \* \* \*

(1) \* \* \*

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

\* \* \* \* \*

(2) \* \* \*

(i) For further guidance, see § 1.861–14(e)(2)(i) and (ii).

\* \* \* \* \*

(4) *Section 250 deduction.* For further guidance, see § 1.861–14(e)(4).

(5) *Legal and accounting fees and expenses; damages awards, prejudgment interest, and settlement payments.* For further guidance, see § 1.861–14(e)(5).

\* \* \* \* \*

(h) *Special rule for allocation of reserve expenses of life insurance companies.* For further guidance, see § 1.861–14(h).

\* \* \* \* \*

(j) \* \* \*

<sup>1</sup> Examples 1 and 4 of this paragraph (j) apply to taxable years beginning before January 1, 2018.

\* \* \* \* \*

■ **Par. 13.** Section 1.861–17 is revised to read as follows:

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

(a) *Scope.* This section provides rules for the allocation and apportionment of research and experimental expenditures that a taxpayer deducts, or amortizes and deducts, in a taxable year under section 174 or section 59(e) (applicable

to expenditures that are allowable as a deduction under section 174(a)) (*R&E expenditures*). R&E expenditures do not include any expenditures that are not deductible expenses by reason of the second sentence under § 1.482–7(j)(3)(i) (relating to CST Payments (as defined in § 1.482–7(b)(1)) owed to a controlled participant in a cost sharing arrangement).

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

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

dividends or any amounts included in income under section 951, 951A, or 1293. See § 1.904–4(f)(2)(vi) for rules addressing the assignment of gross income, including gross intangible income, to a separate category by reason of certain disregarded payments to or from a taxpayer's foreign branch.

(3) *SIC code categories*—(i) *Allocation based on SIC code categories.*

Ordinarily, a taxpayer's R&E expenditures are incurred to produce gross intangible income that is reasonably connected with one or more relevant SIC code categories. Except as provided in paragraph (b)(3)(iv) of this section, where research and experimentation is conducted with respect to more than one SIC code category, the taxpayer may aggregate the categories for purposes of allocation and apportionment, provided the categories are in the same Major Group. However, the taxpayer may not subdivide any categories. Where research and experimentation is not clearly related to any SIC code category (or categories), it will be considered conducted with respect to all of the taxpayer's SIC code categories.

(ii) *Use of three digit standard industrial classification codes.* A taxpayer determines the relevant Major Groups and SIC code categories by reference to the two digit and three digit classification, respectively, of the Standard Industrial Classification Manual (SIC code). The SIC Manual is available at [https://www.osha.gov/pls/imis/sic\\_manual.html](https://www.osha.gov/pls/imis/sic_manual.html).

(iii) *Consistency.* Once a taxpayer selects a SIC code category or Major Group for the first taxable year for which this section applies to the taxpayer, it must continue to use that category in following years unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in the category is appropriate. Therefore, once a taxpayer elects a permissible aggregation of three digit SIC code categories into a two digit Major Group, it must continue to use that two digit category in following years unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change is appropriate.

(iv) *Wholesale trade and retail trade categories.* A taxpayer must use a SIC code category within the divisions of "wholesale trade" or "retail trade" if it is engaged solely in sales-related activities with respect to a particular category of products. In the case of a taxpayer that conducts material non-sales-related activities with respect to a particular category of products, all R&E

expenditures related to sales of the products must be allocated and apportioned as if the expenditures were reasonably connected to the most closely related three digit SIC code category other than those within the wholesale and retail trade divisions. For example, if a taxpayer engages in both the manufacturing and assembling of cars and trucks (SIC code 371) and in a wholesaling activity related to motor vehicles and motor vehicle parts and supplies (SIC code 501), the taxpayer must allocate and apportion all R&E expenditures related to both activities as if they relate solely to the manufacturing SIC code 371. By contrast, if the taxpayer engages only in the wholesaling activity related to motor vehicles and motor vehicle parts and supplies, the taxpayer must allocate and apportion all R&E expenditures to the wholesaling SIC code 501.

(c) *Exclusive apportionment.* Solely for purposes of applying this section to section 904 as the operative section, an amount equal to fifty percent of a taxpayer's R&E expenditures in a SIC code category (or categories) is apportioned exclusively to the residual grouping of U.S. source gross intangible income if research and experimentation that accounts for at least fifty percent of such R&E expenditures was performed in the United States. Similarly, an amount equal to fifty percent of a taxpayer's R&E expenditures in a SIC code category (or categories) is apportioned exclusively to the statutory grouping (or groupings) of foreign source gross intangible income in that SIC code category if research and experimentation that accounts for more than fifty percent of such R&E expenditures was performed outside the United States. If there are multiple separate categories with foreign source gross intangible income in the SIC code category, the fifty percent of R&E expenditures apportioned under the previous sentence is apportioned ratably to foreign source gross intangible income based on the relative amounts of gross receipts from gross intangible income in the SIC code category in each separate category, as determined under paragraph (d) of this section. Solely for purposes of determining whether fifty percent or more of R&E expenditures in a year are performed within or without the United States under this paragraph (c), a taxpayer's R&E expenditures with respect to a taxable year are determined by taking into account only the R&E expenditures incurred in such taxable year (without regard to whether such expenditures are capitalized under section 59(e) or any other provision in

the Code), and do not include amounts that were capitalized in a prior taxable year and are deducted in such taxable year.

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

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

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

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

(ii) For purposes of this paragraph (d), gross receipts from sales and leases of products are related to gross intangible income if intangible property is embedded or used in connection with the manufacture or sale of such products, and gross income from services is related to gross intangible income if intangible property is incorporated in or directly or indirectly benefits such services. See paragraph (g)(7) of this section (*Example 7*). The amount of the gross receipts used to apportion R&E expenditures also includes gross receipts from sales and leases of products or services of any controlled or uncontrolled party to the extent described in paragraphs (d)(3) and (4) of this section. A royalty or other amount paid to the taxpayer for intangible property constitutes gross intangible income, but is not considered part of gross receipts arising from the sale or lease of a product or service, and so is not taken into account in apportioning the taxpayer's R&E expenditures to its gross intangible income.

(iii) The statutory grouping (or groupings) or residual grouping to which the gross receipts are assigned is the grouping to which the gross intangible income related to the sale, lease, or service is assigned. In cases where the gross intangible income of the

taxpayer is income not described in paragraph (d)(3) or (4) of this section, the grouping to which the taxpayer's gross receipts and the gross intangible income are assigned is the same. In cases where the taxpayer's gross intangible income is related to sales, leases, or services described in paragraph (d)(3) or (4) of this section, the gross receipts that will be used for purposes of this paragraph (d) are the gross receipts of the controlled and uncontrolled parties that are taken into account under paragraphs (d)(3) and (4) of this section. The grouping to which the controlled or uncontrolled parties' gross receipts are assigned is determined based on the grouping of the taxpayer's gross intangible income attributable to the license, sale, or other transfer of intangible property to such controlled or uncontrolled party as described in paragraph (d)(3)(i) or (d)(4)(i) of this section, and not the grouping to which the gross receipts would be assigned if the assignment were based on the income earned by the controlled or uncontrolled party. See paragraph (g)(1) of this section (*Example 1*). For purposes of applying this paragraph (d)(1)(iii) to section 250 or section 904 as the operative section, the assignment of gross receipts to the general and foreign branch categories is made after taking into account the assignment of gross intangible income to those categories as adjusted by reason of disregarded payments under the rules of § 1.904-4(f)(2)(vi), and by making similar adjustments to gross receipts under the principles of § 1.904-4(f)(2)(vi).

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

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

(3) *Sales or services of uncontrolled parties—(i) In general.* For purposes of the apportionment within a class under paragraph (d)(1) of this section, if a taxpayer reasonably expects an

uncontrolled party to (through a license, purchase, or transfer): Acquire intangible property that would arise from the taxpayer's current R&E expenditures; acquire products in which such intangible property is embedded or used in connection with the manufacture or sale of such products; or receive services that incorporate or directly or indirectly benefit from such intangible property, then the gross receipts of the uncontrolled party from sales, licenses, leases, or services of the particular products or services in which the taxpayer's intangible property is embedded or incorporated or which the taxpayer's intangible property directly or indirectly benefitted are taken into account. If the taxpayer has previously licensed, sold, or transferred intangible property related to a SIC code category to an uncontrolled party, the taxpayer is presumed to expect to license, sell, or transfer to that uncontrolled party all future intangible property related to the same SIC code category. The presumption described in the preceding sentence may be rebutted by the taxpayer with facts that demonstrate that the taxpayer reasonably expects not to license, sell, or transfer future intangible property to the uncontrolled party.

(ii) *Definition of uncontrolled party.* For purposes of this paragraph (d)(3), the term *uncontrolled party* means a person that is not a controlled party as defined in paragraph (d)(4)(ii) of this section.

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

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

(4) *Sales or services of controlled parties—(i) In general.* For purposes of the apportionment within a class under

paragraph (d)(1) of this section, if the controlled party is reasonably expected to (through a license, sale, or transfer): Acquire intangible property that would arise from the taxpayer's current R&E expenditures; acquire products in which such intangible property is embedded or used in connection with the manufacture or sale of such products; or receive services that incorporate or directly or indirectly benefit from such intangible property, then the gross receipts of the controlled party from all of its sales, licenses, leases, or services are taken into account. Except to the extent provided in paragraph (d)(4)(iv) of this section, if the taxpayer has previously licensed, sold, or transferred intangible property related to a SIC code category to a controlled party, the taxpayer is presumed to expect to license, sell, or transfer to that controlled party all future intangible property related to the same SIC code category. The presumption described in the preceding sentence may be rebutted by the taxpayer with facts that demonstrate that the taxpayer will not license, sell, or transfer future intangible property to the controlled party.

(ii) *Definition of a controlled party.* For purposes of this paragraph (d)(4), the term *controlled party* means any person that has a relationship to the taxpayer specified in section 267(b) or 707(b), or is a member of a controlled group of corporations (within the meaning of section 267(f)) to which the taxpayer belongs. Because an affiliated group is treated as a single taxpayer, a member of an affiliated group is not a controlled party. See paragraph (e) of this section.

(iii) *Gross receipts not to be taken into account more than once.* Sales, licenses, leases, or services among the taxpayer, controlled parties, and uncontrolled parties are not taken into account more than once; in such a situation, the amount of gross receipts of the selling person must be subtracted from the gross receipts of the buying person. Therefore, the gross receipts taken into account under paragraph (d)(4)(i) of this section generally reflect the gross receipts from sales made to end users.

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

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

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

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

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

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

(3) *Apportionment based on gross receipts.* In applying the remaining apportionment under paragraph (d) of this section, if a taxpayer is a partner in a partnership that incurs R&E expenditures described in paragraph (f)(1) of this section and the taxpayer is not reasonably expected to license, sell, or transfer to the partnership (directly or indirectly) intangible property that would arise from the taxpayer's current R&E expenditures, in the manner described in paragraph (d)(3)(i) or (d)(4)(i) of this section, then the taxpayer's gross receipts in a SIC code category include only the taxpayer's share of any gross receipts in the SIC code category of the partnership. For purposes of the preceding sentence, the taxpayer's share of gross receipts is proportionate to the taxpayer's distributive share of the partnership's gross income in the product category. However, if the taxpayer is reasonably expected to license, sell, or transfer to the partnership (directly or indirectly) intangible property that would arise from the taxpayer current R&E expenditures, in the manner described in paragraph (d)(3)(i) or (d)(4)(i) of this

section, then the taxpayer's gross receipts in a SIC code category include the full amount of any gross receipts in the SIC code category of the partnership as provided in paragraph (d)(3)(i) or (d)(4)(i) of this section.

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

(1) *Example 1: Controlled party and single product—(i) Facts.* X, a domestic corporation, is a manufacturer and distributor of small gasoline engines for lawnmowers. Gasoline engines are a product within the category, Engines and Turbines (SIC Industry Group 351). Y, a wholly owned foreign subsidiary of X, also manufactures and sells these engines abroad. X owns no other foreign subsidiaries. During Year 1, X incurred R&E expenditures of \$60,000x, which it deducts under section 174 as a current expense, to invent and patent a new and improved gasoline engine. All of the research and experimentation was performed in the United States. Also in Year 1, the domestic gross receipts of X from sales of gasoline engines total \$500,000x and foreign gross receipts of Y from sales of gasoline engines total \$300,000x. X provides technology for the manufacture of engines to Y through a license that requires the payment of an arm's length royalty. Because X has licensed its intangible property to Y related to the SIC code, it is presumed to reasonably expect to license the intangible property that would be developed from the current research and experimentation. In Year 1, X's gross income is \$210,000x, of which \$140,000x is U.S. source income from domestic sales of gasoline engines, \$40,000x is income included under section 951A, all of which relates to Y's foreign source income from sales of gasoline engines, \$20,000x is foreign source royalties from Y, and \$10,000x is U.S. source interest income. None of the foreign source royalties are allocable to passive category income of Y, and therefore, under §§ 1.904–4(d) and 1.904–5(c)(3), the foreign source royalties are general category income to X.

(ii) *Analysis—(A) Allocation.* The R&E expenditures were incurred in connection with developing intangible property related to small gasoline engines and they are definitely related to X's items of gross intangible income related to the SIC code category 351, namely gross income from the sale of small gasoline engines in the United States and royalties received from subsidiary Y, a foreign manufacturer of gasoline engines. Accordingly, under paragraph (b) of this section, the R&E expenditures are allocable to the class of

gross intangible income related to SIC code category 351, all of which is general category income of X. X's U.S. source interest income and income included under section 951A are not within this class of gross intangible income and, therefore, no portion of the R&E expenditures are allocated to the U.S. source interest income or foreign source income in the section 951A category.

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

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

(3) *Apportionment based on gross receipts.* After taking into account exclusive apportionment, X has \$30,000x ( $\$60,000x - \$30,000x$ ) of R&E expenditures that must be apportioned between the statutory and residual groupings. Under paragraph (d)(4) of this section, Y's gross receipts within the SIC code are taken into account in apportioning X's R&E expenditures. Although X has gross intangible income of \$140,000x from domestic sales and \$20,000x in royalties from Y, X's R&E expenditures are apportioned to that gross intangible income on the basis of the relative amounts of gross receipts arising from the sale of products by X and Y (and not the relative amounts of X's gross intangible income) in the statutory and residual groupings. Therefore, under paragraphs (d)(1) and (4) of this section  $\$11,250x$  ( $\$30,000x \times \$300,000x / (\$500,000x + \$300,000x)$ ) is apportioned to the statutory grouping of X's gross intangible income attributable to its license of intangible property to Y, or foreign source general category income. No portion of the gross receipts by X or Y are disregarded under section 864(e)(3), regardless of whether the income related to those sales is eligible for a deduction under section 250(a)(1)(A). The remaining \$18,750x

( $\$30,000x \times \$500,000x / (\$500,000x + \$300,000x)$ ) is apportioned to the residual grouping of gross intangible income, or U.S. source income.

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

(2) *Example 2: Controlled party and two products in same SIC code category—(i) Facts.* The facts are the same as in paragraph (g)(1)(i) of this section (the facts in *Example 1*), except that X also spends \$30,000x in Year 1 for research on steam turbines, all of which is performed in the United States, and X has steam turbine gross receipts in the United States of \$400,000x. X's foreign subsidiary Y neither manufactures nor sells steam turbines. The steam turbine research is in addition to the \$60,000x in R&E expenditures incurred by X on gasoline engines for lawnmowers. X thus has \$90,000x of R&E expenditures. X's gross income is \$260,000x, of which \$140,000x is U.S. source income from domestic sales of gasoline engines, \$50,000x is U.S. source income from domestic sales of steam turbines, \$40,000x is income included under section 951A all of which relates to foreign source income derived from Y's sales of gasoline engines, \$20,000x is foreign source royalties from Y, and \$10,000x is U.S. source interest income.

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

(B) *Apportionment—(1) In general.* For purposes of applying this section to section 904 as the operative section, the statutory grouping of gross intangible



income is foreign source general category income and the residual grouping of gross intangible income is U.S. source income.

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

(3) *Apportionment based on gross receipts.* After taking into account exclusive apportionment, X has  $\$45,000x$  ( $\$90,000x - \$45,000x$ ) of R&E expenditures that must be apportioned between the statutory and residual groupings. Although X has gross intangible income of  $\$190,000x$  from domestic sales and  $\$20,000x$  in royalties from Y, X's R&E expenditures are apportioned to that gross intangible income on the basis of the relative amounts of gross receipts arising from the sale of products by X and Y (and not the relative amounts of X's gross intangible income) in the statutory and residual groupings. Even though a portion of the R&E expenditures that must be apportioned are attributable to research performed with respect to steam turbines, and Y does not sell steam turbines, because Y is reasonably expected to license all intangible property related to SIC code category 351 from X, including intangible property related to steam turbines, under paragraphs (d)(1) and (4) of this section  $\$11,250x$  ( $\$45,000x \times \$300,000x / (\$500,000x + \$400,000x + \$300,000x)$ ) is apportioned to the statutory grouping of gross intangible income, or foreign source general category income attributable to the royalty income to which the gross receipts of Y are related. The remaining  $\$33,750x$  ( $\$45,000x \times (\$500,000x + \$400,000x) / (\$500,000x + \$400,000x + \$300,000x)$ ) is apportioned to the residual grouping of gross intangible income, or U.S. source gross income.

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

R&E expenditures are apportioned to U.S. source income.

(3) *Example 3: Cost sharing arrangement—(i) Facts—(A) Acquisitions and transfers by X.* The facts are the same as in paragraph (g)(1)(i) of this section (the facts in *Example 1*) except that, in Year 2, X and Y terminate the license for the manufacture of engines that was in place in Year 1 and enter into a cost sharing arrangement, in accordance with the provisions of § 1.482-7, to share the costs and risks of developing the intangible property related to the engines. Pursuant to the cost sharing arrangement, X has the exclusive rights to exploit the cost shared intangibles within the United States, and Y has the exclusive rights to exploit the cost shared intangibles outside the United States. X's and Y's shares of the reasonably anticipated benefits from the cost shared intangibles are 70% and 30%, respectively. In Year 2, Y makes a PCT Payment (as defined in § 1.482-7(b)(1)(ii)) of  $\$50,000x$  that is characterized and sourced as a royalty for a license of small gasoline engine technology.

(B) *Gross receipts and R&E expenditures.* In Year 2, X and Y continue to sell gasoline engines, with gross receipts of  $\$600,000x$  in the United States by X and  $\$400,000x$  abroad by Y. X incurs intangible development costs associated with the cost shared intangibles of  $\$100,000x$  in Year 2, which consist exclusively of research activities conducted in the United States. Y also makes a  $\$30,000x$  CST Payment (as defined in § 1.482-7(b)(1)(i)) under the cost sharing arrangement. X is entitled to deduct  $\$70,000x$  of its intangible development costs ( $\$100,000x$  less the  $\$30,000x$  CST Payment by Y) by reason of the second sentence under § 1.482-7(j)(3)(i) (relating to CST Payments).

(C) *Gross income of X.* In Year 2, X's gross income is  $\$360,000x$ , of which  $\$200,000x$  is U.S. source income from domestic sales of small gasoline engines,  $\$50,000x$  is foreign source general category income attributable to the PCT Payment,  $\$100,000x$  is income included under section 951A (all of which relates to foreign source income derived from engine sales by Y), and  $\$10,000x$  is U.S. source interest income.

(ii) *Analysis—(A) Allocation.* The  $\$70,000x$  of R&E expenditures incurred in Year 2 by X in connection with small gasoline engines are definitely related to the items of gross intangible income related to the SIC code category, namely gross income from the sale of small gasoline engines in the United States and PCT Payments from Y. Accordingly,

under paragraph (a) of this section, the R&E expenditures are allocable to this class of gross intangible income. X's U.S. source interest income and income included under section 951A are not within this class of gross intangible income and, therefore, no portion of X's R&E expenditures is allocated to X's U.S. source interest income or section 951A category income.

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

(2) *Exclusive apportionment.* Under paragraph (c) of this section, because at least 50% of X's research and experimentation in Year 2 was performed in the United States, 50% of the R&E expenditures, or  $\$35,000x$  ( $\$70,000x \times 50\%$ ), is apportioned exclusively to the residual grouping of gross intangible income, U.S. source income.

(3) *Apportionment based on gross receipts.* Although X has gross intangible income of  $\$200,000x$  from domestic sales and  $\$50,000x$  as a PCT Payment from Y, X's R&E expenditures are apportioned to its gross intangible income on the basis of the relative amounts of gross receipts arising from the sale of products by X (and not the relative amounts of X's gross intangible income) in the statutory and residual groupings. Under paragraph (d)(4)(iv) of this section, because of the cost sharing arrangement, Y's gross receipts from sales are not taken into account in apportioning X's R&E expenditures that are intangible development costs with respect to the cost sharing arrangement. Because all of the gross receipts from sales that are taken into account under paragraph (d)(1) of this section relate to gross intangible income that is included in the residual grouping,  $\$35,000x$  is apportioned to the residual grouping of gross intangible income, or U.S. source income.

(4) *Summary.* Accordingly, for purposes of the foreign tax credit limitation,  $\$70,000x$  of X's R&E expenditures are apportioned to U.S. source income.

(4) *Example 4: Uncontrolled party—(i) Facts—(A) X's R&E expenditures.* X, a domestic corporation, is engaged in continuous research and experimentation to improve the quality of the products that it manufactures and sells, which are floodlights, flashlights, fuse boxes, and solderless connectors. All of these products are in the same three digit SIC code category, Electric

Lighting and Wiring Equipment (SIC Industry Group 364). X incurs \$100,000x of R&E expenditures in Year 1 that is performed exclusively in the United States. As a result of this research activity, X acquires patents that it uses in its own manufacturing activity.

(B) *License to Y and Z.* In Year 1, X licenses its floodlight patent to Y and Z, uncontrolled parties, for use in their own territories, Countries Y and Z, respectively. Y pays X a royalty of \$3,000x plus \$0.20x for each unit sold. Gross receipts from sales of floodlights by Y for the taxable year are \$135,000x (30,000 units at \$4.50x per unit), and the royalty is \$9,000x ( $\$3,000x + \$0.20x/\text{unit} \times 30,000 \text{ units}$ ). Y has sales of other products of \$500,000x. Z pays X a royalty of \$3,000x plus \$0.30x for each unit sold. Z manufactures 30,000 floodlights in the taxable year, and the royalty is \$12,000x ( $\$3,000x + \$0.30x/\text{unit} \times 30,000 \text{ units}$ ). The dollar value of Z's gross receipts from floodlight sales is not known to X because, in this case, the floodlights are not sold separately by Z but are instead used as a component in Z's manufacture of lighting equipment for theaters. However, a reasonable estimate of Z's gross receipts attributable to the floodlights, based on the principles of section 482, is \$120,000x. The gross receipts from sales of all Z's products, including the lighting equipment for theaters, are \$1,000,000x. Because X has licensed its intangible property to Y and Z related to the SIC code, it is presumed to reasonably expect to license the intangible property that would be developed from the current research and experimentation.

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

(ii) *Analysis—(A) Allocation.* X's R&E expenditures are definitely related to all of the gross intangible income from the products that it produces, which are floodlights, flashlights, fuse boxes, and solderless connectors. All of these products are in SIC code category 364. Therefore, under paragraph (b) of this section, X's R&E expenditures are

definitely related to the class of gross intangible income related to SIC code category 364 and to all items of gross intangible income attributable to the class. These items of X's gross intangible income are gross income from the sale of floodlights, flashlights, fuse boxes, and solderless connectors in the United States and royalties from Corporations Y and Z.

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

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

(3) *Apportionment based on gross receipts.* After taking into account exclusive apportionment, X has \$50,000x ( $\$100,000x - \$50,000x$ ) of R&E expenditures that must be apportioned between the statutory and residual groupings. Under paragraph (d)(3)(i) of this section, gross receipts from sales of Y and Z are taken into account in apportioning X's R&E expenditures. Although X has gross intangible income of \$479,000x from domestic sales and \$21,000x in royalties from Y and Z, X's R&E expenditures are apportioned to its gross intangible income on the basis of the relative amounts of gross receipts arising from the sale of products by X, Y and Z (and not the relative amounts of X's gross intangible income) in the statutory and residual groupings. In addition, under paragraph (d)(3)(iii) of this section only the portion of Z's gross receipts that are attributable to the floodlights that incorporate the intangible property licensed from X, rather than Z's total gross receipts, are used for purposes of apportionment. All of X's gross receipts from sales in the entire SIC code category are included for purposes of apportionment on the basis of gross intangible income attributable to those sales. Under paragraph (d)(1) of this section, \$11,039x ( $\$50,000x \times (\$135,000x + \$120,000x) / (\$900,000x + \$135,000x + \$120,000x)$ ) is apportioned to the statutory grouping of gross intangible income, or foreign source general category income. The remaining \$38,961x ( $\$50,000x \times \$900,000x / (\$900,000x + \$135,000x + \$120,000x)$ ) is apportioned to the residual grouping of

gross intangible income, or U.S. source income.

(4) *Summary.* Accordingly, for purposes of the foreign tax credit limitation, \$11,039x of X's R&E expenditures are apportioned to foreign source general category income and \$88,961x ( $\$50,000x + \$38,961x$ ) of X's R&E expenditures are apportioned to U.S. source income.

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

(ii) *Analysis—(A) Allocation.* The R&E expenditures were incurred in connection with the development of cloud computing software and they are definitely related to the items of gross intangible income related to the SIC Code category, namely gross income

from the storage monitoring and management software in the United States and royalties received from U. Accordingly, under paragraph (b) of this section, the R&E expenditures are allocable to this class of gross intangible income.

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

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

(3) *Apportionment based on gross receipts—(i) In general.* After taking into account exclusive apportionment, X has \$25,000x ( $\$50,000x - \$25,000x$ ) of R&E expenditures that must be apportioned between the statutory and residual groupings. Because X has licensed its intangible property related to the SIC code to U and U has licensed it to the sub-licensees, under paragraph (d)(3)(i) of this section, gross receipts from sales of U's sublicensees are taken into account in apportioning X's R&E expenditures. Although X has gross intangible income of \$300,000x from domestic sales of services and \$5,000x in royalties from U, X's R&E expenditures are apportioned to its gross intangible income on the basis of the relative amounts of gross receipts arising from the sale of services by X and U's sub-licensees (and not the relative amounts of X's gross intangible income) in the statutory and residual groupings.

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

(iii) *Results of apportionment based on gross receipts.* Therefore, under paragraphs (d)(1) and (3) of this section, \$10,000x ( $\$25,000x \times \$200,000x /$

$\$300,000x + \$200,000x$ ) is apportioned to the statutory grouping of gross intangible income, or foreign source general category income. The remaining \$15,000x ( $\$25,000x \times \$300,000x / (\$300,000x + \$200,000x)$ ) is apportioned to the residual grouping of gross intangible income, or U.S. source income.

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

(6) *Example 6: Foreign branch—(i) Facts—(A) Overview for X.* X, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch within the meaning of § 1.904-4(f)(3)(vii). FDE conducts activities solely in Country Y. FDE's functional currency is the U.S. dollar. X is a manufacturer and distributor of small gasoline engines for lawnmowers in the United States. Gasoline engines are a product within the category, Engines and Turbines (SIC Industry Group 351). FDE also manufactures and distributes small gasoline engines but only in Country Y. During Year 1, X incurred R&E expenditures of \$60,000x, which it deducts under section 174 as a current expense, to invent and patent a new and improved gasoline engine. All of the research and experimentation was performed in the United States. Also in Year 1, the domestic gross receipts of X from gasoline engines total \$500,000x. X provides technology for the manufacture of engines to FDE through a license. FDE compensates X for the technology with an arm's length royalty payment of \$10,000x, which is disregarded for Federal income tax purposes.

(B) *Overview for FDE.* FDE accrues and records on its books and records \$100,000x of gross income from sales of gasoline engines to unrelated persons. FDE's gross income is non-passive category income and is foreign source income. In Year 1, the foreign gross receipts of FDE from sales of gasoline engines total \$300,000x. The disregarded royalty payment from FDE to X is not recorded on FDE's separate books and records (as adjusted to conform to Federal income tax principles) within the meaning of paragraph § 1.904-4(f)(2)(i) because it is disregarded for Federal income tax purposes. However, the \$10,000x disregarded royalty payment would be allocable to foreign source gross income attributable to FDE under § 1.904-4(f)(2)(vi)(B)(1)(ii). Therefore, under § 1.904-4(f)(2)(vi)(A) the amount of

foreign source gross income attributable to FDE is adjusted downwards and the amount of foreign source gross income attributable to X is adjusted upward to take the \$10,000x disregarded royalty payment into account.

(C) *Assignment of X's gross income to separate categories.* In Year 1, X has U.S. source general category gross income of \$140,000x from domestic sales of gasoline engines. After application of § 1.904-4(f)(2)(vi)(A) to the disregarded payment made by FDE, X has \$10,000x of foreign source general category gross income and X also has \$90,000x of foreign source foreign branch category gross income.

(ii) *Analysis—(A) Allocation.* The R&E expenditures were incurred in connection with developing intangible property related to small gasoline engines and are definitely related to the items of gross intangible income related to the SIC code category 351, namely gross income from the sale of small gasoline engines in both the United States and Country Y.

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

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

(3) *Apportionment based on gross receipts.* After taking into account exclusive apportionment, X has \$30,000x ( $\$60,000x - \$30,000x$ ) of R&E expenditures that must be apportioned between the statutory and residual groupings. Because X's gross intangible income is not described in paragraph (d)(3) or (4) of this section (that is, there is no gross intangible income related to sales, leases or services from controlled or uncontrolled parties that are incorporating intangible property that was licensed, sold, or transferred to controlled or uncontrolled parties), the

groupings to which the taxpayer's gross receipts and gross intangible income are assigned is the same. However, because the assignment of X's gross income to the foreign branch and general categories is made by taking into account disregarded payments under § 1.904-4(f)(2)(vi), the assignment of gross receipts between the general category and foreign branch category must be determined by making similar adjustments to X's gross receipts under the principles of § 1.904-4(f)(2)(vi). See paragraph (d)(1)(iii) of this section. Foreign gross receipts of FDE from gasoline engines total \$300,000x. However, those gross receipts are adjusted under the principles of § 1.904-4(f)(2)(vi) for purposes of apportioning the remaining R&E expenditures by reducing the gross receipts initially assigned to the foreign branch category by an amount equal to the ratio of the royalty income to FDE's gross income that is initially assigned to the foreign branch category. Accordingly, since the disregarded royalty payment of \$10,000x caused an adjustment equal to 10% of FDE's initial gross income of \$100,000x, 10% of the gross receipts or \$30,000x (10% × \$300,000x) are similarly assigned to the grouping of foreign source general category income, and the remaining \$270,000x of gross receipts are assigned to the grouping of foreign source foreign branch category income. Therefore, under paragraph (d)(1) of this section,  $\$1,125x (\$30,000x \times \$30,000x / (\$500,000x + \$270,000x + \$30,000x))$  is apportioned to the statutory grouping of X's gross intangible income attributable to foreign source general category income.  $\$10,125x (\$30,000x \times \$270,000x / (\$500,000x + \$270,000x + \$30,000x))$  is apportioned to the statutory grouping of X's foreign source foreign branch category income. The remaining  $\$18,750x (\$30,000x \times \$500,000x / (\$500,000x + \$270,000x + \$30,000x))$  is apportioned to the residual grouping of gross intangible income or U.S. source income.

(7) *Example 7: Indirectly derived gross intangible income*—(i) *Facts*. P, a domestic corporation, develops and publishes an internet website that persons use (referred to as “users” and collectively referred to as “user base”) without a fee. P incurs R&E expenditures to update software code and write new software code to maintain the website and develop new products that are incorporated into the website. P's activities consist of services that fall within SIC code category 737 (computer programming, data processing, and other computer related

services). P sells space on its website for businesses to advertise to its user base in exchange for a fee. P's technology allows it to collect data on users and to use that data to effectively target advertisements. P does not grant rights to the technology or other intangible property to the businesses advertising on its website. In Year 1, P incurs R&E expenditures of \$60,000x, which it deducts under section 174. All the research and experimentation is performed in the United States. Also in Year 1, P earns gross receipts of \$200,000x from the sale of advertisements, all of which gives rise to U.S. source gross income.

(ii) *Analysis*—(A) *Allocation*. The R&E expenditures were incurred in connection with developing intangible property used for P's website. Accordingly, they are definitely related and allocable to gross intangible income derived directly or indirectly (in whole or in part) from that intangible property. Because P's advertising sales are dependent on the users attracted to its website, P's gross income from advertising is indirectly derived from intangible property and is included in gross intangible income. Accordingly, under paragraph (b) of this section, the R&E expenditures are allocable to the class of gross intangible income related to SIC code category 737, which consists of U.S. source income.

(B) *Apportionment*. Because all gross receipts from services that the intangible property directly or indirectly benefits result in U.S. source income, no apportionment is required.

(h) *Applicability date*. This section applies to taxable years beginning after December 31, 2019. However, taxpayers may choose to apply this section to taxable years beginning on or after January 1, 2018, and before January 1, 2020, provided they apply this section in its entirety and for any subsequent year beginning before January 1, 2020.

■ **Par. 14.** Section 1.861-20 is added to read as follows:

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

(a) *Scope*. This section provides rules for the allocation and apportionment of foreign income taxes, including allocating and apportioning foreign income taxes to separate categories for purposes of the foreign tax credit. The rules of this section apply except as modified under the rules for an operative section (as described in § 1.861-8(f)(1)). See, for example, §§ 1.704-1(b)(4)(viii)(d)(1), 1.904-6, 1.960-1(d)(3)(ii), and 1.965-5(b)(2). Paragraph (b) of this section provides definitions for the purposes of this

section. Paragraph (c) of this section provides the general rule for allocation and apportionment of foreign income taxes. Paragraph (d) of this section provides rules for assigning foreign gross income to statutory and residual groupings. Paragraph (e) of this section provides rules for allocating and apportioning foreign law deductions to foreign gross income in the statutory and residual groupings. Paragraph (f) of this section provides rules for apportioning foreign income taxes among statutory and residual groupings. Paragraph (g) of this section provides examples that illustrate the application of this section. Paragraph (h) of this section provides the applicability date for this section.

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

(1) *Corporation*. The term *corporation* has the same meaning as set forth in § 301.7701-2(b) of this chapter, and so includes a reverse hybrid.

(2) *Corresponding U.S. item*. The term *corresponding U.S. item* means the item of U.S. gross income or U.S. loss, if any, that arises from the same transaction or other realization event from which an item of foreign gross income also arises. An item of U.S. gross income or U.S. loss is a corresponding U.S. item even if the item of foreign gross income that arises from the same transaction or realization event differs in amount from the item of U.S. gross income or U.S. loss. A corresponding U.S. item does not include an item of gross income that is exempt, excluded, or eliminated from U.S. gross income, nor does it include an item of U.S. gross income or U.S. loss that is not realized, recognized or taken into account by the taxpayer in the U.S. taxable year in which the taxpayer paid or accrued the foreign income tax, except as provided in the next sentence. If a taxpayer pays or accrues a foreign income tax that is imposed on foreign taxable income that includes an item of foreign gross income by reason of a transaction or other realization event that also gave rise to an item of U.S. gross income or U.S. loss, but the U.S. and foreign taxable years end on different dates and the event occurred in the last U.S. taxable year that ends before the end of the foreign taxable year, then the item of U.S. gross income or U.S. loss is a corresponding U.S. item.

(3) *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.

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

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

(6) *Foreign gross income.* The term *foreign gross income* means the items of gross income included in the base upon which a foreign income tax is imposed.

This includes all items of foreign gross income included in the foreign tax base, even if the foreign taxable year begins in the U.S. taxable year that precedes the U.S. taxable year in which the taxpayer pays or accrues the foreign income tax.

(7) *Foreign income tax.* The term *foreign income tax* means an income, war profits, or excess profits tax within the meaning of § 1.901–2(a) that is a separate levy within the meaning of § 1.901–2(d) and that is paid or accrued to any foreign country (as defined in § 1.901–2(g)).

(8) *Foreign law CFC.* The term *foreign law CFC* means an entity that is a body corporate under foreign law, certain of the earnings of which are taxable to its shareholder under a foreign law inclusion regime.

(9) *Foreign law disposition.* The term *foreign law disposition* means an event that foreign law treats as a taxable disposition or deemed disposition of property but that Federal income tax law does not treat as a disposition causing the recognition of gain or loss (for example, marking property to market under foreign law).

(10) *Foreign law distribution.* The term *foreign law distribution* means an event that foreign law treats as a taxable distribution (other than by reason of a foreign law inclusion regime) but that Federal income tax law does not treat as a distribution of property within the meaning of section 317(a) (for example, a stock dividend described in section 305 or a foreign law consent dividend).

(11) *Foreign law inclusion regime.* A *foreign law inclusion regime* is a foreign law tax regime similar to the subpart F or GILTI regime described in sections 951 through 959, or the PFIC regime described in sections 1293 through 1295 (relating to qualified electing funds), that imposes a tax on a shareholder of an entity based on an inclusion in the shareholder's taxable income of certain of the entity's current earnings, whether or not the foreign law deems the entity's earnings to be distributed.

(12) *Foreign law inclusion regime income.* The term *foreign law inclusion regime income* means the items of foreign gross income included by a

taxpayer with respect to a foreign law CFC by reason of a foreign law inclusion regime.

(13) *Foreign law pass-through income.* The term *foreign law pass-through income* means the items of a reverse hybrid, computed under foreign law, that give rise to an inclusion in a taxpayer's foreign gross income under the laws of a foreign country imposing tax by reason of the taxpayer's ownership of the reverse hybrid.

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

(15) *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."

(16) *Partnership.* The term *partnership* has the same meaning as set forth in § 301.7701–2(c)(1) of this chapter.

(17) *Reverse hybrid.* The term *reverse hybrid* means a corporation that is a fiscally transparent entity (under the principles of § 1.894–1(d)(3)) or a branch under the laws of a foreign country imposing tax on the income of the entity.

(18) *Taxpayer.* The term *taxpayer* has the meaning described in § 1.901–2(f)(1).

(19) *U.S. capital gain amount.* The term *U.S. capital gain amount* means gain recognized by a taxpayer on the sale or exchange of stock or, in the case of a distribution with respect to stock, the portion of the distribution to which section 301(c)(3)(A) applies. However, a U.S. capital gain amount does not include any portion of the gain recognized by a taxpayer that is treated as a dividend under section 964(e) or 1248.

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

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

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

(23) *U.S. return of capital amount.* The term *U.S. return of capital amount* means, in the case of the sale or exchange of stock, the adjusted basis of the stock, and in the case of a distribution with respect to stock, the portion of a distribution to which section 301(c)(2) applies.

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

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

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

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

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

(d) *Assigning items of foreign gross income to the statutory and residual groupings—(1) In general.* Each item of foreign gross income is assigned to a statutory or residual grouping. The amount of the item is determined under foreign law. However, Federal income tax law applies to characterize the item and the transaction or other realization event from which the item arose, and to assign it to a grouping. Except as provided in paragraph (d)(3) of this section, if a taxpayer pays or accrues a foreign income tax that is imposed on foreign taxable income that includes an item of foreign gross income with respect to which the taxpayer also realizes, recognizes, or takes into account a corresponding U.S. item, then the item of foreign gross income is assigned to the grouping to which the corresponding U.S. item is assigned. See paragraph (g)(2) of this section (*Example 1*). If the corresponding U.S. item is a U.S. loss (or zero), the foreign gross income is assigned to the grouping to which a gain would be assigned had the transaction or other realization event given rise to a gain, rather than a U.S. loss (or zero), for Federal income tax

purposes, and not (if different) to the grouping to which the U.S. loss is allocated and apportioned in computing U.S. taxable income. Paragraph (d)(3) of this section provides special rules regarding the assignment of the item of foreign gross income in particular circumstances.

(2) *Items of foreign gross income with no corresponding U.S. item*—(i) *In general.* The rules in paragraphs (d)(2)(ii) and (iii) of this section apply for purposes of characterizing an item of foreign gross income and assigning it to a grouping if the taxpayer does not realize, recognize, or take into account a corresponding U.S. item. But see paragraphs (d)(3)(i)(C) and (d)(3)(iii) of this section for special rules with respect to items of foreign gross income attributable to foreign law pass-through income and foreign law inclusion regime income.

(ii) *Foreign gross income from U.S. nonrecognition event, or U.S. recognition event that falls in a different U.S. taxable year*—(A) *In general.* If a taxpayer recognizes an item of foreign gross income arising from a transaction or other foreign realization event that does not result in the recognition of gross income or loss under Federal income tax law in the same U.S. taxable year in which the foreign income tax is paid or accrued or (in the circumstance described in the last sentence of paragraph (b)(2) of this section) in the immediately preceding U.S. taxable year, then the item of foreign gross income is characterized and assigned to the grouping to which the corresponding U.S. item (or the items described in paragraph (d)(3) of this section that are used to assign certain items of foreign gross income to the statutory and residual groupings) would be assigned if the event giving rise to the foreign gross income resulted in the recognition of gross income or loss under Federal income tax law in the U.S. taxable year in which the foreign income tax is paid or accrued.

(B) *Foreign law distributions.* An item of foreign gross income that a taxpayer includes as a result of a foreign law distribution with respect to either stock or a partnership interest is assigned to the same statutory or residual groupings to which the foreign gross income would be assigned if a distribution of property in the amount of the taxable distribution under foreign law were made for Federal income tax purposes on the date on which the foreign law distribution occurred. See paragraph (g)(6) of this section (*Example 5*). See paragraph (d)(3)(i)(B) of this section for rules regarding the assignment of foreign gross income arising from a

distribution with respect to stock. For purposes of applying paragraph (d)(3)(i)(B) of this section to a foreign law distribution, the U.S. dividend amount, U.S. capital gain amount, and U.S. return of capital amount are computed as if the distribution occurred on the date the distribution occurs for foreign law purposes. See § 1.960–1(d)(3)(ii) for rules for assigning foreign gross income arising from a foreign law distribution to income groups or PTEP groups for purposes of section 960 as the operative section.

(C) *Foreign law dispositions.* A foreign gross income item of gain that a taxpayer includes as a result of a foreign law disposition of property is assigned to the grouping to which a corresponding U.S. item of gain or loss would be assigned on a taxable disposition of the property under Federal income tax law in exchange for an amount equal to the gross receipts or other value used under foreign law to determine the amount of the items of foreign gross income arising from the foreign law disposition in the U.S. taxable year in which the taxpayer paid or accrued the foreign income tax. For example, an item of foreign gross income that results from a deemed disposition of stock under a foreign law mark-to-market regime is assigned under the rules of this paragraph (d)(2)(ii)(C) as though a taxable disposition of the stock occurred under Federal income tax law for an amount equal to the fair market value determined under foreign law for purposes of marking the stock to market. See paragraph (g)(3) of this section (*Example 2*).

(iii) *Foreign gross income of a type that is recognized but excluded from U.S. gross income*—(A) *In general.* If a taxpayer recognizes an item of foreign gross income that is a type of recognized gross income that Federal income tax law excludes from U.S. gross income, then the item of foreign gross income is assigned to the grouping to which the item of gross income would be assigned if it were included in U.S. gross income. See paragraph (g)(4) of this section (*Example 3*). Notwithstanding the first sentence of this paragraph (d)(2)(iii)(A), foreign gross income that is attributable to a base difference is assigned under paragraph (d)(2)(iii)(B) of this section.

(B) *Base differences.* If a taxpayer recognizes an item of foreign gross income that is attributable to a base difference, then the item of foreign gross income is assigned to the residual grouping. But see § 1.904–6(b)(1) (assigning foreign gross income attributable to a base difference to foreign source income in the separate

category described in section 904(d)(2)(H)(i)) for purposes of applying section 904 as the operative section). An item of foreign gross income is attributable to a base difference under this paragraph (d)(2)(iii)(B) only if the item results from the receipt of one of the following items:

(1) Death benefits described in section 101;

(2) Gifts and inheritances described in section 102;

(3) Contributions to capital described in section 118;

(4) Money or other property in exchange for stock described in section 1032 (including by reason of a transfer described in section 351(a)); or

(5) Money or other property in exchange for a partnership interest described in section 721.

(3) *Special rules for assigning certain items of foreign gross income to a statutory or residual grouping*—(i) *Items of foreign gross income that a taxpayer includes by reason of its ownership of an interest in a corporation*—(A) *Scope.* The rules of this paragraph (d)(3)(i) apply to characterize and assign to a statutory or residual grouping an item of foreign gross income that a taxpayer includes in foreign taxable income as a result of its ownership of an interest in a corporation with respect to which there is a distribution under both foreign and Federal income tax law or an inclusion of foreign law pass-through income.

(B) *Foreign gross income items arising from a distribution with respect to a corporation*—(1) *In general.* If there is a distribution by a corporation that is treated as a distribution of property for both foreign law and Federal income tax purposes, a taxpayer first applies the rules of paragraph (d)(3)(i)(B)(2) of this section, and then (if necessary) applies the rules of paragraph (d)(3)(i)(B)(3) of this section to characterize and assign to the statutory and residual groupings the items of foreign gross income that constitute the foreign dividend amount and the foreign capital gain amount, if any, that arise from the distribution. See paragraph (g)(5) of this section (*Example 4*). For purposes of this paragraph (d)(3)(i)(B), the U.S. dividend amount, U.S. capital gain amount, and U.S. return of capital amount that result from a distribution (including a distribution that occurs on the same date, but in different taxable years, for foreign law purposes and Federal income tax purposes) are computed on the date the distribution occurred for Federal income tax purposes. See paragraph (d)(2)(ii)(B) of this section for rules for assigning foreign gross income arising from any portion of a distribution that

is a foreign law distribution. See § 1.960–1(d)(3)(ii) for rules for assigning foreign gross income arising from a distribution described in this paragraph (d)(3)(i)(B) to income groups or PTEP groups for purposes of section 960 as the operative section.

(2) *Foreign dividend amounts.* The foreign dividend amount is, to the extent of the U.S. dividend amount, assigned to the same statutory and residual grouping (or ratably to the groupings) from which a distribution of the U.S. dividend amount is made under Federal income tax law. If the foreign dividend amount exceeds the U.S. dividend amount, the excess foreign dividend amount is an item of foreign gross income that is, to the extent of the U.S. return of capital amount, assigned to the same statutory and residual grouping (or ratably to the groupings) to which earnings equal to the U.S. return of capital amount would be assigned if they were recognized for Federal income tax purposes in the U.S. taxable year in which the distribution is made. These earnings are deemed to arise in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the stock of the distributing corporation is (or would be if the taxpayer were a United States person) assigned to the groupings under the asset method in § 1.861–9 in the U.S. taxable year in which the distribution is made. Any additional excess of the foreign dividend amount over the sum of the U.S. dividend amount and the U.S. return of capital amount is an item of foreign gross income that is assigned to the statutory or residual grouping (or ratably to the groupings) to which the U.S. capital gain amount is assigned.

(3) *Foreign capital gain amounts.* The foreign capital gain amount is, to the extent of the U.S. capital gain amount, assigned to the statutory and residual groupings to which the U.S. capital gain amount is assigned under Federal income tax law. If the foreign capital gain amount exceeds the U.S. capital gain amount, the excess is, to the extent of the U.S. return of capital amount, assigned to the statutory and residual groupings to which earnings equal to the U.S. return of capital amount would be assigned if they were recognized in the U.S. taxable year in which the distribution is made. These earnings are deemed to arise in the statutory and residual groupings in the same proportions as the proportions in which the tax book value of the stock of the distributing corporation is (or would be if the taxpayer were a United States person) assigned under the asset method in § 1.861–9 in the U.S. taxable year in

which the distribution is made. Any excess of the foreign capital gain amount over the sum of the U.S. capital gain amount and the U.S. return of capital amount is assigned ratably to the statutory and residual groupings to which the U.S. dividend amount is assigned.

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

(ii) [Reserved]

(iii) *Foreign law inclusion regime income.* A gross item of foreign law inclusion regime income that a taxpayer includes in its capacity as a shareholder under foreign law of a foreign law CFC under a foreign law inclusion regime is assigned to the same statutory and residual groupings as the item of foreign gross income of the foreign law CFC that gives rise to the item of foreign law inclusion regime income of the taxpayer. The assignment is made by treating the gross items of foreign law inclusion regime income of the taxpayer as the items of foreign gross income of the foreign law CFC and applying the rules in this paragraph (d) by treating the foreign law CFC as the taxpayer in its U.S. taxable year with or within which its foreign taxable year (under the law of the foreign jurisdiction imposing the shareholder-level tax) ends. See paragraphs (g)(7) and (8) of this section (*Examples 6 and 7*). See § 1.904–6(f) for special rules with respect to items of foreign gross income relating to items of the foreign law CFC that give rise to inclusions under section 951A for purposes of applying section 904 as the operative section.

(iv) *Gain on sale of disregarded entity.* An item of foreign gross income arising from gain recognized on the sale, exchange, or other disposition of a disregarded entity that is characterized

as a disposition of assets for Federal income tax purposes is assigned to statutory and residual groupings in the same proportion as the gain that would be treated as foreign gross income in each grouping if the transaction were treated as a disposition of assets for foreign tax law purposes. See paragraph (g)(9) of this section (*Example 8*).

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

(2) *Application of U.S. expense allocation rules in the absence of foreign law rules.* If foreign law does not provide rules for the allocation or apportionment of expenses, losses or other deductions to particular items of foreign gross income, then the principles of the section 861 regulations (as defined in § 1.861–8(a)(1)) apply in allocating and apportioning such expenses, losses, or other deductions to foreign gross income. For example, in the absence of foreign law expense allocation rules, the principles of the section 861 regulations apply to allocate definitely related expenses to particular categories of foreign gross income and provide the methods for apportioning foreign law expenses that are definitely related to more than one statutory grouping or that are not definitely related to any statutory grouping. For purposes of this paragraph (e)(2), the apportionment of expenses required to be made under the principles of the section 861 regulations need not be made on other than a separate company basis. If the taxpayer applies the principles of the section 861 regulations for purposes of allocating foreign law deductions under this paragraph (e), the taxpayer must apply the principles in the same manner as the taxpayer applies such principles in determining the income or earnings and profits for

Federal income tax purposes of the taxpayer (or of the foreign branch, controlled foreign corporation, or other entity that paid or accrued the foreign taxes, as the case may be). For example, a taxpayer must use the modified gross income method under § 1.861–9T when applying the principles of that section for purposes of this paragraph (e) to determine the amount of foreign taxable income in each grouping if the taxpayer applies the modified gross income method in determining the income and earnings and profits of a controlled foreign corporation for Federal income tax purposes.

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

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

(1) *Presumed facts.* Except as otherwise provided in this paragraph (g), the following facts are assumed for purposes of the examples in paragraphs (g)(2) through (9) of this section:

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

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

(iii) CFC, CFC1, and CFC2 are controlled foreign corporations

organized in Country A, and are not reverse hybrids;

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

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

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

(2) *Example 1: Corresponding U.S. item—(i) Facts.* USP conducts business in Country A that gives rise to a foreign branch (as defined in § 1.904–4(f)(3)). In Year 1, in a transaction that is a sale for purposes of the laws of Country A and Federal income tax law, the foreign branch transfers Asset X to US2 for \$1,000x. For Country A tax purposes, USP earns \$600x of gross income from the sale of Asset X and incurs foreign income tax of \$80x. For Federal income tax purposes, USP earns \$800x of foreign branch category income from the sale of Asset X.

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

(3) *Example 2: Foreign law disposition—(i) Facts.* USP owns all of the outstanding stock of CFC, which conducts business in Country A. CFC sells Asset X for \$1,000x. For Country A tax purposes, CFC's basis in Asset X is \$600x, the sale of Asset X occurs in

Year 1, and CFC recognizes \$400x of foreign gross income and incurs \$80x of foreign income tax. For Federal income tax purposes, CFC's basis in Asset X is \$500x, the sale of Asset X occurs in Year 2, and CFC recognizes \$500x of general category income.

(ii) *Analysis.* For purposes of allocating and apportioning the \$80x of Country A foreign income tax in Year 1, the \$400x of Country A gross income from the sale of Asset X is first assigned to separate categories. There is no corresponding U.S. item because the sale occurs on a different date and in a different U.S. taxable year for U.S. and foreign tax purposes. Under paragraph (d)(2)(ii)(C) of this section, the item of foreign gross income (the \$400x from the sale of Asset X) is characterized and assigned to the groupings to which the corresponding U.S. item would be assigned if for Federal income tax purposes Asset X were sold for \$1,000x in Year 1, the same U.S. taxable year in which the foreign income tax accrued. This is the case even though the amount of gross income that would be recognized for Federal income tax purposes differs from the amount recognized for Country A tax purposes. Accordingly, the \$400x of Country A gross income is assigned to the general category. Additionally, because all of the Country A taxable income is assigned to a single separate category, the \$80x of Country A tax is also allocated to the general category. No apportionment of the \$80x is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, general category income.

(4) *Example 3: Foreign gross income excluded from U.S. gross income—(i) Facts.* USP conducts business in Country A. In Year 1, USP earns \$200x of interest income on a State or local bond. For Country A tax purposes, the \$200x of income is included in gross income and incurs \$10x of foreign income tax. For Federal income tax purposes, the \$200x is excluded from gross income under section 103.

(ii) *Analysis.* For purposes of allocating and apportioning the \$10x of Country A foreign income tax, the \$200x of Country A gross income is first assigned to separate categories. There is no corresponding U.S. item because the interest income is excluded from U.S. gross income. Thus, the rules of paragraph (d)(2) of this section apply to characterize and assign the foreign gross income to the groupings to which a corresponding U.S. item would be assigned if it were recognized under Federal income tax law in that U.S. taxable year. The interest income is



excluded from U.S. gross income but is otherwise described or identified by section 103. Accordingly, under paragraph (d)(2)(iii)(A) of this section, the \$200x of Country A gross income is assigned to the separate category to which the interest income would be assigned under Federal income tax law if the income were included in gross income. Under section 904(d)(2)(B)(i), the interest income would be passive category income. Accordingly, the \$200x of Country A gross income is assigned to the passive category. Additionally, because all of the Country A taxable income is assigned to a single separate category, the \$10x of Country A tax is also allocated to the passive category (subject to the rules in § 1.904-4(c)). No apportionment of the \$10x is necessary because the class of gross income to which the deduction is allocated consists entirely of a single statutory grouping, passive category income.

(5) *Example 4: Actual distribution—*(1) *Facts.* USP owns all of the outstanding stock of CFC1, which in turn owns all of the outstanding stock of CFC2. CFC1 and CFC2 conduct business in Country A. In Year 1, CFC2 distributes \$300x to CFC1. For Country A tax purposes, \$100x of the distribution is the foreign dividend amount, \$160x is treated as a nontaxable return of capital, and the remaining \$40x is the foreign capital gain amount. CFC1 incurs \$20x of foreign income tax with respect to the foreign dividend amount and \$4x of foreign income tax with respect to the foreign capital gain amount. The \$20x and \$4x of foreign income tax are each a separate levy within the meaning of § 1.901-2(d). For Federal income tax purposes, \$150x of the distribution is the U.S. dividend amount, \$100x is the U.S. return of capital amount, and the remaining \$50x is the U.S. capital gain amount. Under section 904(d)(3)(D) and §§ 1.904-4(d) and 1.904-5(c)(4), the \$150x of U.S. dividend amount consists solely of general category income in the hands of CFC1. Under section 904(d)(2)(B)(i) and § 1.904-4(b)(2)(i)(A), the \$50x of U.S. capital gain amount is passive category income to CFC1.

(ii) *Analysis—*(A) *In general.* Because the \$20x of Country A foreign income tax and the \$4x of Country A foreign income tax are separate levies, the taxes are allocated and apportioned separately. For purposes of allocating and apportioning each foreign income tax, the relevant item of Country A gross income (the foreign dividend amount or foreign capital gain amount) is first assigned to separate categories. The U.S. dividend amount and U.S. capital gain

amount are corresponding U.S. items. However, paragraph (d)(3)(i)(B) of this section (and not paragraph (d)(1) of this section) applies to assign the items of foreign gross income arising from the distribution.

(B) *Foreign dividend amount.* Under paragraph (d)(3)(i)(B)(2) of this section, the foreign dividend amount (\$100x) is, to the extent of the U.S. dividend amount (\$150x), assigned to the same separate category from which the distribution of the U.S. dividend amount is made under Federal income tax law. Thus, \$100x of foreign gross income that is the foreign dividend amount is assigned to the general category. Additionally, because all of the Country A taxable income included in the base on which the \$20x of foreign income tax is imposed is assigned to a single separate category, the \$20x of Country A tax on the foreign dividend amount is also allocated to the general category. No apportionment of the \$20x is necessary because the class of gross income to which the deduction for foreign income tax is allocated consists entirely of a single statutory grouping, general category income. See also section 245A(d) for rules that may apply to disallow a credit or deduction for certain foreign taxes.

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

(6) *Example 5: Foreign law distribution—*(i) *Facts.* USP owns all of the outstanding stock of CFC. In Year 1, for Country A tax purposes, CFC distributes \$1,000x of its stock that is treated entirely as a dividend to USP, and Country A imposes a withholding tax on USP of \$150x with respect to the \$1,000x of foreign gross income. For Federal income tax purposes, the distribution is treated as a stock dividend described in section 305(a) and USP recognizes no U.S. gross

income. At the time of the distribution, CFC has \$800x of section 965(a) PTEP (as defined in § 1.960-3(c)(2)(vi)) in a single annual PTEP account (as defined in § 1.960-3(c)(1)), and \$500x of earnings and profits described in section 959(c)(3). Section 965(g) is the operative section for purposes of this paragraph (g)(6). See § 1.965-5(b)(2). Section 904 is also a relevant operative section, but is not addressed in this paragraph (g)(6).

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

percentage (as defined in § 1.965–5(d)) to the foreign income tax allocated and apportioned to the statutory grouping.

(7) *Example 6: Foreign law inclusion regime, CFC shareholder*—(i) *Facts.* USP owns all of the outstanding stock of CFC1, which in turn owns all of the outstanding stock of CFC2. CFC2 is organized and conducts business in Country B. Country A has a foreign law inclusion regime that imposes a tax on CFC1 for certain earnings of CFC2, a foreign law CFC. In Year 1, CFC2 earns \$400x of interest income and \$200x of royalty income. CFC2 incurs no foreign income tax. For Country A tax purposes, the \$400x of interest income and \$200x of royalty income are each an item of foreign law inclusion regime income of CFC2 that are included in the gross income of CFC1. CFC1 incurs \$150x of Country A foreign income tax with respect to the foreign law inclusion regime income. For Federal income tax purposes, with respect to CFC2, the \$400x of interest income is passive category income under section 904(d)(2)(B)(i) and the \$200x of royalty income is general category income under § 1.904–4(b)(2)(iii).

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

(8) *Example 7: Foreign law inclusion regime, U.S. shareholder*—(i) *Facts.* The facts are the same as in paragraph (g)(7)(i) of this section (the facts in

*Example 6*), except that both CFC1 and CFC2 are organized and conduct business in Country B, all of the outstanding stock of CFC1 is owned by Individual X, a U.S. citizen resident in Country A, and Country A imposes tax of \$150x on foreign gross income of \$600x under its foreign law inclusion regime on Individual X, rather than on CFC1. For Federal income tax purposes, in the hands of CFC2, the \$400x of interest income is passive category subpart F income and the \$200x of royalty income is general category tested income (as defined in § 1.951A–2(b)(1)). CFC2’s \$400x of interest income gives rise to a passive category subpart F inclusion under section 951(a)(1)(A), and its \$200x of tested income gives rise to a GILTI inclusion amount (as defined in § 1.951A–1(c)(1)) of \$200x, with respect to Individual X.

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

(9) *Example 8: Sale of disregarded entity*—(i) *Facts.* USP sells FDE, a disregarded entity that is organized and operates a trade or business in Country A, for \$500x. FDE owns Asset X and Asset Y in Country A, each having a fair market value of \$250x. For Country A tax purposes, FDE has a basis in Asset X of \$100x and a basis in Asset Y of \$200x, USP’s basis in FDE is \$100x, and the sale is treated as a sale of stock. Country A imposes foreign income tax of \$40x on USP on the Country A gross income of \$400x resulting from the sale of FDE, based on its rules for taxing capital gains of nonresidents selling stock of companies operating a trade or business in Country A. For Federal income tax purposes, USP has a basis of \$150x in each of Assets X and Y, and so the sale of FDE results in \$100x of passive category income with respect to the sale of Asset X and \$100x of general category income with respect to the sale of Asset Y.

(ii) *Analysis.* For purposes of allocating and apportioning USP’s \$40x of Country A foreign income tax, the \$400x of Country A gross income resulting from the sale of FDE is first

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

(h) [Reserved]

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

■ **Par. 15.** Section 1.881–3 is amended by:

- 1. Adding two sentences at the end of paragraph (a)(1).
- 2. Revising paragraph (a)(2)(i)(C).
- 3. In paragraph (a)(2)(ii)(B)(1) introductory text, removing “one of the following” and adding “one or more of the following” in its place.
- 4. In paragraph (a)(2)(ii)(B)(1)(ii), removing the word “or” at the end of the paragraph.
- 5. In paragraph (a)(2)(ii)(B)(1)(iii), removing the period at the end and adding “; or” in its place.
- 6. Adding paragraph (a)(2)(ii)(B)(1)(iv) and reserved paragraph (a)(2)(ii)(B)(1)(v).
- 7. In paragraph (c)(2)(ii), adding “(as in effect for taxable years beginning before January 1, 2018)” at the end of the last sentence.
- 8. Adding reserved paragraph (d)(1)(iii).
- 9. Adding a sentence at the end of paragraph (e) introductory text.
- 10. In paragraph (e), designating Examples 1 through 26 as paragraphs (e)(1) through (26), respectively.
- 11. Redesignating newly designated paragraphs (e)(4) through (26) as paragraphs (e)(5) through (27), respectively.
- 12. Adding new paragraph (e)(4).
- 13. For each paragraph listed in the table, remove the language in the “Remove” column and add in its place the language in the “Add” column:

Paragraph	Remove	Add
(a)(2)(i)(A) .....	Examples 1, 2, 3 and 4 of paragraph (e) of this section .....	paragraphs (e)(1) through (5) of this section (Examples 1 through 5).
(a)(2)(i)(B) .....	Examples 5 and 6 of paragraph (e) of this section .....	paragraphs (e)(6) and (7) of this section (Examples 6 and 7).
(a)(3)(ii)(E)(2)(ii) .....	Example 7 of paragraph (e) of this section .....	paragraph (e)(8) of this section (Example 8).
(a)(4)(ii)(B) .....	Examples 8 and 9 of paragraph (e) of this section .....	paragraphs (e)(9) and (10) of this section (Examples 9 and 10).
(b)(1) .....	Examples 12 and 13 of paragraph (e) of this section .....	paragraphs (e)(13) and (14) of this section (Examples 13 and 14).
(b)(2)(i) .....	Examples 14, 15 and 16 of paragraph (e) of this section .....	paragraphs (e)(15) through (17) of this section (Examples 15 through 17).
(b)(2)(iii) .....	Example 17 of paragraph (e) of this section .....	paragraph (e)(18) of this section (Example 18).
(b)(2)(iv) .....	Example 18 of paragraph (e) of this section .....	paragraph (e)(19) of this section (Example 19).
(b)(3)(i) .....	Examples 22, 23 and 24 of paragraph (e) of this section .....	paragraphs (e)(23) through (25) of this section (Examples 23 through 25).
(d)(1)(i) .....	Example 25 of paragraph (e) of this section .....	paragraph (e)(26) of this section (Example 26).
(d)(1)(ii)(A) .....	Example 26 of paragraph (e) .....	paragraph (e)(27) of this section (Example 27).
newly designated paragraph (e)(3).	Example 2 .....	paragraph (e)(2) of this section (the facts in Example 2).
newly designated paragraph (e)(3).	§ 301.7701-3 .....	§ 301.7701-3 of this chapter.
newly designated paragraph (e)(8)(ii).	(a)(4)(i) .....	(a)(4)(i) of this section.
newly designated paragraph (e)(22)(i).	Example 20 .....	paragraph (e)(21) of this section (the facts in Example 21).
newly designated paragraph (e)(22)(ii).	Example 19 .....	paragraph (e)(20) of this section (Example 20).
newly designated paragraph (e)(22)(ii).	paragraph (i) of this Example 21 .....	paragraph (e)(22)(i) of this section (this Example 22).
newly designated paragraph (e)(24)(i).	Example 22 .....	paragraph (e)(23) of this section (the facts in Example 23).
newly designated paragraph (e)(25)(i).	Example 22 .....	paragraph (e)(23) of this section (the facts in Example 23).
(f) .....	Paragraph (a)(2)(i)(C) and Example 3 of paragraph (e) of this section.	Paragraphs (a)(2)(i)(C) and (e)(3) (Example 3) of this section.

■ 14. In paragraph (f), revising the heading and adding a sentence at the end of the paragraph.

The additions and revisions read as follows:

**§ 1.881-3 Conduit financing arrangements.**

(a) \* \* \*  
 (1) \* \* \* See § 1.1471-3(e)(5) for withholding rules applicable to conduit financing arrangements for purposes of sections 1471 and 1472. See also §§ 1.267A-1 and 1.267A-4 (disallowing a deduction for certain interest or royalty payments to the extent the income attributable to the payment is offset by a hybrid deduction).

(2) \* \* \*  
 (i) \* \* \*  
 (C) *Treatment of disregarded entities.*

For purposes of this section, the term *person* includes a business entity that is disregarded as an entity separate from its single member owner under §§ 301.7701-1 through 301.7701-3 of this chapter and, therefore, such entity may, for example, be treated as a party to a financing transaction with its

owner. See paragraph (e)(3) of this section (Example 3).

- (ii) \* \* \*
- (B) \* \* \*
- (1) \* \* \*

(iv) The stock or similar interest is treated as debt under the tax law of the issuer's country of residence or, if the issuer is not a tax resident of any country, such as a partnership, the tax law of the country in which the issuer is created, organized, or otherwise established.

\* \* \* \* \*  
 (e) \* \* \* For purposes of the examples in this paragraph (e), unless otherwise indicated, it is assumed that no stock is of the type described in paragraph (a)(2)(ii)(B)(1)(iv) of this section.

\* \* \* \* \*  
 (4) *Example 4. Hybrid instrument as financing arrangement.* The facts are the same as in paragraph (e)(2) of this section (the facts in Example 2), except that FP assigns the DS note to FS in exchange for stock issued by FS. The stock issued by FS is in form convertible

debt with a 49-year term that is treated as debt under the tax law of Country T. The FS stock is not subject to any of the redemption, acquisition, or payment rights or requirements specified in paragraphs (a)(2)(ii)(B)(1)(i) through (iii) of this section. However, because the FS stock is treated as debt under the tax law of Country T, the FS stock is a financing transaction under paragraph (a)(2)(ii)(B)(1)(iv) of this section. Therefore, the DS note held by FS and the FS stock held by FP are financing transactions within the meaning of paragraphs (a)(2)(ii)(A)(1) and (2) of this section, respectively, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. See also § 1.267A-4 for rules applicable to disqualified imported mismatch amounts.

\* \* \* \* \*  
 (f) *Applicability date.* \* \* \* Paragraph (a)(2)(ii)(B)(1)(iv) of this section applies to payments made on or after November 12, 2020.

■ **Par. 16.** Section 1.904–1 is amended by revising the section heading and paragraph (a) as follows:

**§ 1.904–1 Limitation on credit for foreign income taxes.**

(a) *In general.* For each separate category described in § 1.904–5(a)(4)(v), the total credit for foreign income taxes (as defined in § 1.901–2(a)) paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(c)) to any foreign country (as defined in § 1.901–2(g)) does 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 the taxpayer’s entire taxable income for the same taxable year.

\* \* \* \* \*

■ **Par. 17.** Section 1.904–4 is amended by:

- 1. Revising paragraph (c)(7)(i), the third and fourth sentences of paragraph (c)(7)(ii), and paragraph (c)(7)(iii).
- 2. Adding paragraphs (c)(8)(v) through (viii).
- 3. In paragraph (o), removing the language “§ 1.904–6(b)” and adding the language “1.904–6(e)” in its place.
- 4. Revising paragraph (q).

The revisions and additions read as follows:

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

\* \* \* \* \*

(c) \* \* \*  
(7) \* \* \*

(i) *In general.* If the effective rate of tax imposed by a foreign country on income of a foreign corporation that is included in a taxpayer’s gross income is reduced under foreign law on distribution of such income, the rules of this paragraph (c) apply at the time that the income is included in the taxpayer’s gross income, without regard to the possibility of a subsequent reduction of foreign tax on the distribution. If the inclusion is considered to be high-taxed income, then the taxpayer must initially treat the inclusion as general category income, section 951A category income, or income in a specified separate category as provided in paragraph (c)(1) of this section. When the foreign corporation distributes the earnings and profits to which the inclusion was attributable and the foreign tax on the inclusion is reduced, then if a redetermination of U.S. tax liability is required under § 1.905–3(b)(2), the taxpayer must redetermine whether the revised inclusion (if any) is considered

to be high-taxed income. See § 1.905–3(b)(2)(ii) (requiring a redetermination of the amount of the inclusion, the application of the high-tax exception under section 954(b)(4), and the amount of foreign taxes deemed paid). If, taking into account the reduction in foreign tax, the inclusion is not considered high-taxed income, then the taxpayer, in redetermining its U.S. tax liability for the year or years affected, must treat the inclusion and the associated taxes (as reduced on the distribution) as passive category income and taxes. For purposes of this paragraph (c), the foreign tax on an inclusion under section 951(a)(1) or 951A(a) is considered reduced on distribution of the earnings and profits associated with the inclusion if the total taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is less than the total taxes deemed paid in the year of inclusion. Therefore, any foreign currency gain associated with the earnings and profits that are distributed with respect to the inclusion is not taken into account in determining whether there is a reduction of tax requiring a redetermination of whether the inclusion is high-taxed income.

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

(iii) *Treatment of income excluded under section 954(b)(4) or section 951A(c)(2)(A)(i)(III).* If the effective rate of tax imposed by a foreign country on income of a foreign corporation is reduced under foreign law on

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

(8) \* \* \*

(v) *Example 5.* CFC, a controlled foreign corporation, is a wholly-owned subsidiary of USP, a domestic corporation. USP and CFC are calendar year taxpayers. In Year 1, CFC’s only earnings consist of \$200x of pre-tax passive income that is foreign personal holding company income that is earned in foreign Country X. Under Country X’s tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed. In Year 1, CFC pays \$100x of foreign tax with respect to its passive income. USP does not elect to exclude this income from subpart F under section 954(b)(4) and includes \$200x in gross income (\$100x of net foreign personal holding company income and \$100x of the amount under section 78 (the “section 78 dividend”). At the time of the inclusion, the income is considered to be high-taxed income under paragraphs (c)(1) and (c)(6)(i) of this section and is general category income to USP (\$100x > \$42x (21% ×

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

(vi) *Example 6.* The facts are the same as in paragraph (c)(8)(v) of this section (the facts in *Example 5*), except that in Year 1, USP elects to apply section 954(b)(4) to exclude CFC's passive income from its subpart F income, both before and after the recomputation of CFC's Year 1 subpart F income and USP's Year 1 U.S. tax liability that is required by reason of the Year 2 \$60x foreign tax redetermination. Although the income is not considered to be subpart F income, under paragraph (c)(7)(iii) of this section it remains passive category income until distribution. In Year 2, the \$100x distribution is a dividend to USP, because CFC has \$160x of accumulated

earnings and profits described in section 959(c)(3) (the \$100x of earnings in Year 1 increased by the \$60x refund received in Year 2 that under § 1.905–3(b)(2) is taken into account in Year 1). Under paragraph (c)(7)(iii) of this section, USP must determine whether the dividend income is high-taxed income to USP in Year 2. The treatment of the dividend as passive category income may be relevant in determining deductions allocable or apportioned to such dividend income or related stock that are excluded in the computation of USP's foreign tax credit limitation under section 904(a) in Year 2. See section 904(b)(4). Under paragraph (c)(1) of this section, the dividend income is passive category income to USP because the foreign taxes paid and deemed paid by USP (\$0x) with respect to the dividend income do not exceed the highest U.S. tax rate on that income.

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

(viii) *Example 8.* (A) CFC, a controlled foreign corporation operating in Country G, is a wholly-owned subsidiary of USP, a domestic corporation. USP and CFC are calendar year taxpayers. Country G imposes a tax of 50% on CFC's earnings. Under Country G's system, the foreign corporate tax on particular earnings is reduced on distribution of those earnings to 30% and no withholding tax is imposed. Under Country G's law, distributions are treated as made out of a pool of undistributed earnings subject to the 50% tax rate. For Year 1, CFC's only earnings consist of passive income that is foreign personal holding company income that is earned in foreign Country G. CFC has taxable income of \$110x for Federal income tax purposes and \$100x for Country G

purposes. Country G, therefore, imposes a tax of \$50x on the Year 1 earnings of CFC. USP does not elect to exclude this income from subpart F under section 954(b)(4) and includes \$110x in gross income (\$60x of net foreign personal holding company income under section 951(a) and \$50x of the section 78 dividend). The highest rate of tax under section 11 in Year 1 is 34%. Therefore, at the time of the section 951(a) inclusion, the income is considered to be high-taxed income under paragraph (c) of this section ( $\$50x > \$37.4x (34\% \times \$110x)$ ) and is general category income to USP. CFC does not distribute any of its earnings in Year 1.

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

(C) Under paragraph (c)(7) of this section, in connection with the section 905(c) adjustment USP must redetermine whether its Year 1 subpart F inclusion is considered high-taxed income. By taking into account the reduction in foreign tax, the inclusion is

increased by \$20x to \$80x, the deemed paid taxes are reduced by \$20x to \$30x, and the inclusion is not considered high-taxed income (\$30x < 34% × \$110x). Therefore, USP must treat the revised section 951(a) inclusion and the taxes associated with the section 951(a) inclusion as passive category income and taxes in Year 1. USP must follow the appropriate procedures under § 1.905–4.

\* \* \* \* \*

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

(2) Paragraphs (c)(7)(i) and (iii) and (c)(8)(v) through (viii) apply to taxable years ending on or after December 16, 2019. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also end before December 16, 2019, see § 1.904–4(c)(7)(i) and (iii) as in effect on December 17, 2019.

■ **Par. 18.** Section 1.904–6 is amended by:

- 1. Revising the section heading and paragraph (a).
- 2. Redesignating paragraph (b) as paragraph (e).
- 3. Adding a new paragraph (b) and paragraph (c).
- 4. Revising paragraph (d).
- 5. In newly redesignated paragraph (e)(4)(i), removing the language “paragraph (b)(4)(ii)” and adding the language “paragraph (e)(4)(ii)” in its place.
- 6. In newly redesignated paragraph (e)(4)(ii)(C), removing the language “paragraph (b)(4)(ii)(B)” and adding the language “paragraph (e)(4)(ii)(B)” in its place.
- 7. Adding paragraphs (f) and (g).

The revisions and additions read as follows:

**§ 1.904–6 Allocation and apportionment of foreign income taxes.**

(a) *In general.* The amount of foreign income taxes paid or accrued with respect to a separate category (as defined in § 1.904–5(a)(4)(v)) of income (including U.S. source income assigned to the separate category) includes only those foreign income taxes that are allocated and apportioned to the separate category under the rules of § 1.861–20 (as modified by this section). In applying the foreign tax credit limitation under sections 904(a) and (d) to general category income described in section 904(d)(2)(A)(ii) and § 1.904–4(d), foreign source income in the general category is a statutory grouping. However, general category income is the

residual grouping of income for purposes of assigning foreign income taxes to separate categories. In addition, in determining the numerator of the foreign tax credit limitation under sections 904(a) and (d), where U.S. source income is the residual grouping, the amount of foreign income taxes paid or accrued for which a deduction is allowed, for example, under section 901(k)(7), with respect to foreign source income in a separate category includes only those foreign income taxes that are allocated and apportioned to foreign source income in the separate category under the rules of § 1.861–20 (as modified by this section). For purposes of this section, unless otherwise stated, terms have the same meaning as provided in § 1.861–20(b). For examples illustrating the application of this section, see § 1.861–20(g).

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

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

(2) [Reserved]

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

income under section 954(b)(5) and § 1.904–5(c)(2)(ii)(C).

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

\* \* \* \* \*

(f) *Treatment of certain foreign income taxes paid or accrued by United States shareholders.* Some or all of the foreign gross income of a United States shareholder of a controlled foreign corporation that is attributable to foreign law inclusion regime income with respect to a foreign law CFC described in § 1.861–20(d)(3)(iii) or foreign law pass-through income from a reverse hybrid described in § 1.861–20(d)(3)(i)(C) is assigned to the section 951A category if, were the controlled foreign corporation the taxpayer that recognizes the foreign gross income, the foreign gross income would be assigned to the controlled foreign corporation’s tested income group (as defined in § 1.960–1(b)(33)) within the general category to which an inclusion under section 951A is attributable. The amount of the United States shareholder’s foreign gross income that is assigned to the section 951A category (or a specified separate category associated with the section 951A category) is based on the inclusion percentage (as defined in § 1.960–2(c)(2)) of the United States shareholder. For example, if a United States shareholder has an inclusion percentage of 60 percent, then 60 percent of the foreign gross income of a United States shareholder that would be assigned (under § 1.861–20(d)(3)(iii)) to the tested income group within the general category income of a reverse hybrid that is a controlled foreign corporation to which an inclusion under section 951A is attributable is assigned to the section

951A category or the specified separate category for income resourced under a tax treaty, and not to the general category.

(g) *Applicability date.* This section applies to taxable years beginning after December 31, 2019. For taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, and also begin before January 1, 2020, see § 1.904–6 as in effect on December 17, 2019.

■ **Par. 19.** Section 1.904(b)–3 is amended by revising the first sentence in paragraph (c)(1), adding paragraph (d)(2), and revising paragraph (f) to read as follows:

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

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \* For purposes of applying the section 861 regulations (as defined in § 1.861–8(a)) 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. \* \* \*

\* \* \* \* \*

(d) \* \* \*

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

\* \* \* \* \*

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

(2) Paragraph (d)(2) of this section applies to taxable years ending on or after December 16, 2019.

■ **Par. 20.** Section 1.904(g)–3 is amended by:

- 1. Adding a sentence at the end of paragraph (b)(1) and adding paragraph (j).
- 2. Revising paragraph (l).

The additions and revision read as follows:

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

\* \* \* \* \*

(b) \* \* \*

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

\* \* \* \* \*

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

(2) *Rules for additional recapture of loss accounts.* For the purpose of recapturing and reducing loss accounts under paragraph (j)(1) of this section, the taxpayer also takes into account any creation of or addition to loss accounts that result from the application of paragraphs (b) through (i) of this section in the current tax year. If any of the additional income described in paragraph (j)(1) of this section is foreign source income in a separate category for which there is a remaining balance in an overall foreign loss account after applying paragraph (i) of this section, the section 904(f)(1) recapture amount under § 1.904(f)–2(c) for that additional income is determined by first computing a hypothetical recapture amount as it would have been determined prior to the application of paragraph (i) of this section but taking into account the additional foreign source income described in this paragraph (j)(2) and then subtracting the actual overall foreign loss recapture determined prior to the application of paragraph (i) of this section (that did not take into account the additional foreign source income). The remainder is the overall foreign loss recapture amount

with respect to the additional foreign source income described in this paragraph (j)(2).

\* \* \* \* \*

(l) *Applicability date.* This section applies to taxable years ending on or after November 2, 2020.

■ **Par. 21.** Section 1.905–3 is amended by:

- 1. Revising the section heading and the first sentence of paragraph (a).
- 2. Adding paragraphs (b)(2) and (3).
- 3. Revising paragraph (d).

The revisions and additions read as follows:

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

(a) \* \* \* For purposes of this section and § 1.905–4, the term *foreign tax redetermination* means a change in the liability for foreign income tax, as defined in § 1.960–1(b)(5), or certain other changes described in this paragraph (a) that may affect a taxpayer’s U.S. tax liability, including by reason of a change in the amount of its foreign tax credit, the amount of its distributions or inclusions under section 951, 951A, or 1293, the application of the high-tax exception described in section 954(b)(4) (including for purposes of determining amounts excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and § 1.951A–2(c)(1)(iii)), or the amount of tax determined under sections 1291(c)(2) and 1291(g)(1)(C)(ii). \* \* \*

(b) \* \* \*

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

(ii) *Required adjustments.* If a redetermination of U.S. tax liability is required for any taxable year under paragraph (b)(2)(i) of this section, the foreign corporation’s taxable income, earnings and profits, and current year taxes (as defined in § 1.960–1(b)(4)) must be adjusted in the year to which the redetermined tax relates (or, in the case of a foreign corporation that receives a refund of foreign income tax and uses the cash basis of accounting, in the year the tax was paid). The redetermination of U.S. tax liability is made by treating the redetermined amount of foreign tax as the amount of tax paid or accrued by the foreign corporation in such year. For example, in the case of a refund of foreign income

taxes taken into account in the year accrued, the foreign corporation's subpart F income, tested income, and current earnings and profits are increased, as appropriate, in the year to which the foreign tax relates to reflect the functional currency amount of the foreign income tax refund. The required redetermination of U.S. tax liability must account for the effect of the foreign tax redetermination on the characterization and amount of distributions or inclusions under section 951, 951A, or 1293 taken into account by each of the foreign corporation's United States shareholders, on the application of the high-tax exception described in section 954(b)(4) (including for purposes of determining the exclusions from gross tested income under section 951A(c)(2)(A)(i)(III) and § 1.951A-2(c)(1)(iii)), and the amount of tax determined under sections 1291(c)(2) and 1291(g)(1)(C)(ii), as well as on the amount of foreign taxes deemed paid under section 960 in such year, regardless of whether any such shareholder chooses to deduct or credit its foreign income taxes in any taxable year. In addition, a redetermination of U.S. tax liability is required for any subsequent taxable year in which the characterization or amount of a United States shareholder's distribution or inclusion from the foreign corporation is affected by the foreign tax redetermination, up to and including the taxable year in which the foreign tax redetermination occurs, as well as any year to which unused foreign taxes from such year were carried under section 904(c).

(iii) *Reduction of corporate level tax on distribution of earnings and profits.* If a United States shareholder of a controlled foreign corporation receives a distribution out of previously taxed earnings and profits described in section 959(c)(1) and (2) and a foreign country has imposed tax on the income of the controlled foreign corporation, which tax is reduced on distribution of the earnings and profits of the corporation (resulting in a foreign tax redetermination), then the United States shareholder must redetermine its U.S. tax liability for the year or years affected. See also § 1.904-4(c)(7)(i).

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

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

(A) *Presumed Facts.* Except as otherwise provided in this paragraph (b)(2)(v), the following facts are assumed for purposes of the examples in paragraphs (b)(2)(v)(B) through (E) of this section:

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

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

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

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

(5) No election to exclude high-taxed income under section 954(b)(4) or § 1.951A-2(c)(7) is made with respect to CFC, CFC1, or CFC2; and

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

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

§ 1.960-2(c)(3)) with respect to CFC are \$300x. In Year 3, CFC carries back a loss for foreign tax purposes and receives a refund of foreign tax of 100u that relates to Year 1.

(2) *Analysis—(i) Result in Year 1.* In Year 1, CFC has tested income of 3,360u and tested foreign income taxes of \$300x. Under section 951A(a) and § 1.951A-1(c)(1), USP has a GILTI inclusion amount of \$3,360x (3,360u translated at \$1x:1u). Under section 960(d) and § 1.960-2(c), USP is deemed to have paid \$240x (80% × 100% × \$300x) of foreign income taxes. Under section 78 and § 1.78-1(a), USP is treated as receiving a dividend of \$300x (a "section 78 dividend"). USP's section 250 deduction is \$1,830x (50% × (\$3,360x + \$300x)). Accordingly, for Year 1, USP has taxable income of \$1,830x (\$3,360x + \$300x - \$1,830x) and pre-credit U.S. tax liability of \$384.30x (21% × \$1,830x). Accordingly, USP pays U.S. tax of \$144.30x (\$384.30x - \$240x).

(ii) *Result in Year 3.* The refund of 100u to CFC in Year 3 is a foreign tax redetermination under paragraph (a) of this section. Under paragraph (b)(2)(ii) of this section, USP must account for the effect of the foreign tax redetermination on its GILTI inclusion amount and foreign taxes deemed paid in Year 1. In redetermining USP's U.S. tax liability for Year 1, USP must increase CFC's tested income and its earnings and profits in Year 1 by the refunded tax amount of 100u, must determine the effect of that increase on its GILTI inclusion amount, and must adjust the amount of foreign taxes deemed paid and the section 78 dividend to account for CFC's refund of foreign tax. Under § 1.986(a)-1(c), the refund is translated into dollars at the exchange rate that was used to translate such amount when initially accrued. As a result of the foreign tax redetermination, for Year 1, CFC has tested income of 3,460u (3,360u + 100u) and tested foreign income taxes of \$200x (\$300x - \$100x). Under section 951A(a) and § 1.951A-1(c)(1), USP has a redetermined GILTI inclusion amount of \$3,460x (3,460u translated at \$1x:1u). Under section 960(d) and § 1.960-2(c), USP is deemed to have paid \$160x (80% × 100% × \$200x) of foreign income taxes. Under section 78 and § 1.78-1(a), USP's section 78 dividend is \$200x. USP's redetermined section 250 deduction is \$1,830x (50% × (\$3,460x + \$200x)). Accordingly, USP's redetermined taxable income is \$1,830x (\$3,460x + \$200x - \$1,830x) and its pre-credit U.S. tax liability is \$384.30x (21% × \$1,830x). Therefore, USP's redetermined U.S. tax liability is



\$224.3x (\$384.30x – \$160x), an increase of \$80x (\$224.30x – \$144.30x).

(C) *Example 2: Additional payment of foreign income taxes*—(1) *Facts*. CFC is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns 1,000u of general category gross foreign base company sales income and accrues and pays 100u of foreign income taxes with respect to that income. CFC has no allowable deductions other than the foreign income tax expense. The average exchange rate used to translate USP's subpart F inclusion and CFC's foreign income taxes into dollars for Year 1 is \$1x:1u. See section 989(b)(3) and § 1.986(a)–1(a)(1). In Year 1, USP earns no other income and has no other expenses. In Year 5, pursuant to a Country X audit CFC accrues and pays additional foreign income tax of 80u with respect to its 1,000u of general category foreign base company sales income earned in Year 1. The spot rate (as defined in § 1.988–1(d)) on the date of payment of the tax in Year 5 is \$1x:0.8u. The foreign income taxes accrued and paid in Year 1 and Year 5 are properly attributable to CFC's foreign base company sales income that is included in income by USP under section 951(a)(1)(A) (“subpart F inclusion”) in Year 1 with respect to CFC.

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

(ii) *Result in Year 5*. CFC's payment of 80u of additional foreign income tax in Year 5 with respect to Year 1 is a foreign tax redetermination as defined in paragraph (a) of this section. Under paragraph (b)(2)(ii) of this section, USP must reduce CFC's subpart F income and its earnings and profits in Year 1 by the additional tax amount of 80u. Further, USP must reduce its subpart F inclusion, adjust the amount of foreign taxes deemed paid, and adjust the amount of the section 78 dividend to account for CFC's additional payment of foreign tax. Under section 986(a)(1)(B)(i) and § 1.986(a)–1(a)(2)(i), because CFC's payment of additional tax occurs more than 24 months after the close of the

taxable year to which it relates, the additional tax is translated into dollars at the spot rate on the date of payment (\$1x:0.8u). Therefore, CFC has foreign income taxes of \$200x (100u translated at \$1x:1u plus 80u translated at \$1x:0.8u) that are properly attributable to CFC's foreign base company sales income that gives rise to USP's subpart F inclusion in Year 1. As a result of the foreign tax redetermination, for Year 1, USP has a subpart F inclusion of \$820x (1,000u – 180u = 820u translated at \$1x:1u). Under section 960(a) and § 1.960–2(b), USP is deemed to have paid \$200x of foreign income taxes. Under section 78 and § 1.78–1(a), USP's section 78 dividend is \$200x. USP's redetermined U.S. taxable income is \$1,020x (\$820x + \$200x) and its pre-credit U.S. tax liability is \$214.20x (21% × \$1,020x). Therefore, USP's redetermined U.S. tax liability is \$14.20x (\$214.20x – \$200x), a decrease of \$95.80x (\$110x – \$14.20x). If USP makes a timely refund claim within the period allowed by section 6511, USP will be entitled to a refund of any overpayment resulting from the redetermination of its U.S. tax liability.

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

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

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

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

Under section 78 and § 1.78–1(a), USP's section 78 dividend is \$168x. Accordingly, USP's redetermined taxable income is \$958x (\$790x + \$168x), its pre-credit U.S. tax liability is \$201.18x (21% × \$958x), and its redetermined U.S. tax liability is \$33.18 (\$201.18x – \$168x), a decrease of \$176.82x (\$210x – \$33.18x). If USP makes a timely refund claim within the period allowed by section 6511, USP will be entitled to a refund of any overpayment resulting from the redetermination of its U.S. tax liability.

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

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

section 78 and § 1.78–1(a), USP's section 78 dividend is \$160x. USP's section 250 deduction is \$180x (50% × (\$200x + \$160x)). Accordingly, for Year 1, USP has taxable income of \$180x (\$200x + \$160x – \$180x) and a pre-credit U.S. tax liability of \$37.80x (21% × \$180x). Under section 904(a), because all of USP's income is section 951A category income (see § 1.904–4(g)), USP's foreign tax credit limitation is \$37.80x (\$37.80x × \$180x/\$180x), which is less than the \$128x of foreign income tax that USP is deemed to have paid. Accordingly, USP owes no U.S. tax (\$37.80x – \$37.80x = 0).

(ii) *Result in Year 5.* CFC's accrual and payment of the additional 20u of foreign income tax with respect to Year 1 is a foreign tax redetermination under paragraph (a) of this section. Under § 1.461–4(g)(6)(iii)(B), the additional taxes accrue when the tax contest is resolved, that is, in Year 4. However, because the taxes, which relate to Year 1, were not paid on or before the date 24 months after close of CFC's taxable year to which the tax relates, that is, Year 1, under section 905(c)(2) and paragraph (a) of this section CFC cannot take these taxes into account when they accrue in Year 4. Instead, the taxes are taken into account when they are paid in Year 5. Under paragraph (b)(2)(ii) of this section, USP must decrease CFC's tested income and its earnings and profits in Year 1 by the additional tax amount of 20u. Further, USP must adjust its GILTI inclusion amount, the amount of foreign taxes deemed paid, and the amount of the section 78 dividend to account for CFC's additional payment of tax. Under section 986(a)(1)(B)(i) and § 1.986(a)–1(a)(2)(i), because CFC's payment of additional tax occurs more than 24 months after the close of the taxable year to which it relates, the additional tax is translated into dollars at the spot rate on the date of payment (\$1.1x:1u). Therefore, CFC has tested foreign income taxes of \$182x (160u translated at \$1x:1u plus 20u translated at \$1.1x:1u). As a result of the foreign tax redetermination, for Year 1, CFC has tested income of 180u (200u – 20u). Under section 951A(a) and § 1.951A–1(c)(1), USP has a redetermined GILTI inclusion amount of \$180x (180u, translated at \$1x:1u). Under section 960(d) and § 1.960–2(c), USP is deemed to have paid \$145.60x (80% × 100% × \$182x) of foreign income taxes. Under section 78 and § 1.78–1(a), USP's section 78 dividend is \$182x. USP's redetermined section 250 deduction is \$181x (50% × (\$180x + \$182x)). Accordingly, USP's redetermined

taxable income is \$181x (\$180x + \$182x – \$181x), its pre-credit U.S. tax liability is \$38.01x (21% × \$181x), and its redetermined U.S. tax liability is zero (\$38.01x – \$38.01x).

(3) *Foreign tax redeterminations of successors or transferees.* If at the time of a foreign tax redetermination the person with legal liability for the tax (or in the case of a refund, the legal right to such refund) (the “successor”) is a different person than the person that had legal liability for the tax in the year to which the redetermined tax relates (the “original taxpayer”), the required redetermination of U.S. tax liability is made as if the foreign tax redetermination occurred in the hands of the original taxpayer. Federal income tax principles apply to determine the tax consequences if the successor remits (or receives a refund of) a tax that in the year to which the redetermined tax relates was the legal liability of, and thus under § 1.901–2(f) is considered paid by, the original taxpayer.

\* \* \* \* \*

(d) *Applicability dates.* This section applies to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019, and to foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a United States shareholder ending on or after December 16, 2019 and that relate to taxable years of foreign corporations beginning after December 31, 2017.

■ **Par. 22.** Section 1.905–4 is added to read as follows:

**§ 1.905–4 Notification of foreign tax redetermination.**

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

(b) *Time and manner of notification—(1) Redetermination of U.S. tax liability—(i) In general.* Except as provided in paragraphs (b)(1)(v) and (b)(2) through (4) of this section, any taxpayer for which a redetermination of U.S. tax liability is required must notify the Internal Revenue Service (IRS) of the foreign tax redetermination by filing an amended return, Form 1118 (Foreign Tax Credit—Corporations) or Form 1116 (Foreign Tax Credit (Individual, Estate, or Trust)), and the statement described in paragraph (c) of this section for the taxable year with respect to which a redetermination of U.S. tax liability is required. Such notification must be filed within the time prescribed by this

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

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

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

(iv) *Multiple redeterminations of U.S. tax liability for same taxable year.* The rules of this paragraph (b)(1)(iv) apply except as provided in paragraphs (b)(1)(v) and (b)(2) through (4) of this section. If more than one foreign tax redetermination requires a redetermination of U.S. tax liability for the same affected taxable year of the taxpayer and those foreign tax

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

(v) *Amended return required only if there is a change in amount of U.S. tax due.* If a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination (or multiple foreign tax redeterminations, in the case of redeterminations described in paragraph (b)(1)(iv) of this section), but does not change the amount of U.S. tax due for any taxable year, the taxpayer may, in lieu of applying the applicable rules of paragraphs (b)(1)(i) through (iv) of this section, notify the IRS of such redetermination by attaching a statement to the original return for the taxpayer's taxable year in which the foreign tax redetermination occurs. The statement must be filed by the due date (with extensions) of the original return for the taxpayer's taxable year in which the foreign tax redetermination occurs and contain the information described in § 1.904-2(f). If a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination (either alone, or if the taxpayer chooses to apply paragraph (b)(1)(iv) of this section, in combination with other

foreign tax redeterminations, as provided therein) and the redetermination of U.S. tax liability results in a change to the amount of U.S. tax due for a taxable year, but does not change the amount of U.S. tax due for other taxable years, for example, because of a carryback or carryover of an unused foreign tax under section 904(c), the notification requirements for such other taxable years are deemed to be satisfied if the taxpayer complies with the applicable rules of paragraphs (b)(1)(i) through (iv) of this section with respect to each taxable year for which the foreign tax redetermination changes the amount of U.S. tax due.

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

(ii) *Partnerships subject to subchapter C of chapter 63 of the Code.* Except as provided in paragraph (b)(4) of this section, if a redetermination of U.S. tax liability that is required under § 1.905-3(b) by reason of a foreign tax redetermination described in § 1.905-3(a) would require a partnership adjustment as defined in § 301.6241-1(a)(6) of this chapter, the partnership must file an administrative adjustment request under section 6227 and make any adjustments required under section 6227. See §§ 301.6227-2 and 301.6227-3 of this chapter for procedures for making adjustments with respect to an administrative adjustment request. An administrative adjustment request required under this paragraph (b)(2)(ii) must be filed by the due date (with extensions) of the original return for the partnership's taxable year in which the

foreign tax redetermination occurs, and the restrictions in section 6227(c) do not apply to such filing. However, unless the administrative adjustment request may otherwise be filed after applying the limitations contained in section 6227(c), such a request is limited to adjustments that are required to be made under section 905(c). The requirements of paragraph (b)(2)(i) of this section are deemed to be satisfied with respect to any item taken into account in an administrative adjustment request filed under this paragraph (b)(2)(ii).

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

(4) *Taxpayers under examination within the jurisdiction of the Large Business and International Division—(i) In general.* The alternative notification requirements of this paragraph (b)(4) apply if all of the conditions described in paragraphs (b)(4)(i)(A) through (E) of this section are satisfied.

(A) A foreign tax redetermination occurs while the taxpayer is under examination within the jurisdiction of the Large Business and International Division.

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

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

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

(E) The due date specified in paragraph (b)(1)(ii) or (b)(2)(ii) of this

section for providing notice of such foreign tax redetermination is not before the later of the opening conference or the hand-delivery or postmark date of the opening letter concerning an examination of the return for the taxable year for which a redetermination of U.S. tax liability is required by reason of such foreign tax redetermination.

(ii) *Notification requirements—(A) Foreign tax redetermination occurring before commencement of the examination.* If a foreign tax redetermination described in paragraphs (b)(4)(i)(B) and (C) of this section occurs before the later of the opening conference or the hand-delivery or postmark date of the opening letter and if the condition provided in paragraph (b)(4)(i)(E) of this section with respect to such foreign tax redetermination is met, the taxpayer, in lieu of applying the rules of paragraphs (b)(1)(i) and (ii) of this section (requiring the filing of an amended return, Form 1116 or 1118, and the statement described in paragraph (c) of this section) or paragraph (b)(2)(ii) of this section (requiring the filing of an administrative adjustment request), must notify the IRS of such redetermination by providing the statement described in paragraph (b)(4)(iii) of this section to the examiner no later than 120 days after the later of the date of the opening conference or the hand-delivery or postmark date of the opening letter concerning the examination.

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

(C) *Foreign tax redetermination occurring more than 180 days after commencement of the examination.* If a foreign tax redetermination described in paragraphs (b)(4)(i)(B) and (C) of this section occurs after the date that is 180 days after the later of the opening conference or the hand-delivery or postmark date of the opening letter, the taxpayer must either apply the rules of

paragraphs (b)(1)(i) and (ii) of this section or paragraph (b)(2) of this section, or, in lieu of applying paragraphs (b)(1)(i) and (ii) of this section or paragraph (b)(2) of this section, provide the statement described in paragraph (b)(4)(iii) of this section to the examiner within 120 days after the date the foreign tax redetermination occurs. However, the IRS, in its discretion, may either accept such statement or require the taxpayer to comply with the rules of paragraphs (b)(1)(i) and (ii) of this section or paragraph (b)(2) of this section, as applicable.

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

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

(v) *Notification of foreign tax redetermination that decreases U.S. tax liability in an affected year under audit.* A taxpayer may (but is not required to) notify the IRS as provided in this paragraph (b)(4)(v) if the taxpayer has a foreign tax redetermination that meets the conditions in paragraphs (b)(4)(i)(A), (B), and (D) of this section and results in a decrease in the amount of U.S. tax liability that, but for this paragraph (b)(4), would require the taxpayer to notify the IRS of such foreign tax redetermination under paragraph (b)(1)(iii) or (b)(2)(ii) of this section (determined without regard to paragraphs (b)(1)(iv) and (v) of this section). The notification should be made in the time and manner specified in paragraph (b)(4)(ii) of this section. The IRS, in its discretion, may either accept such alternate notification or require the taxpayer to comply with the

rules of paragraphs (b)(1)(i) and (iii) or paragraphs (b)(2) of this section, as applicable.

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

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

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

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

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

(E) Both of the refunds and the assessment are foreign tax redeterminations under § 1.905-3(a). Under § 1.905-3(b)(1), X must redetermine its U.S. tax liability for both Year 1 and Year 2. With respect to Year 1, under paragraph (b)(1)(ii) of this section X must notify the IRS of the June 15, Year 5, refund of 10n from Country N that increased X's U.S. tax liability by filing an amended return, Form 1118, and the statement required by paragraph

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

(F) With respect to Year 2, under paragraph (b)(1)(ii) of this section X must notify the IRS by filing an amended return, Form 1118, and the statement required by paragraph (c) of this section for Year 2, in addition to the amended return, Form 1118, and statement that are required by reason of

the separate foreign tax redeterminations that affect Year 1. The amended return, Form 1118, and the statement required by paragraph (c) of this section for Year 2 must be filed by the due date (with extensions) of X's original return for Year 6. The amended return and Form 1118 must reflect the reduced amount of foreign income taxes claimed as a credit under section 901 and the increase in X's U.S. tax liability of \$7.50 (5n refund translated at the average exchange rate for Year 2, or \$1.50:1n).

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

(6) *Transition rule for certain foreign tax redeterminations.* In the case of foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019, and before November 12, 2020, and foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a United States shareholder ending on or after December 16, 2019, and before November 12, 2020, any amended return or other notification that under paragraph (b)(1)(ii), (iv), or (v) or

(b)(2)(ii) of this section must be filed by the due date (with extensions) of, or attached to, the original return for the taxpayer's taxable year in which the foreign tax redetermination occurs must instead be filed by the due date (with extensions) of, or attached to, the original return for the taxpayer's first taxable year ending on or after November 12, 2020. For purposes of paragraph (b)(4)(i)(E) of this section, the relevant due date is the due date specified in this paragraph (b)(6).

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

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

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

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

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

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

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

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

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

(d) *Payment or refund of U.S. tax.* The amount of tax, if any, due upon a redetermination of U.S. tax liability is paid by the taxpayer after notice and demand has been made by the IRS. Subchapter B of chapter 63 of the Internal Revenue Code (relating to deficiency procedures) does not apply with respect to the assessment of the amount due upon such redetermination. In accordance with sections 905(c) and 6501(c)(5), the amount of additional tax due is assessed and collected without regard to the provisions of section 6501(a) (relating to limitations on assessment and collection). The amount of tax, if any, shown by a redetermination of U.S. tax liability to have been overpaid is credited or refunded to the taxpayer in accordance with subchapter B of chapter 66 (sections 6511 through 6515).

(e) *Interest and penalties—(1) In general.* If a redetermination of U.S. tax liability is required by reason of a foreign tax redetermination, interest is computed on the underpayment or overpayment in accordance with sections 6601 and 6611. No interest is assessed or collected on any underpayment resulting from a refund of foreign income taxes for any period before the receipt of the refund, except to the extent interest was paid by the foreign country or possession of the United States on the refund for the period before the receipt of the refund. See section 905(c)(5). In no case,

however, will interest assessed and collected pursuant to the preceding sentence for any period before receipt of the refund exceed the amount that otherwise would have been assessed and collected under section 6601 for that period. Interest is assessed from the time the taxpayer (or the foreign corporation, partnership, trust, or other pass-through entity of which the taxpayer is a shareholder, partner, or beneficiary) receives a refund until the taxpayer pays the additional tax due the United States.

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

(f) *Applicability date.* This section applies to foreign tax redeterminations (as defined in § 1.905–3(a)) occurring in taxable years ending on or after December 16, 2019, and to foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a United States shareholder ending on or after December 16, 2019.

#### § 1.905–4T [REMOVED]

■ **Par. 23.** Section 1.904–4T is removed.

■ **Par. 24.** Section 1.905–5 is added to read as follows:

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

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

(2) *Required redetermination of U.S. tax liability.* Except as provided in paragraph (e) of this section, a redetermination of U.S. tax liability is required to account for the effect of the foreign tax redetermination on the earnings and profits and taxable income

of the foreign corporation, the taxable income of a United States shareholder, and the amount of foreign taxes deemed paid by the United States shareholder under section 902 or 960 (as in effect before December 22, 2017), in the year to which the redetermined foreign taxes relate. For example, in the case of a refund of foreign income taxes, the subpart F income, earnings and profits, and post-1986 undistributed earnings (or pre-1987 accumulated profits, as applicable) of the foreign corporation are increased in the year to which the foreign tax relates to reflect the functional currency amount of the foreign income tax refund. The required redetermination of U.S. tax liability must account for the effect of the foreign tax redetermination on the characterization and amount of distributions or inclusions under section 951 or 1293 taken into account by each of the foreign corporation's United States shareholders and on the application of the high-tax exception described in section 954(b)(4), as well as on the amount of foreign income taxes deemed paid in such year. In addition, a redetermination of U.S. tax liability is required for any subsequent taxable year in which the United States shareholder received or accrued a distribution or inclusion from the foreign corporation, up to and including the taxable year in which the foreign tax redetermination occurs, as well as any year to which unused foreign taxes from such year were carried under section 904(c).

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

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

(3) *Notification relating to pre-1987 accumulated profits and pre-1987 foreign income taxes.* In the case of foreign tax redeterminations with

respect to pre-1987 accumulated profits, in addition to the information required by § 1.905-4(c), the taxpayer must provide the following: The dates and amounts of any dividend distributions made out of earnings and profits for the affected year or years; the rate of exchange on the date of any such distribution; and the amount of earnings and profits from which such dividends were paid for the affected year or years.

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

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

(e) *Election to account for certain foreign tax redeterminations with*

*respect to pre-2018 taxable years in the foreign corporation's last pooling year—*

(1) *In general.* A taxpayer may elect under the rules in paragraph (e)(2) of this section to account for foreign tax redeterminations of a foreign corporation that occur in the foreign corporation's taxable years ending with or within a taxable year of a United States shareholder of the foreign corporation ending on or after November 2, 2020, and that relate to taxable years of the foreign corporation beginning before January 1, 2018, by treating such foreign tax redeterminations as if they occurred in the foreign corporation's last taxable year beginning before January 1, 2018 (the "last pooling year"), and applying the rules in §§ 1.905-3T(d) and 1.905-5T for purposes of determining whether the foreign tax redetermination is accounted for in the foreign corporation's last pooling year or must be accounted for in the year to which the redetermined foreign tax relates. Except with respect to determining under the preceding sentence whether the foreign tax redetermination is accounted for in the foreign corporation's last pooling year or in the year to which the redetermined foreign tax relates, the rules of this section apply to foreign tax redeterminations covered by an election under this paragraph (e). Therefore, unless an exception in § 1.905-3T(d)(3) applies, a foreign tax redetermination to which an election under this paragraph (e) applies is accounted for under paragraph (a)(2) of this section by adjusting the foreign corporation's pools of post-1986 undistributed earnings and post-1986 foreign income taxes in the last pooling year, rather than in the year to which the redetermined foreign tax relates. For purposes of this paragraph (e), references to §§ 1.905-3T and 1.905-5T are to such provisions as contained in 26 CFR part 1, revised as of April 1, 2019.

(2) *Rules regarding the election—(i) Time and manner of election.* For a foreign corporation's first taxable year that ends with or within a taxable year of a United States shareholder of the foreign corporation ending on or after November 2, 2020 in which the foreign corporation has a foreign tax redetermination (the "first redetermination year"), the controlling domestic shareholders (as defined in § 1.964-1(c)(5)) of the foreign corporation make the election described in paragraph (e)(1) of this section by—

(A) Filing the statement required under § 1.964-1(c)(3)(ii) with a timely filed original income tax return for the taxable year of each controlling

domestic shareholder of the foreign corporation in which or with which the foreign corporation's first redetermination year ends;

(B) Providing any notices required under § 1.964-1(c)(3)(iii);

(C) Filing amended returns as required under § 1.905-4 and this section for each controlling domestic shareholder's taxable year with or within which ends the foreign corporation's last pooling year and each other affected year before the controlling domestic shareholder's taxable year with or within which ends the foreign corporation's first redetermination year reflecting a redetermination of the controlling domestic shareholder's U.S. tax liability for each such taxable year, in cases where a redetermination of the shareholder's U.S. tax liability for taxable years ending before the foreign corporation's last pooling year ends is not required under the rules in §§ 1.905-3T(d) and 1.905-5T;

(D) Filing amended returns as required under § 1.905-4 and this section with respect to each affected year before the controlling domestic shareholder's taxable year with or within which ends the foreign corporation's first redetermination year reflecting a redetermination of the controlling domestic shareholder's U.S. tax liability for each such taxable year, in cases where a redetermination of the shareholder's U.S. tax liability for taxable years ending before the foreign corporation's last pooling year ends is required under the rules in §§ 1.905-3T(d) and 1.905-5T and this section; and

(E) Providing any additional information required by applicable administrative pronouncements.

(ii) *Scope, duration, and effect of election.* An election under paragraph (e)(1) of this section with respect to the first redetermination year of a foreign corporation is binding on all persons who are, or were in a prior year to which the election applies, United States shareholders of the foreign corporation. In addition, such election applies to all foreign tax redeterminations in the first redetermination year and all subsequent taxable years of such foreign corporation and cannot be revoked. For foreign tax redeterminations that occur in taxable years after the first redetermination year, all United States shareholders of such foreign corporation must account for the foreign tax redeterminations under the rules in paragraph (e)(1) of this section by filing amended returns and providing other information as required by § 1.905-4 and paragraphs (e)(2)(i)(C) through (E) of this section.

(iii) *Requirements for valid election.* An election under paragraph (e)(1) of this section is valid only if all of the requirements in paragraph (e)(2)(i) of this section, including the requirement to provide notice under paragraph (e)(2)(i)(B) of this section, are satisfied by each of the controlling domestic shareholders with respect to the first redetermination year.

(iv) *CFC group conformity requirement—(A) In general.* An election made under paragraph (e)(1) of this section applies to all controlled foreign corporations that are members of the same CFC group, and the rules in paragraphs (e)(1) and (e)(2)(i) through (iii) of this section apply by reference to the CFC group. Therefore, an election by the controlling domestic shareholders of any controlled foreign corporation with respect to that controlled foreign corporation's first redetermination year also applies to foreign tax redeterminations of all members of the CFC group that includes that controlled foreign corporation, determined as of the close of that controlled foreign corporation's first redetermination year. The election is binding on all persons who are, or were in a prior year to which the election applies, United States shareholders of any member of the CFC group, applies with respect to foreign tax redeterminations of each member that occur in and after that member's first taxable year with or within which ends such controlled foreign corporation's first redetermination year, and cannot be revoked.

(B) *Determination of the CFC group—(1) Definition.* Subject to the rules in paragraphs (b)(2)(iv)(B)(2) and (3) of this section, the term *CFC group* means an affiliated group as defined in section 1504(a) without regard to section 1504(b)(1) through (6), except that section 1504(a) is applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears, and section 1504(a)(2)(A) is applied by substituting "or" for "and." For purposes of this paragraph (e)(2)(iv)(B)(1), stock ownership is determined by applying the constructive ownership rules of section 318(a), other than section 318(a)(3)(A) and (B), by applying section 318(a)(4) only to options (as defined in § 1.1504-4(d)) that are reasonably certain to be exercised as described in § 1.1504-4(g), and by substituting in section 318(a)(2)(C) "5 percent" for "50 percent."

(2) *Member of a CFC group.* The determination of whether a controlled foreign corporation is included in a CFC group is made as of the close of the first

redetermination year of any controlled foreign corporation for which an election is made under paragraph (e)(1) of this section. One or more controlled foreign corporations are members of a CFC group if the requirements of paragraph (e)(2)(iv)(B)(2) of this section are satisfied as of the end of the first redetermination year of at least one of the controlled foreign corporations, even if the requirements are not satisfied as of the end of the first redetermination year of all controlled foreign corporations. If the controlling domestic shareholders do not have the same taxable year, the determination of whether a controlled foreign corporation is a member of a CFC group is made with respect to the first redetermination year that ends with or within the taxable year of the majority of the controlling domestic shareholders (determined based on voting power) or, if no such majority taxable year exists, the calendar year.

(3) *Controlled foreign corporations included in only one CFC group.* A controlled foreign corporation cannot be a member of more than one CFC group. If a controlled foreign corporation would be a member of more than one CFC group under paragraph (e)(2)(iv)(B)(2) of this section, then ownership of stock of the controlled foreign corporation is determined by applying paragraph (e)(2)(iv)(B)(2) of this section without regard to section 1504(a)(2)(B) or, if applicable, by reference to the ownership existing as of the end of the first redetermination year of a controlled foreign corporation that would cause a CFC group to exist.

(3) *Rules for successor entities.* All of the United States persons that own equity interests in a successor entity to a foreign corporation ("U.S. owners") may elect under the principles of paragraph (e)(2) of this section to apply the rules in paragraph (e)(1) to foreign tax redeterminations of such foreign corporation that occur in taxable years of the successor entity that end with or within taxable years of its U.S. owners ending on or after November 2, 2020.

(f) *Applicability date.* This section applies to foreign tax redeterminations (as defined in § 1.905-3(a)) of foreign corporation and successor entities that occur in taxable years that end with or within taxable years of a United States shareholder or other United States persons ending on or after November 2, 2020, and that relate to taxable years of such foreign corporations beginning before January 1, 2018.

#### § 1.905-5T [REMOVED]

■ **Par. 25.** Section 1.905-5T is removed.



■ **Par. 26.** Section 1.951A–2 is amended by adding paragraph (c)(6) to read as follows:

**§ 1.951A–2 Tested income and tested loss.**

\* \* \* \*

(c) \* \* \*  
(6) *Allocation of deductions attributable to disqualified payments—*

(i) *In general.* A deduction related directly or indirectly to a disqualified payment is allocated and apportioned solely to residual CFC gross income, and any deduction related to a disqualified payment is not properly allocable to property produced or acquired for resale under section 263, 263A, or 471.

(ii) *Definitions.* The following definitions apply for purposes of this paragraph (c)(6).

(A) *Disqualified payment.* The term *disqualified payment* means a payment made by a person to a related recipient CFC during the disqualified period with respect to the related recipient CFC, to the extent the payment would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies.

(B) *Disqualified period.* The term *disqualified period* has the meaning provided in § 1.951A–3(h)(2)(ii)(C)(1), substituting “related recipient CFC” for “transferor CFC.”

(C) *Related recipient CFC.* The term *related recipient CFC* means, with respect to a payment by a person, a recipient of the payment that is a controlled foreign corporation that bears a relationship to the payor described in section 267(b) or 707(b) immediately before or after the payment.

(iii) *Treatment of partnerships.* For purposes of determining whether a payment is made by a person to a related recipient CFC for purposes of paragraph (c)(6)(ii)(A) of this section, a payment by or to a partnership is treated as made proportionately by or to its partners, as applicable.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(6).

(A) *Example 1: Deduction related directly to disqualified payment to related recipient CFC—(1) Facts.* USP, a domestic corporation, owns all of the stock in CFC1 and CFC2, each a controlled foreign corporation. Both USP and CFC2 use the calendar year as their taxable year. CFC1 uses a taxable year ending November 30. On October 15, 2018, before the start of its first CFC inclusion year, CFC1 receives and accrues a payment from CFC2 of \$100x of prepaid royalties with respect to a license. The \$100x payment is excluded from subpart F income pursuant to

section 954(c)(6) and would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies.

(2) *Analysis.* CFC1 is a related recipient CFC (within the meaning of paragraph (c)(6)(ii)(C) of this section) with respect to the royalty prepayment by CFC2 because it is related to CFC2 within the meaning of section 267(b). The royalty prepayment is received by CFC1 during its disqualified period (within the meaning of paragraph (c)(6)(ii)(B) of this section) because it is received during the period beginning January 1, 2018, and ending November 30, 2018. Because it would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies, the payment is a disqualified payment. Accordingly, CFC2’s deductions related to such payment accrued during taxable years ending on or after April 7, 2020, are allocated and apportioned solely to residual CFC gross income under paragraph (c)(6)(i) of this section.

(B) *Example 2: Deduction related indirectly to disqualified payment to partnership in which related recipient CFC is a partner—(1) Facts.* The facts are the same as in paragraph (c)(6)(iv)(A)(1) of this section (the facts in *Example 1*), except that CFC1 and USP own 99% and 1%, respectively of FPS, a foreign partnership, which has a taxable year ending November 30. USP receives a prepayment of \$100x from CFC2 for the performance of future services. USP subcontracts the performance of these future services to FPS for which FPS receives and accrues a \$100x prepayment from USP. The services will be performed in the same country under the laws of which CFC1 and FPS are created or organized, and the \$100x prepayment is not foreign base company services income under section 954(e) and § 1.954–4(a). The \$100x prepayment would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies.

(2) *Analysis.* CFC1 is a related recipient CFC (within the meaning of paragraph (c)(6)(ii)(C) of this section) with respect to the services prepayment by USP because, under paragraph (c)(6)(iii) of this section, it is treated as receiving \$99x (99% of \$100x) of the services prepayment from USP, and it is related to USP within the meaning of section 267(b). The services prepayment is received by CFC1 during its disqualified period (within the meaning of paragraph (c)(6)(ii)(B) of this section)

because it is received during the period beginning January 1, 2018, and ending November 30, 2018. Because it would constitute income described in section 951A(c)(2)(A)(i) and paragraph (c)(1) of this section without regard to whether section 951A applies, the prepayment is a disqualified payment. In addition, CFC2’s deductions related to its prepayment to USP are indirectly related to the disqualified payment by USP. Accordingly, CFC2’s deductions related to such payment accrued during taxable years ending on or after April 7, 2020 are allocated and apportioned solely to residual CFC gross income under paragraph (c)(6)(i) of this section.

\* \* \* \*

■ **Par. 27.** Section 1.951A–7 is amended by adding reserved paragraph (c) and paragraph (d) to read as follows:

**§ 1.951A–7 Applicability dates.**

\* \* \* \*

(d) *Deduction for disqualified payments.* Section 1.951A–2(c)(6) applies to taxable years of foreign corporations ending on or after April 7, 2020, and to taxable years of United States shareholders in which or with which such taxable years end.

■ **Par. 28.** Section 1.954–1 is amended by:

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

■ 2. Adding two sentences to the end of paragraph (d)(3)(iii).

■ 3. Revising paragraph (h)(1).

The revision and additions read as follows:

**§ 1.954–1 Foreign base company income.**

\* \* \* \*

(d) \* \* \*

(3) \* \* \*

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

\* \* \* \*

(h) \* \* \*

(1) *Paragraph (d)(3) of this section.* Paragraph (d)(3) of this section applies to taxable years of a controlled foreign corporation ending on or after December

16, 2019. For taxable years of a controlled foreign corporation ending on or after December 4, 2018, but ending before December 16, 2019, see § 1.954–1(d)(3) as contained in 26 CFR part 1 revised as of April 1, 2019.

\* \* \* \* \*

■ **Par. 29.** Section 1.954–2 is amended by:

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

The additions read as follows:

**§ 1.954–2 Foreign personal holding company income.**

\* \* \* \* \*

- (h) \* \* \*
- (2) \* \* \*
- (i) \* \* \*

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

\* \* \* \* \*

- (j) \* \* \*
- (3) \* \* \* Paragraph (h)(2)(i)(I) of this section applies to taxable years of controlled foreign corporations ending on or after December 16, 2019, and to taxable years of United States shareholders in which or with which such taxable years end.

■ **Par. 30.** Section 1.960–1 is amended by:

- 1. Adding a sentence at the end of paragraph (c)(2).
- 2. Revising paragraphs (d)(3)(ii)(A) and (B).
- 3. Removing paragraph (d)(3)(ii)(C).

The addition and revisions 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).**

\* \* \* \* \*

- (c) \* \* \*
- (2) \* \* \*

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

\* \* \* \* \*

- (d) \* \* \*
- (3) \* \* \*
- (ii) \* \* \*

(A) *In general.* A current year tax is allocated and apportioned among the section 904 categories under the rules of § 1.904–6. An amount of the current year tax that is allocated and apportioned to a section 904 category is then allocated and apportioned among the income groups within the section 904 category under § 1.861–20 (as modified by § 1.904–6(c)) by treating each income group as a statutory grouping and treating the residual income group as the residual grouping. Therefore, foreign gross income attributable to a base difference is assigned to the residual income grouping under § 1.861–20(d)(2)(ii)(B). See, however, paragraph (d)(3)(ii)(B) of this section for special rules for applying § 1.861–20 in the case of PTEP groups. For purposes of determining foreign income taxes deemed paid under the rules in §§ 1.960–2 and 1.960–3, the U.S. dollar amount of a current year tax is assigned to the section 904 categories, income groups, and PTEP groups (to the extent provided in paragraph (d)(3)(ii)(B) of this section) to which the current year tax is allocated and apportioned.

(B) *Foreign taxable income that includes previously taxed earnings and profits.* For purposes of allocating and apportioning a current year tax under this paragraph (d)(3)(ii), a PTEP group that is increased under § 1.960–3(c)(3) as a result of the receipt of a section 959(b) distribution in the current taxable year of the controlled foreign corporation is treated as an income group within the section 904 category. In such case, under § 1.861–20, the portion of the foreign gross income (as defined in § 1.861–20(b)(5)) that is characterized under Federal income tax principles as a distribution of previously taxed earnings and profits that results in the increase in the PTEP group in the current taxable year is assigned to that PTEP group. If a PTEP group is not treated as an income group under the first sentence of this paragraph (d)(3)(ii)(B), and the rules of § 1.861–20 would otherwise apply to assign foreign gross income to a PTEP group, that foreign gross income is instead assigned to the subpart F income group or tested income group to which the income that gave rise to the previously taxed earnings and profits

would be assigned if the income were recognized by the recipient controlled foreign corporation under Federal income tax principles in the current taxable year. For example, a net basis or withholding tax imposed on a controlled foreign corporation’s receipt of a section 959(b) distribution is allocated or 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 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 payment that gives rise to the foreign gross income from which the tax was withheld does not constitute a section 959(b) distribution in the current taxable year. That foreign gross income, however, may be assigned to a subpart F income group or tested income group.

\* \* \* \* \*

■ **Par. 31.** Section 1.960–2 is amended by adding a sentence at the end of paragraph (b)(3)(iii) to read as follows:

**§ 1.960–2 Foreign income taxes deemed paid under sections 960(a) and (d).**

\* \* \* \* \*

- (b) \* \* \*
- (3) \* \* \*

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

\* \* \* \* \*

**§ 1.960–3 [Amended]**

■ **Par. 32.** Section 1.960–3 is amended by removing the language “§ 1.951A–6(b)(2)” from the twelfth sentence of paragraph (e)(2)(i) and adding the language “§ 1.951A–5(b)(2)” in its place.

■ **Par. 33.** Section 1.960–4 is amended in table 2 to paragraph (f)(1) by revising the entry “Limitation for Year 2 before increase under section 960(c)(1) (\$10.50x × \$0/\$50x)” to read as follows:

**§ 1.960–4 Additional foreign tax credit in year of receipt of previously taxed earnings and profits.**

\* \* \* \* \*

- (f) \* \* \*
- (1) \* \* \*

TABLE 2 TO PARAGRAPH (f)(1)

*	*	*	*	*	*	*	*
Limitation for Year 2 before increase under section 960(c)(1) (\$10.50x × \$0/\$50x) .....							0
*	*	*	*	*	*	*	*

\* \* \* \* \*

■ **Par. 34.** Section 1.960–7 is revised to read as follows:

**§ 1.960–7 Applicability dates.**

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

(b) Section 1.960–1(c)(2) and (d)(3)(ii) applies to taxable years of a foreign corporation beginning after December 31, 2019, and to each taxable year of a domestic corporation that is a United States shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends. For taxable years of a foreign corporation that end on or after December 4, 2018, and also begin before January 1, 2020, see § 1.960–1(c)(2) and (d)(3)(ii) as in effect on December 17, 2019.

■ **Par. 35.** Section 1.965–5 is amended by:

- 1. Designating the text of paragraph (b) as paragraph (b)(1).
- 2. Adding a heading for newly designated paragraph (b)(1).
- 3. Adding paragraph (b)(2).

The revision and additions read as follows:

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

\* \* \* \* \*

(b) \* \* \*

(1) *In general.* \* \* \*  
 (2) *Attributing taxes to section 959(a) distributions of section 965 previously taxed earnings and profits.* For purposes of paragraph (b)(1) of this section, foreign income taxes are attributable to a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits if such taxes would be allocated and apportioned to a distribution of such previously taxed earnings and profits under the principles of § 1.904–6(a)(1)(iv), regardless of whether an actual distribution is made or recognized for Federal income tax purposes. Therefore,

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

■ **Par. 36.** Section 1.965–9 is amended by adding a sentence to the end of paragraph (c) to read as follows:

**§ 1.965–9 Applicability dates.**

\* \* \* \* \*

(c) \* \* \* Section 1.965–5(b)(2) applies to taxable years of foreign corporations that end on or after December 16, 2019, and with respect to a United States person, to the taxable years in which or with which such taxable years of the foreign corporations end.

■ **Par. 37.** Section 1.1502–4 is revised to read as follows:

**§ 1.1502–4 Consolidated foreign tax credit.**

(a) *In general.* The foreign tax credit under section 901 is allowed to the group only if the agent for the group (as defined in § 1.1502–77(a)) chooses to use the credit in the computation of the consolidated tax liability of the group for the consolidated return year. If that choice is made, section 275(a)(4) provides that no deduction against

taxable income may be taken on the consolidated return for foreign taxes paid or accrued by any member. However, if section 275(a)(4) does not apply, a deduction against consolidated taxable income may be allowed for certain taxes for which a credit is not allowed, even though the choice is made to claim a credit for other taxes. See, for example, sections 901(j)(3), 901(k)(7), 901(l)(4), 901(m)(6), and 908(b).

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

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

(1) *Computation of taxable income from foreign sources—(i) Separate categories.* The group must compute a separate foreign tax credit limitation for income in each separate category (as defined in § 1.904–5(a)(4)(v)) for purposes of this section. The numerator of the limiting fraction in any separate category is the consolidated taxable income of the group determined in accordance with § 1.1502–11, taking into account adjustments required under section 904(b), if any, from sources without the United States in that category, determined in accordance with the rules of §§ 1.904–4 and 1.904–5 and the section 861 regulations (as defined in § 1.861–8(a)(1)).

(ii) *Adjustments under sections 904(f) and (g).* The rules for allocation and recapture of separate limitation losses and overall foreign losses under section 904(f) and § 1.1502–9 apply to determine the foreign source and U.S. source taxable income in each separate category of the consolidated group. Similarly, the rules for allocation and recapture of overall domestic losses under section 904(g) and § 1.1502–9 apply to determine the foreign source and U.S. source taxable income in each separate category of the consolidated group. See § 1.904(g)–3 for allocation rules under sections 904(f) and 904(g).

The rules of sections 904(f) and 904(g) do not operate to recharacterize foreign income tax attributable to any separate category.

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

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

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

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

apportionment in that grouping, and the denominator of which is the total tentative apportionments in all groupings.

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

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

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

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

(d) *Carryover and carryback of unused foreign tax—(1) Allowance of unused foreign tax as consolidated carryover or carryback.* The consolidated group's carryovers and carrybacks of unused foreign tax (as defined in § 1.904-2(c)(1)) to the taxable year is determined on a consolidated basis under the principles of section 904(c) and § 1.904-2 and is deemed to be paid or accrued to a foreign country or possession for that year. The consolidated group's unused foreign tax carryovers and carrybacks to the taxable year consist of any unused foreign tax of the consolidated group, plus any unused foreign tax of members for separate return years, which may be

carried over or back to the taxable year under the principles of section 904(c) and § 1.904-2. The consolidated group's unused foreign tax carryovers and carrybacks do not include any unused foreign taxes apportioned to a corporation for a separate return year pursuant to § 1.1502-79(d). A consolidated group's unused foreign tax in each separate category is the excess of the foreign taxes paid, accrued or deemed paid under section 960 by the consolidated group over the limitation in the applicable separate category for the consolidated return year. See paragraph (c) of this section.

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

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

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

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

(1) *Facts.* (i) Domestic corporation P is incorporated on January 1, Year 1. On that same day, P incorporates domestic corporations S and T as wholly owned subsidiaries. P, S, and T file consolidated returns for Years 1 and 2 on the basis of a calendar year. T engages in business solely through a qualified business unit in Country A. S engages in business solely through qualified business units in Countries A and B. P does business solely in the United States. During Year 1, T sold an item of inventory to P at a gain of \$2,000. Under § 1.1502-13 the intercompany gain has not been taken into account as of the close of Year 1. The taxable income of each member for Year 1 from foreign and U.S. sources, and the foreign taxes paid on such foreign income, are as follows:

TABLE 1 TO PARAGRAPH (e)(1)(i)

Corporation	U.S. source taxable income	Foreign branch category foreign source taxable income	Foreign branch category foreign tax paid	Total taxable income
P .....	\$40,000	.....	.....	\$40,000
T .....	.....	\$20,000	\$12,000	20,000
S .....	.....	20,000	9,000	20,000
Group .....	40,000	40,000	21,000	80,000

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

(2) *Analysis.* Under section 904(d) and paragraph (c)(1)(i) of this section, the aggregate amount of foreign income taxes paid to all foreign countries with respect to the foreign branch category income of \$21,000 (\$12,000 + \$9,000) that may be claimed as a credit in Year 1 is limited to \$8,400 (\$16,800 × \$40,000/\$80,000). Assuming P, as the agent for the group, chooses to use the foreign taxes paid as a credit, the group may claim a \$8,400 foreign tax credit.

(f) *Applicability date.* This section applies to taxable years for which the original consolidated Federal income tax return is due (without extensions) after January 11, 2021.

■ **Par. 38.** Section 1.1502-21 is amended by adding a sentence to the end of paragraph (b)(2)(iv)(B)(1) to read as follows:

**§ 1.1502-21 Net operating losses.**

\* \* \* \* \*

- (b) \* \* \*
- (2) \* \* \*
- (iv) \* \* \*
- (B) \* \* \*
- (1) \* \* \*

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

\* \* \* \* \*

**PART 301—PROCEDURE AND ADMINISTRATION**

■ **Par. 39.** The authority citation for part 301 is amended by adding an entry for § 301.6689-1 in numerical order to read in part as follows:

**Authority:** 26 U.S.C. 7805.

\* \* \* \* \*

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

\* \* \* \* \*

■ **Par. 40.** Section 301.6227-1 is amended by adding paragraph (g) to read as follows:

**§ 301.6227-1 Administrative adjustment request by partnership.**

\* \* \* \* \*

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

\* \* \* \* \*

■ **Par. 41.** Section 301.6689-1 is added to read as follows:

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

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

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

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

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

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

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

(e) *Applicability date.* This section applies to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019, and to foreign tax redeterminations of foreign corporations occurring in taxable years that end with or within a taxable year of a United States shareholder ending on or after December 16, 2019.

**§ 301.6689–1T [REMOVED]**

■ **Par. 42.** Section 301.6689–1T is removed.

**Sunita Lough,**

*Deputy Commissioner for Services and Enforcement.*

Approved: September 18, 2020.

**David J. Kautter,**

*Assistant Secretary of the Treasury (Tax Policy).*

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