CAPITOL TAX
PARTNERS

Summary of Proposed Regulations Related to Foreign Tax Credits
Under Sections 78, 861, 901, 904, 960, and 965
Released November 28, 2018*

Background and Overview

The Treasury Department and IRS released proposed regulations on November 28, 2018 related to the changes made to the foreign tax credit system by the Tax Cuts and Jobs Act ("TCJA") and the interaction of those changes with pre-existing provisions of the Code and Regulations (the "Proposed Regulations"). Although TCJA moved the United States from a worldwide system (with deferral) to a dividend exemption system, it significantly increased the impact and complexity of the foreign tax credit system in ways that many taxpayers did not anticipate at the time of enactment. The Proposed Regulations are comprehensive and reflect the complexity created by TCJA statutory changes, but also reflect an exercise of Treasury's discretion to provide rules where Congress was silent.

Statutory changes made by TCJA

In general, for a US shareholder of one or more controlled foreign corporations ("CFC"), TCJA eliminated deferral and replaced it with a dividends received deduction ("DRD") under section 245A and an annual income inclusion of the US shareholder's global intangible low-taxed income ("GILTI") under section 951A. Under section 250(a)(1), a US shareholder that is a domestic corporation generally is eligible for a deduction equal to (i) 50 percent of its GILTI inclusion and associated section 78 gross-up (37.5 percent after 2025); plus (ii) 37.5 percent of its foreign derived intangible income ("FDII") (21.875 percent after 2025). Because GILTI is an automatic inclusion (rather than subject to a high-tax exception prior to inclusion, like section 951(a) subpart F inclusions), domestic corporate taxpayers must rely on foreign tax credits associated with the net GILTI inclusion to alleviate double taxation. TCJA made the following amendments to the rules for computing foreign tax credits and the foreign tax credit limitation:

- Repealed section 902 and deny a credit or deduction for foreign taxes attributable to dividends exempt under section 245A.
- Amended section 960 by (i) replacing the multi-year pooling method with a "properly attributable" standard for deemed paid foreign tax credits with respect to subpart F inclusions, GILTI inclusions, and distributions of previously taxed earnings and profits ("PTEP") under section 959; (ii) adding section 960(d) for deemed paid credits associated with GILTI inclusions, which are limited to 80 percent of the aggregate foreign taxes attributable to CFC tested income (reduced by the GILTI inclusion percentage); and (iii) providing special rules in section 960(b) and (c) for foreign taxes attributable to earnings distributed as PTEP.
- Amended section 905(c) to require foreign tax credit redeterminations to be taken into account in the tax year to which the tax relates.
- Amended section 78 by (i) applying the section 78 gross-up to 100 percent of the taxes deemed paid with respect to tested income under section 960(d); and (ii) making it ineligible for the section 245A DRD.
- Amended section 904 by (i) adding new separate foreign tax credit limitation categories for GILTI and foreign branch income under section 904(d)(1); (ii) denying carryover and carryback of excess taxes in the GILTI category under section 904(c); and (iii) disregarding for purposes of the foreign tax credit limitation dividends eligible for the section 245A DRD and US shareholder

* References to Preamble are to the document released by Treasury and IRS on November 28, 2018, which may vary slightly from the document published in the Federal Register on December 7, 2018.

expenses allocated and apportioned to such dividends or stock to the extent income with respect to such stock is other than subpart F or GILTI.

- Repealed the fair market value method of asset valuation to apportion interest expense under section 864(e), requiring apportionment based on the adjusted tax basis of assets.
- Amended the source rule for sales of inventory produced by the taxpayer under section 863(b)(2) to source income based on the location of production activities.

Overview of Proposed Regulations

The Proposed Regulations provide detailed rules to implement most of the statutory changes to the foreign tax credit system made by TCJA and other rules to provide taxpayers with clarity with respect to areas TCJA did not address. The Proposed Regulations substantially amend existing rules for purposes of computing the foreign tax credit limitation and make other changes and clarifications to reflect statutory changes made prior to TCJA. The rules that relate to TCJA generally apply to tax years beginning after 2017. Rules that do not relate to TCJA generally apply to tax years ending after the date the proposed regulations are published in the Federal Register (December 7, 2018). Regulations that contain both types of rules generally apply to tax years that both begin after 2017 and end after December 7, 2018. The following is an overview of the more significant rules, with a more detailed summary attached.

Expense allocation and apportionment. The Proposed Regulations confirm that pre-existing expense allocation rules under Reg. §§1.861-8 through 1.861-17 apply to determine the foreign tax credit limitation under section 904(a) with respect to the new GILTI and foreign branch income baskets. As a result, for example, expenses borne by a US shareholder that are allocated to the GILTI basket could cause foreign tax credits to be lost, since allocated expenses reduce the foreign tax credit limitation and excess credits in the GILTI basket cannot be carried over or carried back.

- *Exempt income and asset treatment*. The amount of gross income that is offset by the GILTI and FDII deduction under section 250(a)(1) is treated as exempt income, and a corresponding percentage of assets producing such gross income, including CFC stock basis that generates GILTI, are treated as exempt assets under section 864(e)(3). As a result, such amounts of income and assets are excluded from gross income and asset ratios applied to allocate and apportion US shareholder deductions, reducing the amount of deductions apportioned to the GILTI (but increasing the amount of deductions apportioned to other baskets).
    - Relative to a "no-action baseline," (i.e., absent the Proposed Regulations, TCJA could be interpreted to require full expense allocation to the GILTI basket), Treasury and IRS view this exempt income and asset treatment as potentially (i) increasing the competitiveness of US corporations; and (ii) reducing Federal tax revenue.
    - Treasury and IRS also view the lower corporate rate and new section 163(j) as counterbalancing potential incentives to shift debt into the US as a result of reduced interest expense allocation to the GILTI basket.
- *Characterizing CFC stock basis*. For asset-based apportionment (e.g., for interest expense), a detailed five-step process is provided to characterize CFC stock basis (under either the asset method or modified gross income method) as an asset producing foreign source income in the US shareholder's separate foreign tax credit limitation categories, or as producing US source income. The rules take into account the fact that a CFC does not have a GILTI category – its general and passive categories are divided into ten groupings, and a portion of the stock assigned to the general gross tested income group is assigned to the GILTI category (a portion of which may be treated as an exempt asset). Stock in the separate categories is further subdivided into a section 245A subgroup and non-section 245A subgroup for purposes of applying section 904(b)(4).

Transition relief is provided with respect to the repeal of the fair market value method for interest expense apportionment.

- *Allocation of foreign taxes and section 250 deduction*. Rules are provided to allocate and apportion foreign taxes (by expressly incorporating the principles of Reg. §1.904-6 into the rules under Reg. §1.861-8(e), see below) and the section 250 deduction (generally treated as definitely allocable to the income the deduction reduces).

- *Allocation of research expenses*. For research and experimental expenses, a one-time exception is provided with respect to the five-year binding election period to use either the sales method or gross income method under Reg. §1.861-17. While the Proposed Regulations make no other changes to the existing approaches for apportioning R&E expenses, Treasury and IRS request comments on whether and how to revise such approaches due to the new GILTI basket.

- *Reexamination of expense allocation rules*. Citing the application of worldwide interest expense allocation under section 864(f) after 2020, Treasury and IRS expect to reexamine existing approaches for allocating and apportioning all expenses and request comments.

Foreign tax credit limitation. In addition to the expense allocation rules discussed above, the Proposed Regulations provide additional guidance related to the foreign tax credit limitation that implement the rules of section 904(b)(4) and amend the regulations under section 904 to take into account the new foreign tax credit limitation baskets for GILTI and foreign branch income.

- *Disregard of deductions under section 904(b)(4)*. Rules are provided for determining deductions that are disregarded under section 904(b)(4) in determining foreign source income in a separate category (the numerator of the section 904(a) foreign tax credit limitation fraction) and entire taxable income (the denominator). In general, deductions are first allocated and apportioned to section 245A subgroups in each of the separate limitation categories, and then the resulting amounts are disregarded. Disregarded deductions increase the foreign tax credit limitation in the category to which they were allocated, and decrease the limitation in the other categories.

- *Transition rules*. Transition rules are provided for pre-2018 foreign tax credit carryovers and post-2017 carrybacks to a pre-2018 tax year. In general, pre-2018 carryovers are allocated to the same post-2017 basket from which they are carried, but taxpayers with general basket carryovers attributable to one or more foreign branches may choose to allocate such carryovers (other than deemed paid credits) to the post-2017 foreign branch basket. Comments are requested regarding whether a simplified rule should be provided for making the allocation and what form the rule should take. Pre-2018 carryovers are neither permitted nor required to be allocated to the GILTI basket. Post-2017 carrybacks from the general and foreign branch baskets are allocated to the general basket in the last tax year beginning before 2018. Similar transition rules are provided for SLLs, OFLs, and ODLs.

- *Income in GILTI basket*. Rules are provided to define the gross income included in the new GILTI and foreign branch baskets. The GILTI basket includes only (i) a US shareholder's foreign source GILTI inclusion not allocated to the passive basket; and (ii) the corresponding section 78 gross-up by reason of taxes deemed paid under section 960(d).

- *Income in foreign branch basket*. The foreign branch basket generally includes income attributable to a US person's foreign branches and its distributive share of partnership income attributable to the partnership's foreign branches, other than passive income, income attributable to US activities, income arising from stock (with an exception for stock gains on dealer property), or gain from the disposition of an interest in a pass-through or disregarded entity. Income is attributable to a foreign branch to the extent reflected on its separate books and records, adjusted to conform to US tax principles. Attribution rules are provided to properly reflect disregarded payments as foreign branch income or income of the foreign branch owner. Rules regarding the

foreign branch basket are relevant for both the section 904 foreign tax credit limitation and the section 250 deduction (deduction eligible income ("DEI") excludes foreign branch income).

- *Look-through rules*. The section 904(d)(3)(A) look-through rules apply to treat payments of dividends, interest, rents, and royalties a US shareholder receives from a CFC that are not allocable to passive category income of the CFC as income in the US shareholder's general, foreign branch, or as income resourced by treaty, as the case may be; notably, they are not included in the US shareholder's GILTI basket (CFCs do not have a GILTI category).
- *Allocation of foreign taxes*. The general rule for allocating and apportioning foreign taxes is retained – taxes are allocated to the income (determined under US tax principles) to which they relate, and taxes relate to income if the income is included in the foreign base upon which the tax is imposed. Base differences arise in only limited circumstances, and do not include computational differences in the amount of an item of income subject to tax. The rule for timing differences allocates taxes in the year imposed under foreign law as if the income were recognized under US tax principles in that year. Additional rules are provided for allocating taxes imposed on foreign branches, taxes deemed paid with respect to subpart F and GILTI inclusions, and partnership creditable foreign tax expenditures.

Deemed paid foreign tax credits under section 960. The Proposed Regulations implement the TCJA amendments to section 960. The rules under section 960 are the exclusive rules for determining deemed paid foreign tax credits. Only taxes paid or accrued by a CFC that are properly attributable to a domestic corporate US shareholder's subpart F or GILTI inclusion, or a distribution of PTEP, are eligible for credit.

- *Current year taxes*. Only "current year taxes" are potentially eligible for credit. Current year taxes are foreign income taxes paid or accrued in the CFC's US tax year in which there is a subpart F and GILTI inclusion or the CFC receives or makes a PTEP distribution. Foreign income taxes accrue at the end of the CFC's foreign tax year, and are current year taxes in the CFC's inclusion year, even if a portion of the foreign tax year falls within a different inclusion year. Thus, for example, where a CFC has a foreign calendar year-end but a US fiscal year-end, foreign taxes accrue at the end of the calendar year and are current year taxes potentially eligible for credit with respect to a subpart F or GILTI inclusion in the US tax year that ends later. This ensures foreign taxes are not lost due to year-end mismatches, but could have adverse results if the CFC's earnings are volatile from year to year. Similarly, the rule for timing differences looks to when the foreign tax accrues, not when the related income is recognized for US tax purposes. Foreign tax redeterminations "relate back" and are considered to accrue as of the end of the CFC's foreign tax year to which the tax relates. Thus foreign tax redeterminations must be accounted for on an amended return for the prior year.
- *Steps to determine current year taxes eligible for credit*. Detailed guidance is provided to associate a CFC's current year taxes with a CFC's current year income or PTEP distribution and determine deemed paid foreign tax credits under section 960. A six-step process is applied to each CFC in a chain of ownership, beginning with the lowest-tier CFC. In general, CFC gross income and expenses are allocated under the section 904 and 861 regulations to the CFC's separate categories, and then to income groups relevant to the US shareholder – either subpart F, tested income, or residual group. The CFC's current year taxes are then allocated to each category and group, and deemed paid credits under section 960(a) and (d) are determined. If a CFC receives a PTEP distribution, it is assigned to an annual PTEP account and one of ten PTEP groups within the account. Taxes imposed solely by reason of the PTEP distribution are allocated to the PTEP group and the deemed paid credit under section 960(b)(2) is determined. After this is done for each CFC in the chain, the US shareholder determines its deemed paid credit under section 960(b)(1) if a PTEP distribution is received from the top-tier CFC. Taxes not allocated to

a subpart F, tested income, or PTEP groups are allocated to the residual group and cannot be credited (e.g., high-tax exception subpart F income, foreign oil and gas extraction income).

- *Properly attributable standard*. In addition to defining current year taxes and associating such taxes to appropriate categories and subgroups, the statute's "properly attributable" standard for deemed paid foreign tax credits is implemented through a "proportionate share" concept. In general, the amount of CFC taxes eligible for credit under section 960(a) or (d) is a proportionate amount of taxes associated with a subpart F or tested income group based on the amount in the group that is included in the US shareholder's subpart F inclusion or aggregate tested income. The aggregate proportionate amount of tested foreign income taxes of all CFCs is multiplied by 80-percent and the US shareholder's inclusion percentage to arrive at the section 960(d) credit. The amount of foreign taxes eligible for credit under section 960(b) with respect to a PTEP distribution is generally a proportionate amount of PTEP group taxes based on the amount of income in the PTEP group received as a distribution. No taxes are deemed paid under section 960(a) with respect to a section 956 inclusion.

- *Domestic partnerships*. Rules are provided to coordinate the foreign tax credit rules with the treatment of domestic partnerships and domestic corporate partners of domestic partnerships under subpart F and GILTI. If a domestic corporate partner is a US shareholder with respect to a CFC owned by a domestic partnership (i) section 960(a) credits are allowed as if the partner had included its distributive share of the subpart F inclusion directly; (ii) the rules that apply to determine the section 960(d) credit apply at the partner level (see Prop. Reg. §1.951A-5); and (iii) the partner's distributive share of a PTEP distribution received by the partnership is treated as received directly by the partner.

Treatment of section 78 gross-up under section 245A. The Proposed Regulations implement the TCJA amendment to section 78. Section 78 dividends are not eligible for the section 245A DRD. Although the amendment to section 78 was effective for tax years beginning after 2017, and section 245A was effective for distributions made after 2017, the rule in the Proposed Regulations applies to section 78 dividends received after 2017 by reason of taxes deemed paid under section 960(a) with respect to a taxable year of a foreign corporation beginning before 2018 (which includes the section 965 inclusion year of a fiscal year CFC).

Rules related to section 965. The Proposed Regulations include rules related to the determination of stock basis in connection with section 965(b) (treatment of E&P deficits) and the effect of the section 965(n) election to exclude the section 965 inclusion and related section 78 gross-up in determining the section 172 NOL carryover or carryback absorbed in the inclusion year.

- *EDFC stock basis*. For purposes of expense allocation and apportionment, the basis in stock of a specified foreign corporation is determined as if the taxpayer had made the basis shifting election under Prop. Reg. §1.965-2(f)(2)(i), but only the downward basis adjustment to the E&P deficit foreign corporation ("EDFC") stock is taken into account, which offsets the basis increase by reason of the E&P increase under section 965(b)(4)(B). The upward basis adjustment to the deferred foreign income corporation ("DFIC") stock is not taken into account.

- *Section 965(n) election*. The section 965(n) election applies solely for purposes of determining the NOL for the election year and the amount of NOL carryover or carryback to the election year. If the section 965(n) election creates or increases a section 172 NOL, taxable income in the election year cannot be less than the net section 965 inclusion and related section 78 gross-up. The amount of deductions that create or increase a section 172 NOL in the election year are deferred and not taken into account in computing taxable income or separate foreign tax credit limitations in that year. Ordering rules are provided to coordinate the effect of the election with foreign tax credit limitation calculations.

Rules not directly related to TCJA. The Proposed Regulations include several new rules that are not directly related to TCJA, including those described below intended to address positions Treasury and IRS believe taxpayers have taken in the past. The first two described below apply to tax years ending after December 7, 2017, giving them a quasi-retroactive effect. The third is included in a regulation that would apply to tax years that both begin after 2017 and end after December 7, 2018.

- *CFC netting rule*. The CFC netting rule in Reg. §1.861-10(e)(8)(vi) is revised to not treat hybrid debt as related group indebtedness for purposes of the CFC netting rule or for purposes of determining the foreign base period debt-to-asset ratio, even if the hybrid debt was otherwise properly treated as related group indebtedness in a prior year.
- *Subpart F high-tax exception*. The rules to determine the effective tax rate for purposes of the section 954(b)(4) exception are modified to disregard foreign income taxes paid or accrued to the extent they are reasonably certain to be returned to a shareholder upon a subsequent distribution to the shareholder.
- *Specified partnership loans*. For purposes of allocating interest income, a new rule is provided for interest on loans made to a partnership by a person (or affiliated group member) that owns an interest in the partnership (a "specified partnership loan" or "SPL"). A matching rule is provided for an SPL lender with respect to the interest income from the loan, which must be assigned to the same groupings as its distributive share of the partnership's interest expense. In addition, the portion of the loan related to interest income subject to the matching rule is not treated as an asset of the SPL lender.

Next steps

Treasury and IRS have indicated an intent to finalize the Proposed Regulations before the end of June 2019. The applicability dates reflect that intent, as they would be required to do so to meet the requirements of section 7805(b) for adoption of retroactive regulations. Comments must be received by February 5, 2019, which is 60 days after the Proposed Regulations were published in the Federal Register, on December 7, 2018.

Detailed Summary

A. Allocation and apportionment of deductions and the calculation of taxable income for purposes of applying the foreign tax credit limitation of section 904(a)

1. **In general.**

    a. Expense allocation rules apply to income in the new section 951A and foreign branch income baskets. However, exempt income and exempt asset treatment is provided with respect to section 951A basket income that is offset by the section 250(a)(1) deduction for GILTI and a corresponding percentage of CFC stock basis that generates GILTI. As a result, a lower amount of expenses are apportioned to the GILTI foreign tax credit limitation basket (and a higher amount apportioned to other baskets) than would otherwise be the case. Preamble at 7-8.

    b. Treasury and IRS plan to reexamine existing expense allocation rules, based on the application of worldwide interest expense allocation under section 864(f) after 2020. Treasury and IRS expect to reexamine existing approaches allocating and apportioning all expenses, including interest, R&E, stewardship, and G&A, as well as the CFC netting rule in Reg. §1.861-10(e). *Comments requested*. Preamble at 9.

2. **Definitions of exempt income and exempt asset– Preamble at 10-14; Prop. Reg. §1.861-8(d)(2)**.

    a. Definitions revised to clarify that income and assets are treated as exempt (or partially exempt) under section 864(e)(3) only to the extent that the income or the income from the assets are, or are treated as, exempt, excluded, or eliminated.

    b. Gross income offset by the section 250 deduction is treated as exempt income, and the stock or other assets giving rise to such income are treated as a partially-exempt assets. These rules apply for purposes of the section 904(a) FTC limitation; they do not apply for purposes of apportioning deductions to determine DEI under section 250(b)(3).

        i. *Exempt income*. For deductions apportioned based on gross income, gross income excludes the amount of a domestic corporation's deduction allowed under section 250(a)(1) (taking into account the taxable income limitation under section 250(a)(2)(B)) for FDII, GILTI inclusion, and section 78 gross-up attributable to the GILTI inclusion.

        ii. *Exempt FDII assets*. For deductions apportioned based on assets (e.g., interest), the amount of a domestic corporation's assets that produce FDII gross income in proportion to the ratio of FDII treated as exempt income (i.e., FDII deduction divided by FDII) is not taken into account. Royalty income eligible for the FDII deduction and received from a CFC (including a section 367(d) royalty) does not cause any portion of CFC stock to be treated as exempt.

        iii. *Exempt GILTI inclusion stock*. GILTI inclusion stock is generally the amount of CFC stock value assigned under Prop. Reg. §1.861-13(a) to the section 951A category and gross tested income statutory groupings for foreign and US source passive and US source general categories. The amount not taken into account is an amount in proportion to the ratio of the GILTI inclusion treated as exempt income (i.e., GILTI deduction divided by GILTI inclusion).

    c. Section 245A DRD and section 965(c) deduction do not give rise to exempt income or exempt assets under section 864(e)(3). Instead, section 904(b)(4) provides for alternative adjustments. Previously taxed earnings and profits (PTEP) do not result in any portion of the stock in a CFC being treated as an exempt asset.

d. Applicability date. Taxable years that both begin after 2017 and end after the date proposed regulations are published in the Federal Register (December 7, 2018).

3. **Allocation and apportionment of foreign income taxes, the section 250 deduction, and distributive share of partnership deductions – Preamble at 14-16; Prop. Reg. §1.861-8(e).**

   a. Foreign income taxes. Principles of Reg. §1.904-6(a)(1)(i), (ii), and (iv) expressly incorporated into the allocation and apportionment rules in Prop. Reg. §1.861-8(e)(6).

   b. Section 250 deduction. Separate rules allocating section 250(a)(1) deductions for FDII and GILTI (taking into account the taxable income limitation in section 250(a)(2)(B)) to the income reduced by the deductions.

      i. FDII deduction treated as definitely related and allocable to the specific class of gross income that is included in foreign derived deduction eligible income. If the class contains multiple categories under section 904(d) (statutory groupings, e.g., general and passive foreign source) or US source income (residual category), the deduction is ratably apportioned based on relative amounts of gross income. Prop. Reg §1.861-8(e)(13).

      ii. GILTI (and corresponding section 78 gross-up) deduction treated as definitely related and allocable to the class of gross income included under section 951A (GILTI inclusion). If the GILTI inclusion is included in more than one statutory grouping (i.e., GILTI and passive) or residual grouping (i.e., US source), the deduction is apportioned ratably based on the relative amounts of gross income in the different statutory groupings. Prop. Reg. §1.861-8(e)(14).

   c. Distributive share of partnership deductions. If a taxpayer is a partner in a partnership, the taxpayer's deductions that are allocated and apportioned include the taxpayer's distributive share of the partnership's deductions. Prop. Reg. §1.861-8(e)(15).

   d. Applicability date. Taxable years that both begin after 2017 and end after the date proposed regulations are published in the Federal Register (December 7, 2018).

4. **Special rule for specified partnership loans – Preamble at 16-18; Prop. Reg. §1.861-9(e)(8).**

   a. Specified partnership loan (SPL). Loan made to a partnership by a person (or member of same affiliated group) that owns an interest in the partnership (directly or indirectly).

   b. Matching rule. Under a matching rule, an SPL lender assigns the interest income to the same statutory and residual groupings as those from which its distributive share of interest expense on the same loan is deducted. The portion of the loan related to the interest income subject to the matching rule is not treated as an asset of the SPL lender.

   c. Anti-avoidance rules. Anti-avoidance rules extend the rules to certain back-to-back loans or loans made through CFCs. Also applies to transactions not characterized as loans but give rise to deductions allocated and apportioned in the same manner as interest expense.

   d. Applicability date. Taxable years that both begin after 2017 and end after the date proposed regulations are published in the Federal Register (December 7, 2018).

5. **Revision of CFC netting rule relating to hybrid debt – Preamble at 18; Prop. Reg. §1.861-10(e)(8)(vi).**

   a. Hybrid debt is not treated as related group indebtedness for purposes of the CFC netting rule of Reg. §1.861-10(e).

b. Hybrid debt is also not treated as related group indebtedness for purposes of determining the foreign base period debt-to-asset ratio, even if the hybrid debt was otherwise properly treated as related group indebtedness in a prior year.

c. Applicability date. Taxable years ending on or after the date the proposed regulations are published in the Federal Register (December 7, 2018).

6. **Valuation of assets for purposes of apportioning interest expense and other deductions – Preamble at 19-23.**

a. Repeal of fair market value method and transition relief.

i. Taxpayers using the FMV method must switch to the tax book or alternative tax book value method for purposes of interest expense apportionment for the first tax year beginning after 2017. IRS approval not required. Prop. Reg. §§1.861-8(c)(2) and 1.861-9(i)(2).

ii. Affected taxpayers may choose to determine asset values using an average of the end of the first quarter (rather than beginning of year) and year-end values for first tax year beginning after 2017, subject to consistency rule for affiliated groups and that no substantial distortion would result. Prop. Reg. §1.861-9(g)(2)(i).

iii. FMV method and rules in Reg. §1.861-9(h) remain applicable for non-interest expenses apportioned on the relative fair market values of assets.

b. Clarification of rules for adjusting stock basis in nonaffiliated 10 percent owned corporations for earnings and profits.

i. Basis adjustments to stock in non-affiliated 10-percent owned corporations for earnings and profits under section 864(e)(4) and Reg. §1.861-12(c)(2) includes PTEP.

ii. Clarify that the "rules of section 1248" in Reg. §1.861-12T(c)(2)(i)(B) applies for purposes of determining the pro rata share of E&P attributable to the taxpayer's shares; not relevant to determining amount of foreign corporation's E&P subject to the adjustment, which is governed by sections 964(a) and 986. Prop. Reg. §1.861-12(c)(2)(i)(B)(2).

iii. Clarify that beginning and end of year values of stock are determined without regard to any adjustments under sections 961(a) or 1293(d), and before making the adjustment for E&P provided in Reg. §1.861-12(c)(1)(i)(A). The adjustment for total E&P is made after the average of the beginning and end of year values has been determined. Prop. Reg. §1.861-9(g)(2)(i)(B).

c. Determination of stock basis in connection with section 965(b).

i. Basis in stock of a specified foreign corporation is determined as if the taxpayer had made the basis shifting election under Prop. Reg. §1.965-2(f)(2)(i). However, the upward basis adjustment to DFIC stock is not taken into account; only the downward basis adjustment to EDFC stock is taken into account, to offset the increase in the tax book value of the stock by reason of the E&P increase under section 965(b)(4)(B) included in basis under §1.861-12(c)(2)(i)(A). Prop. Reg. §1.861-12(c)(2)(i)(B)(1)(ii).

ii. *Comments requested* on alternative ways to account for section 965(b) that minimize taxpayer burdens without distorting the measurement of a CFC's tax book value.

d. Applicability date. Taxable years that both begin after 2017 and end on or after the date the proposed regulations are published in the Federal Register (December 7, 2018). The proposed regulation related to section 965(b) applies to the last taxable year of a foreign corporation that begins before 2018, and the taxable year in which or with which such taxable year of the foreign corporation ends (i.e., the section 965 inclusion year).

7. **Characterization of stock of certain foreign corporations under Reg. §1.861-12 – Preamble at 24-29.**

a. Characterization of CFC stock to account for section 951A category, treaty categories, and section 904(b)(4) – Prop. Reg. §§1.861-12(c)(3), 1.861-13.

i. Where section 904 is the operative section (i.e., the US shareholder's FTC limitation), a **5-step** process is used to characterize CFC stock (including tested loss CFC stock) as an asset producing foreign source income in the separate categories described in Prop. Reg. §1.904-5(a)(4)(v), or as producing US source income in the residual grouping. Stock in the separate categories is further subdivided into a section 245A subgroup and non-section 245A subgroup (for purposes of applying section 904(b)(4)).

ii. New section 951A category only applies to US shareholders; it does not apply to CFCs. At the CFC level, gross tested income of a CFC is assigned to the general category under Reg. §1.861-12T(c). Prop. Reg. §1.861-13 takes this difference into account, as well as a similar issue that arises with respect to subpart F and GILTI inclusions attributable to US source income under section 904(h) that the US shareholder elects to resource pursuant to a treaty. Proposed rules apply solely for purposes of characterizing stock when section 904 is the operative section (i.e., the US shareholder's FTC limitation).

iii. *Step 1: Determine amount of CFC stock assigned to each statutory grouping under the asset method or modified gross income method.* General and passive categories each have ten subgroups:

- Two for gross tested income (US source, foreign source),
- Two for gross subpart F income (US source, foreign source),
- Two for income resourced by treaty (resourced gross tested income, resourced gross subpart F income),
- Two for gross section 245(a)(5) income (US source ECI, foreign source ECI); and
- Two for any other gross income (specified US source general or passive category, specified foreign source general or passive category).

iv. *Step 2: Assign stock to the section 951A category*. Amount equals the portion of the CFC stock assigned to the general category foreign source gross tested income subgroup, multiplied by the US shareholder's inclusion percentage.

- A portion of the CFC stock assigned to the section 951A category may be treated as an exempt asset under Prop. Reg. §1.861-8(d)(2)(ii)(C)(2)(ii) (i.e., a percentage based on the section 250 deduction).
- The portion of general category gross tested income stock that is not assigned to the section 951A category remains a general category asset and may result in expenses being disregarded under section 904(b)(4).

- No portion of the passive category gross tested income stock or US source gross tested income stock is assigned to the section 951A category.

v. *Step 3: Assign stock to a treaty category.*

- *GILTI inclusions*. Amount equals the portion of the CFC stock assigned to the subgroups in the general and passive categories for gross tested income resourced by treaty, multiplied by the US shareholder's inclusion percentage. A portion of that amount may be treated as exempt under Prop. Reg. §1.861-8(d)(2)(ii)(C)(2)(ii), and the portion not assigned to a treaty category remains US source general or passive category in the residual grouping and may result in expenses being disregarded under section 904(b)(4) for purposes of determining entire taxable income (i.e., the denominator in the FTC limitation fraction).

- *Subpart F inclusions*. Amount equals the portion of the CFC stock assigned to the subgroups in the general and passive categories for subpart F income resourced by treaty.

vi. *Step 4: Aggregate remaining stock within each separate category and assign stock to the residual grouping.*

- Portions of stock assigned to the foreign source subgroups in the general and passive categories not assigned to the section 951A category in step 2 are aggregated within the passive and general categories and characterized as general and passive category stock, respectively.

- Portions of stock assigned to the US source subgroups not assigned to a particular treaty category in step 3 are aggregated and characterized as US source category stock, which is in the residual grouping.

vii. *Step 5: Determine section 245A and non-section 245A subgroups for each separate category and US source category.*

- *Section 245A subgroup of general category stock*. Amount equals the value of the general category gross tested income stock not assigned to the section 951A category in step 2; plus the value of the portion of stock assigned to the specified foreign source general category statutory grouping.

- *Section 245A subgroup of passive category stock*. Amount equals the sum of (A) the value of the portion of stock assigned to the gross tested income statutory grouping within the foreign source passive category, multiplied by [100 percent minus the US shareholder's inclusion percentage for passive category gross tested income]; and (B) the value of the portion of stock assigned to the specified foreign source passive category statutory grouping.

- *Section 245A subgroup of US source category stock*. Amount equals the sum of (A) the value of the portion of stock assigned to the US source gross tested income statutory grouping within the general category, multiplied by [100 percent minus the US shareholder's inclusion percentage for the general category]; (B) the value of the portion of stock assigned to the US source gross tested income within the passive category, multiplied by [100 percent minus the US shareholder's

inclusion percentage for the passive category]; (C) the value of the resourced gross tested income stock not assigned to a particular treaty category in step 3; (D) the value of the portion of stock assigned to the specified US source general category gross income statutory grouping; and (E) the value of the portion of stock assigned to the specified US source passive category gross income statutory grouping.

- *Non-section 245A subgroup*. Amount equals the value of stock not assigned to any section 245A subgroup, which always includes the value of stock assigned to the section 951A category, the section 901(j)(1) category (international boycott), or a particular treaty category.

b. Treatment of gross tested income for tiers of CFCs – Prop. Reg. §§1.861-9(j)(2)(ii)(C), 1.861-12(c)(3)(iii).

   i. Asset method and modified gross income method provide rules to characterize stock in a CFC when there are tiers of CFCs. Preamble at 28; Reg. §1.861-12T(c)(3).

   ii. Similar rules are proposed for GILTI inclusions. For purposes of characterizing CFC stock under the modified gross income method, the gross tested income of lower-tier CFCs, net of interest expense, is excluded from the gross income of intermediate-tier CFCs but is included in the gross income of the first-tier CFC. *Comments requested* on whether additional rules are required to account for gross tested income in lower-tier CFCs, including gross tested income of lower-tier CFCs that produce tested losses.

c. Characterization of stock of a noncontrolled 10-percent owned foreign corporation – Prop. Reg. §1.861-12(c)(4).

   i. To reflect the repeal of section 902 and the new definition for a noncontrolled 10-percent owned foreign corporation in section 904(d)(2)€, proposed regulations modified to provide that stock in a noncontrolled 10-percent owned foreign corporation is generally characterized under the same rules previously used for noncontrolled section 902 corporations.

   ii. Except for nonqualifying shareholders, principles that apply to characterize CFC stock generally apply to characterize stock of a noncontrolled 10-percent owned foreign corporation.

d. Applicability date. Taxable years that both begin after 2017 and end on or after the date the proposed regulations are published in the Federal Register (December 7, 2018).

8. **Allocation and apportionment of research and experimental expenditures – Preamble at 30-31; Prop. Reg. §1.861-17(e)(3).**

   a. One-time exception to the five-year binding election period to use either the sales or gross income method of apportionment under Reg. §1.861-17 provided for taxpayer's first tax year beginning after 2017.

   b. Look-through rules of section 904(d)(3) do not assign royalties that reduce CFC tested income to the section 951A category, even though the CFC's sales to which the royalties relate may generate section 951A category income to the US shareholder. Instead, such royalties are generally assigned to the general category. As a result, the sales method would apportion R&E solely to the section 951A category, while the gross income method would apportion R&E to both the section 951A and general category. *Comments*

requested on whether and how to revise the regulations under the two methods due to the new section 951A category.

c. Applicability date. Taxable years that both begin after 2017 and end on or after the date the proposed regulations are published in the Federal Register (December 7, 2018).

9. **Section 904(b)(4) – Preamble 31-37; Prop. Reg. §1.904(b)-3.**

a. Effect of section 904(b)(4) on the foreign tax credit limitation.

i. Section 904(b)(4) generally disregards dividends eligible for the section 245A DRD and deductions allocated or apportioned to such dividends or the stock of the foreign corporation to the extent characterized as producing such dividends.

- Disregarding deductions after they are allocated and apportioned differs from exempt income and asset treatment provided in section 864(e)(3), which removes exempt income and assets before deductions are allocated and apportioned.
- Disregarding deductions after they have been allocated and apportioned is consistent with a policy that deductions allocated and apportioned to section 245A exempt dividends should not be allocated and apportioned to other separate categories of income.

ii. Dividends and deductions that are disregarded under section 904(b)(4) result in adjustments to both foreign source taxable income in the relevant separate category (the numerator of the section 904(a) fraction) and worldwide taxable income in all separate categories (the denominator).

- Disregard of the dividend eligible for section 245A and the associated deduction has no effect, because they net to zero.
- Disregard of other deductions (i.e., deductions properly allocable and apportioned to income for which a section 245A deduction is allowed) increases the FTC limitation for the separate FTC limitation category to which the deductions are allocated and apportioned (because both numerator and denominator are increased), but decreases the FTC limitation in the other separate limitation categories (because only the denominator is increased). Disregard of deductions allocable to the US source residual category applies solely to the denominator.
- The pre-credit US tax (the multiplicand in determining the foreign tax credit limitation) is not impacted.

b. Determining properly allocable or apportioned deductions.

i. Gross income and assets in each separate FTC limitation category and the US source residual grouping are subdivided into section 245A subgroups and non-section 245A subgroups, and each subgroup is treated as a statutory grouping under Reg. §1.861-8(a)(4). Deductions properly allocable or apportioned to section 245A dividends and stock are those allocated and apportioned to the section 245A subgroups under Reg. §§1.861-8 through 1.861-14T and 1.861-17. The section 245A DRD is always allocated solely to a section 245A subgroup and therefore is always disregarded.

ii. Income in a section 245A subgroup includes only dividends for which a section 245A deduction is allowed (which does not include section 245A(e) hybrid

dividends or dividends for which the section 246(c) holding period requirements are not met).

iii. The only asset included in a section 245A subgroup is a portion of the value of stock in a specified 10-percent owned foreign corporation, determined under the stock characterization rules of Reg. §1.861-12 and Reg. §1.861-13. Stock of a specified 10-percent owned foreign corporation is generally in a section 245A subgroup because it does not generate subpart F or GILTI inclusions. The amounts of CFC stock in section 245A subgroups are determined under Reg. §1.861-13(a)(5).

c. Coordination with OFL/ODL rules. Section 904(b)(4) applies before the OFL rules in section 904(f) and ODL rules in section 904(g). This is consistent with the application of adjustments in section 904(b)(2) and permits loss accounts to be recaptured out of income that is added to the FTC limitation calculation by reason of the section 904(b)(4) adjustments.

d. Applicability date. Taxable years beginning after 2017. For a taxable year that both begins before 2018 and ends after 2017, it applies without regard to the rules relating to GILTI inclusions.

B. Foreign tax credit limitation under section 904

1. Transition rules accounting for the increase in section 904(d)(1) separate categories (i.e., new section 951A and foreign branch categories).

a. Carryovers and carrybacks of unused foreign taxes under section 904(c) – Preamble at 38-42; Prop. Reg. §1.904-2(j).

i. *General rule for carryovers.* Pre-2018 foreign tax credit carryovers are allocated to the same post-2017 separate category from which they are carried. Taxpayers are neither required nor allowed to assign pre-2017 taxes to the section 951A category, which is not eligible to be sheltered from US tax by FTC carryovers.

ii. *Branch carryover exception.* Taxpayers may choose to carryforward pre-2018 general category unused taxes paid or accrued (but not taxes deemed paid) to the post-2017 foreign branch category to the extent they would have been in the branch category had they been paid or accrued in a post-2017 tax year. *Comments requested* on whether there should be a simplified rule to reconstruct the allocation of pre-2018 general category taxes, what form such a rule should take, and whether there are special concerns regarding members that have left a consolidated group.

iii. *Rule for carrybacks.* Post-2017 foreign tax credit carrybacks from general and foreign branch categories are allocated to general category in the last tax year beginning before 2018.

b. Separate limitation losses, overall foreign losses, and overall domestic losses – Preamble at 42-43; Prop. Reg. §1.904(f)-12(j).

i. *Passive and specified separate categories*. Any SLL or OFL accounts in the pre-2018 separate category for passive category income or income in a specified separate category are allocated to the same post-2017 separate category. Pre-2018 SLLs and ODLs are recaptured in subsequent years as income in the same post-2017 separate category as the pre-2018 separate category of income that was offset by the loss.

ii. *General category*. Any SLL or OFL in the pre-2018 separate category for general category income is allocated to the post-2017 separate category for general category income. However, if a taxpayer has pre-2018 general category FTC carryovers and applies the exception in Prop. Reg. §1.904-2(j)(1)(iii), any SLL or OFL account in the pre-2018 general category is allocated between post-2017 general and foreign branch income categories in the same proportion as FTC carryovers are allocated to such categories.

iii. *Recapture of Pre-2018 SLLs and ODLs*. Pre-2018 SLLs and ODLs are recaptured in subsequent years in the same post-2017 separate category as the pre-2018 separate category of income that was offset by the loss. However, if a taxpayer has pre-2018 general category excess FTC carryovers and applies the exception in Prop. Reg. §1.904-2(j)(1)(iii), pre-2018 general category SLLs and ODLs are recaptured in the post-2017 general and foreign branch income categories in the same proportion as FTC carryovers are allocated to such categories.

iv. *Foreign losses that are part of pre-2018 NOL carryforwards*. Rules of Reg. §1.904(g)-3(b)(2) apply to a foreign loss that is part of a pre-2018 NOL carried forward to a post-2017 year under section 172. A foreign loss from the pre-2018 passive and specified separate categories of income are treated as losses in the same post-2017 separate category. A foreign loss from the pre-2018 general category are treated as losses in the general or foreign branch category under the allocation principles for general category SLLs and OFLs.

c. Applicability date. Taxable years beginning after 2017. Rules related to FTC carrybacks also apply to the last taxable year beginning before 2018.

2. Separate categories of income.

a. Treatment of export financing interest, high-taxed income, and financial services income.

i. *Export financing interest and high-taxed income*. Under section 904(d)(2)(B)(iii), passive income does not include export financing interest and high-taxed income. Under the proposed regulations, export financing interest and high taxed income are characterized as non-passive category income based on whether the income otherwise meets the definition of foreign branch category income, section 951A category income, or general category income. Any taxes imposed on that income are considered related to the same separate category under Reg. §1.904-6. Prop. Reg. §§1.904-4(c), (h)(2).

ii. *Financial services income*. Under section 904(d)(2)(C)(i), financial services income is treated as general category income. However, the addition of the new foreign branch category (a more specific category) takes precedence over the treatment of financial services income as general category income. Thus, under the proposed regulations, financial services income not treated as foreign branch category income is treated as general category income. Prop. Reg. §1.904-4(e). Treasury and IRS are considering modifications to the gross income-based test for determining financial services entity status. *Comments requested*, in particular with respect to the appropriate treatment of related party payments. Preamble at 45-46.

b. Foreign branch category income – Preamble at 46-54; Prop. Reg. §1.904-4(f).

i. Relevant for both section 904 FTC limitation and section 250 FDII deduction (DEI excludes foreign branch income).

ii. *Gross income in the category*. Foreign branch category income means (1) the gross income of a US person (other than a pass-through entity) that is attributable to foreign branches held directly or indirectly through disregarded entities by the US person; and (2) a US person's (other than a pass-through entity) distributive share of partnership income that is attributable to a foreign branch held by the partnership directly or indirectly through another partnership or other pass-through entity. Income is attributable to a foreign branch to the extent it is reflected on its separate set of books and records. Several adjustments are made from what is reflected on a separate set of books and records:

- Exclude gross income arising from activities carried out in the US.
- Exclude gross income arising from stock, including stock gains (other than dealer property), dividends, subpart F, GILTI, and PFIC inclusions.
- Exclude gains from the disposition of an interest in a disregarded entity, partnership interest, or other pass-through entity, unless, in the case of a sale of a partnership interest, the gain is reflected on the branch's books and records and the interest is held in the ordinary course of the branch owner's trade or business.
- Anti-abuse rules to reattribute gross income if a principal purpose of recording (or not recording) income on the branch's books is the avoidance of Federal income tax or avoiding the purposes of sections 904 or 250. Presumption is that related party interest income received by a foreign branch is not attributable to the foreign branch unless the interest is financial services income.
- Non-passive category income adjusted, in accordance with the arm's length principle of section 482, to reflect transactions (i) between a foreign branch and its owner, and between or among branches that are disregarded for Federal income tax purposes; (ii) involving payments that would be deductible or capitalized if the payment were regarded ("disregarded transactions").

iii. *Disregarded transactions*. Disregarded transactions result in a redetermination of whether gross income is attributable to a foreign branch or branch owner, but no effect on amount, character or source of income. US source gross income reallocated from the general to the foreign branch category that is subject to foreign tax may be eligible for treaty resourcing (and subject to separate FTC limitation) under section 904(d)(6).

- *Exception*. Exception applies to contributions, remittances, and payments of interest and interest equivalents, which generally reflect a shift of, or return on, capital rather than a payment for goods and services. However, exception does not apply to any disregarded transaction in which section 367(d)(4) property (IP) is transferred to or from a branch – gross income must be adjusted to reflect consideration that would be due, regardless of whether a disregarded payment is made.
- *Comments requested* on (1) whether special rules are required for true branches with respect to amounts deemed made under the foreign jurisdiction's profit attribution rules; (2) how adjustments related to disregarded transactions could be limited or simplified to reduce administrative and compliance burdens, while consistent with the

purposes of sections 904 and 250(b)(3)(A); (3) whether any special rules should be issued for allocating and apportioning deductions between the foreign branch and general category; and (4) whether there should be special rules for financial institutions with branches subject to regulatory capital requirements, e.g., rules similar to Reg. §1.882-5.

iv. *Definition of foreign branch*. A foreign branch is a qualified business unit (QBU) that carries on a trade or business outside the US. QBU is defined by reference to the section 989 regulations, with modifications:

- The per se QBU rules are not incorporated and the trade or business requirements are modified to requiring that a foreign branch carry on a trade or business outside the US – activities conducted in the US do not constitute a trade or business.
- Activities that constitute a permanent establishment in a foreign country under a US tax treaty are presumed to constitute a trade or business outside the US.
- Activities that relate to disregarded transactions are taken into account and may give rise to a trade or business outside the US.

v. *Characterizing partnership assets as foreign branch category assets*. Where a partner's distributive share of partnership income is characterized as foreign branch category income, the partner's pro rata share of partnership assets that give rise to such income is treated as assets in the foreign branch category. Prop. Reg. §1.861-(e)(9).

c. Section 951A category income – Preamble at 54-55; Prop. Reg. §1.904-4(g).

i. Includes the gross income of a US shareholder from a GILTI inclusion (directly or indirectly through a pass-through entity) that is not allocable to passive category income under look-through rules of Reg. §1.904-5(c)(6).

ii. Excludes a CFC's distributive share of partnership income in which the CFC owns less than 10 percent of the value of the partnership, which is treated as passive category. Prop. Reg. §1.904-4(n)(1)(ii). *Comments requested* on whether the rules providing for this treatment should be modified.

iii. Includes section 78 gross up by reason of taxes deemed paid under section 960(d) assigned to the section 951A separate category under Reg. §1.904-6(b) as the deemed taxes paid. Prop. Reg. §1.904-4(o).

d. Items resourced under treaty. Under section 904(d)(6), if a taxpayer chooses to resource US source income as foreign source income under a US tax treaty, FTCs and the FTC limitation are applied separately with respect to each item of income. The proposed regulations provide income grouping rules similar to those that apply for purposes of section 904(h)(10) (US source subpart F and GILTI inclusions resourced under treaty) and rules to coordinate certain treaty and Code provisions. Preamble at 55-58; Prop. Reg. §1.904-4(k)(2). *Comments requested* whether regulations should provide a special rule limiting the tax assigned to section 904(d)(6) separate category to tax paid to the foreign country that is party to the tax treaty pursuant to which the income is resourced.

e. Foreign exchange gain or loss under section 986(c). Gain or loss under section 986(c) on a distribution of previously taxed earnings and profits is assigned to the separate category from which the distribution was made. Prop. Reg. §1.904-4(p).

f. Applicability date. Taxable years that both begin after 2017 and end on or after the date the proposed regulations are published in the Federal Register (December 7, 2018).

3. Look-through rules – Preamble at 60-63; Prop. Reg. §1.904-5.

a. Amounts from CFCs.

i. Look-through rules of section 904(d)(3)(A) apply to exclude from the passive category dividends, interest, rents and royalties a US shareholder receives from a CFC that are not allocable to passive category income of the CFC. Amounts excluded are assigned to another separate category under the rules of §1.904-4, i.e., foreign branch category (if received by a foreign branch), a specified separate category (e.g., resourced under treaty), or the general category—but are not assigned to the section 951A category.

ii. Look-through rules of section 904(d)(3)(B) apply to include subpart F inclusions in the passive basket to the extent attributable to passive category income. Under the authority of section 951A(f)(1)(B), GILTI inclusions are treated in the same manner as subpart F inclusions for purposes of section 904(d)(3)(B).

b. Dividends received by a domestic corporation from a noncontrolled 10-percent owned foreign corporation. Look-through rules of section 904(d)(4) apply to treat such dividends as income in a separate category in proportion to foreign corporation's E&P, unless there is inadequate substantiation. If there is inadequate substantiation, the dividend is treated as income in the separate category described in section 904(d)(4)(C)(ii) (which should be passive income but, without a technical correction, is section 951A income).

c. Applicability date. Taxable years that both begin after 2017 and end on or after the date the proposed regulations are published in the Federal Register (December 7, 2018).

4. Allocation and apportionment of foreign taxes – Preamble at 63-66; Prop. Reg. §1.904-6.

a. The proposed regulations retain the general rule of Reg. §1.904-6(a)(1)(i) that taxes paid or accrued with respect to a separate category of income includes only those taxes that are related to income in that separate category and that taxes are related to income if the income is included in the base upon which the tax is imposed. The proposed regulations amend Reg. §1.904-6(a)(1)(i) to clarify that the income included in the foreign tax base is calculated under foreign law but is characterized as income in a separate category under US tax principles. For example, foreign tax imposed on a CFC stock sale treated as capital gain under foreign law, but as a dividend under section 1248, is generally assigned to the general category, not passive category.

b. Special rule for base and timing differences.

i. *Base differences*. If foreign law imposes tax on a type of income that does not constitute income under Federal tax principles, that tax is treated as imposed on income in the separate category described in section 904(d)(2)(H)(i). (Note, absent a technical correction, section 904(d)(2)(H)(i) refers to the foreign branch income basket, rather than the general basket.) Base differences arise only in limited circumstances. Examples provided in the proposed regulations are gifts or life insurance proceeds. A base difference does not arise due to computational differences in the amount of an item of income subject to tax (e.g., due to different depreciation conventions, timing differences, or permanent differences).

ii. *Timing differences*. If foreign law imposes tax on an item of income that is recognized under Federal tax principles in a different year, that tax is allocated

and apportioned based to the separate categories to which it would be allocated and apportioned if the income were recognized under Federal tax principles in the year in which the tax is imposed. Tax imposed on a distribution of PTEP is a timing difference (and not a base difference) and is treated as imposed on the E&P from which the distribution was paid.

c. Taxes imposed in connection with foreign branches.

   i. Foreign taxes reflected on the books and records of a foreign branch under Reg. §1.987-2(b) are generally allocated and apportioned under the rules of Reg. §1.904-6(a)(1), i.e., by reference to the category of income to which the tax relates.

   ii. Where tax is imposed solely by reason of a disregarded payment from a foreign branch to the branch owner (e.g., withholding tax) that results in a reallocation of foreign branch income to general basket income, the tax is allocated and apportioned to the general basket.

   iii. Where tax is imposed solely by reason of a disregarded payment from a branch owner to a foreign branch that results in a reallocation of general basket income to foreign branch income, the tax is allocated and apportioned to the foreign branch basket.

d. Taxes deemed paid under section 960.

   i. Foreign taxes deemed paid under section 960(a) with respect to a subpart F inclusion or under section 960(d) with respect to a GILTI inclusion are allocated to the separate categories to which the inclusion is assigned.

   ii. Foreign taxes deemed paid under section 960(b)(1) with respect to a distribution of PTEP from a first-tier corporation are allocated to the same separate category as the annual PTEP account and PTEP group from which the distribution is made.

   iii. Foreign taxes deemed paid by a CFC under section 960(b)(2) with respect to a distribution of PTEP from an immediately lower-tier corporation are allocated to the same separate category as the annual PTEP account and PTEP group from which the distribution is made.

e. Partnership creditable foreign tax expenditures (CFTEs).

   i. In general, CFTEs allocated to a partner under Reg. §1.704-1(b)(4)(viii)(a) are allocated to the same separate category as the separate category to which the taxes were allocated in the hands of the partnership under the rules of Reg. §1.904-6(a).

   ii. CFTEs are allocated to the foreign branch category of the partner to the extent that (A) the CFTEs are allocated by the partnership to the general category; (B) in the hands of the partnership, the CFTEs are related to general category income attributable to a foreign branch; and (C) the partner's distributive share of the income is foreign branch category income of the partner under Prop. Reg. §1.904-4(f)(1)(i)(B).

f. Applicability date. Taxable years that both begin after 2017 and end on or after the date the proposed regulations are published in the Federal Register (December 7, 2018).

C. Treatment of subsequent reductions in tax in applying section 954(b)(4) – Preamble at 66; Prop. Reg. §1.954-1(d)(3).

1. Modified effective tax rate determination for purposes of the high-tax exception from subpart F to address the position certain taxpayers have taken for CFCs formed in certain jurisdictions that purport to have a type of integration regime that returns CFC taxes to the shareholder upon distribution, but does not subject the shareholder to tax.
2. Under the proposed regulations, foreign income taxes are not treated as paid or accrued by a CFC for purposes of the high-tax exception under section 954(b)(4) to the extent they are reasonably certain to be returned to a shareholder upon a subsequent distribution to the shareholder.
3. Comments requested on what special rules under Reg. §1.954-1(d)(3), Reg. §1.901-2, and section 905(c) should be considered to account for genuine integration regimes that do not have the effect of exempting resident corporations and their shareholders from all or substantially all tax.
4. Applicability date. Tax years of a CFC ending on or after the date the proposed regulations are published in the Federal Register (December 7, 2018).

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

1. In general.

a. The proposed regulations under §§1.960-1 through -3 ("960 Proposed Regulations") provide detailed guidance on rules to associate a CFC's current year foreign income taxes ("current year taxes") with a CFC's current year income, or a distribution received by a CFC of PTEP. These taxes, in turn, may be deemed paid by the US shareholder of an upper-tier CFC under section 960. Preamble at 70; Prop. Reg. §1.960-1(a).

b. The 960 Proposed Regulations explicitly state they are the exclusive rules for determining the foreign income taxes deemed paid by a domestic corporation. Thus, only CFC foreign income taxes associated with a subpart F or GILTI inclusion of a domestic corporate US shareholder of the CFC, or with PTEP, are eligible to be deemed paid. Prop. Reg. §1.960-1(a)(1).

i. There is no deemed paid credit available for CFC taxes associated to income that is not subpart F or tested income that generates GILTI (e.g., section 954(b)(4) high-taxed subpart F income, section 907(c)(1) foreign oil and gas extraction income).

ii. The creditable amount of CFC taxes associated with tested income is reduced by the US shareholder's inclusion percentage.

2. Current Year Taxes – Prop. Reg. §1.960-1(b)(4); Preamble at 70-71.

a. A CFC's current year taxes are foreign income taxes paid or accrued by the CFC in its current taxable year; section 461 rules and the "relation-back" doctrine apply to determine the timing of the accrual and the year taken into account.

i. *Subpart F or GILTI inclusion year*. Current taxable year of a CFC is its US tax year for which a domestic corporation that is a US shareholder of the CFC has a subpart F or GILTI inclusion with respect to the CFC, or during which the CFC receives or makes a PTEP distribution

ii. *Different foreign taxable year*. Foreign net income taxes accrue at the end of the CFC's foreign tax year, and are "current year taxes" in the CFC's subpart F or

GILTI inclusion year, and thus eligible for credit in the US shareholder's tax year with or within which the CFC's inclusion year ends, even if a portion of the foreign taxable year of the CFC falls within an earlier or later CFC inclusion year.

iii. *Foreign tax redeterminations*. Foreign tax redeterminations, including contested taxes that accrue when the contest is resolved, "relate back" and are considered to accrue as of the end of the CFC's foreign tax year to which the taxes relate.

b. Timing differences. Current year taxes imposed on an amount under foreign law that would be income under US law in a different taxable year are eligible to be deemed paid in the year in which the foreign tax accrues – not in the earlier or later year when the related income is recognized for US tax purposes. See Prop. Reg. §1.904-6(a)(1)(iv).

3. Computational and grouping rules.

a. To calculate foreign income taxes deemed paid by either a domestic corporation that is a US shareholder or by a CFC that is a shareholder of another CFC, the following **6 steps** are applied to each CFC in a chain of ownership, beginning with the lowest-tier CFC with respect to which the domestic corporation is a US shareholder. Preamble at 71.

b. Step 1—Assign CFC income to appropriate section 904 category and income/PTEP group.

CFC items of gross income are assigned under §§1.904-4 and 1.904-5 (i) to separate categories of income (each, a "section 904 category") and then (ii) to groups that correspond to certain types of income (each, an "income group") in a section 904 category. If a CFC receives a distribution of PTEP, it increases the group(s) ("PTEP group(s)") within an annual PTEP account that corresponds both (i) to the taxable year for which a CFC took into account the income from which the PTEP arose, and (ii) to the separate category of the US shareholder to which the amount of the resulting inclusion under sections 951(a)(1)(A) or 951A was assigned. Preamble at 71-72.

i. *Section 904 categories*. CFC items of gross income are assigned under §§1.904-4 and 1.905-5 to one of the section 904(d)(1) FTC limitation categories, or a specified separate category of income (e.g., items resourced under treaties, income from activities in sanctioned countries). CFC income, other than gross income relating to a section 959(b) distribution, cannot be assigned to the section 951A category or foreign branch category. Prop. Reg. §§1.904-5(a)(4)(v), 1.960-1(d)(2)(i).

ii. *Income groups*. Gross income within a section 904 category is assigned to (i) 1 of 3 following income groups or (ii) a PTEP group. Preamble at 73-75; Prop. Reg. §§1.960-1(d)(2)(ii), 1.960-3(c).

- *Subpart F income groups*. Separate subpart F groups for (i) each item of foreign base company income treated as a single item under Reg. §1.954-1(c)(1)(iii); (ii) insurance income; and (iii) a group including international boycott income, illegal bribes and other section 952(a)(4) payments, and section 901(j) income.

- *Tested income groups*. Items of gross tested income in each section 904 category are aggregated and generally will be in a single tested income group within the general category; since a CFC cannot earn section 951A or foreign branch income, there is no tested income within either

category. With respect to a CFC's general category tested income group, GILTI inclusion amounts will generally be treated as income in the US shareholder's section 951A category.

- *Residual group*. Income in a section 904 category not of a type included in one of the subpart F groups or tested income groups is assigned to the residual group (e.g., non-subpart F income excluded from CFC tested income and U.S. source income).

iii. *PTEP groups (for section 959(b) distributions received by the CFC).*

- *Establish PTEP accounts*. A CFC is required to establish a separate, annual account for its E&P for its current taxable year to which section 951(a) (section 956 and subpart F) or GILTI inclusions of US shareholders of the CFC are attributable. Each account must correspond to the PTEP and to the section 904 category of the inclusions at the US shareholder level. Thus, a CFC may have an annual PTEP account in the section 951A or treaty category, even though CFC income that gave rise to PTEP cannot be initially assigned to either category. Preamble at 83; Prop. Reg. §1.960-3(c)(1).

- *PTEP groups within annual PTEP account*. PTEP in each annual PTEP account is assigned to one of ten groups related to section 956 inclusions, section 965(a) inclusions, section 965(b) PTEP, subpart F inclusions, and GILTI inclusions. Such groups provide the mechanism for associating foreign taxes paid or accrued, or deemed paid, by a CFC with section 959 distributions. Preamble at 83; Prop. Reg. §1.960-3(c)(2).

    - Section 959(c)(1)(A) E&P by reason of section 951(a)(1)(B) and not by reason of section 959(a)(2)
    - Section 959(c)(1)(A) E&P initially described in section 959(c)(2) by reason of section 965(a) inclusion
    - Section 959(c)(1)(A) E&P initially described in section 959(c)(2) by reason of section 965(b)(4)(A)
    - Section 959(c)(1)(A) E&P initially described in section 959(c)(2) by reason of section 951A inclusion
    - Section 959(c)(1)(A) E&P initially described in section 959(c)(2) by reason of section 951(a)(1)(A) (other than as a result of section 965)
    - Section 959(c)(1)(B) E&P (i.e. earnings invested in excess passive assets)
    - Section 959(c)(2) E&P by reason of section 965(a)
    - Section 959(c)(2) E&P by reason of section 965(b)(4)(A)
    - Section 959(c)(2) E&P by reason of section 951A
    - Section 959(c)(2) E&P by reason of section 951(a)(1)(A) (other than as a result of section 965)

- *Accounting for PTEP distributions*. A recipient CFC accounts for a section 959(b) distribution by adding the distribution amount to an annual PTEP account and PTEP group that corresponds to the annual PTEP account and PTEP group from which the distributing CFC makes the distribution. Similarly, a distributing CFC must reduce the annual PTEP account and PTEP group from which the section 959(b) distribution is made by the distribution amount. Preamble at 84; Prop. Reg. §1.960-3(c)(3).

c. Step 2—Allocation and apportionment of deductions and current year taxes.

CFC deductions, including for expenses attributable to current year taxes, are allocated and apportioned to the income groups. Current year taxes are also allocated to a PTEP group that was increased by a section 959(b) distribution in Step 1. Preamble at 72; Prop. Reg. §1.960-1(d)(3).

i. *Allocation and apportionment of deductions*. Rules of sections 861 through 865 and 904(d) and the regulations thereunder apply to allocate and apportion deductions to reduce gross income (or create a loss) in each section 904 category and income group. Prop. Reg. §1.960-1(d)(3)(i).

ii. *Allocation and apportionment of current year taxes*.

- Apply rules of Reg. §1.904-6 to allocate and apportion current year taxes to and among the section 904 categories based upon the amount of CFC taxable income, as calculated under foreign law, in each section 904 category, and then apply the principles of Reg. §1.904-6 to allocate and apportion current year taxes to and among the income groups. Preamble at 76; Prop. §1.960-1(d)(3)(ii)(A).

  For example, if US treats a distribution as resulting in capital gain that is passive category income, but foreign law treats the item as a dividend that would be general category income, item is assigned to passive category for purposes of allocating and apportioning current year taxes; however, the amount of the item is determined under foreign law. Preamble at 77; Prop. Reg. § 1.904-6(a)(1)(i).

- If a PTEP group of a CFC is increased as a result of a section 959(b) distribution received in a current year, then for purposes of allocating and apportioning current year taxes that are imposed solely by reason of the section 959(b) distribution, the PTEP group is treated as an income group within the section 904 category. Preamble at 76; Prop. §1.960-1(d)(3)(ii)(A).

- Current year taxes not allocated and apportioned to a subpart F, tested income group, or to a PTEP group that is treated as an income group, are allocated and apportioned to a residual group. Current year taxes allocated and apportioned to residual income group cannot be deemed paid under section 960 for any taxable year. Preamble at 76-77; Prop. Reg. §1.960-1(e).

iii. *Base Difference vs. Timing Difference*.

- *In general.* Current year taxes attributable to a base difference are allocated to the residual income group, and therefore ineligible to be deemed paid. Current year taxes attributable to a timing difference (e.g., current year tax imposed on an amount that is CFC income in a different taxable year under Federal income tax law) are allocated and apportioned to a section 904 category and income group to which the tax would be assigned if the income were recognized under Federal tax principles in the year in which the tax was imposed. Preamble at 77-78; Prop. Reg. §1.960-1(d)(3)(ii)(B)(1).

- *Special rule for tax on PTEP.* Current year taxes imposed solely by reason of the CFC's receipt of a section 959(b) distribution are not allocated and apportioned under the general rule of timing differences but are allocated or apportioned to a PTEP group under Reg. §1.904-6 principles. Preamble at 87; Prop. Reg. §1.960-1(d)(3)(ii)(B)(2).

  For example, both (i) a net basis tax imposed on a CFC's receipt of a section 959(b) distribution by the CFC's country of residence; and (ii) a withholding tax imposed with respect to a CFC's receipt of a section 959(b) distribution are allocated and apportioned to a PTEP group; but not (iii) a withholding tax imposed on a disregarded payment from a DRE to its CFC owner—such payment is treated as a timing difference and is never treated as related to a PTEP group because the tax is not imposed solely by reason of a section 959(b) distribution. However, such a withholding tax may be treated as related to a subpart F or tested income group under the general rule.

d. Step 3 – Calculate section 960(a), (d), and (b)(2) deemed paid taxes.

Taxes deemed paid by a domestic corporate US shareholder under section 960(a) and (d), and taxes deemed paid by a CFC under section 960(b)(2) in connection with receipt of a section 959(b) distribution, are calculated. Preamble at 72, 78-82, 87-89; Prop. Reg. §§1.960-2, 1.960-3(b).

i. *Subpart F Inclusions/section 960(a) credits*. A domestic corporate US shareholder that has a subpart F inclusion from its CFC is deemed to pay the CFC's foreign income taxes that are properly attributable to the items of income in a subpart F income group of the CFC that give rise to the subpart F inclusion of that shareholder. The amount *properly attributable* is the domestic corporation's proportionate share of current year taxes of the CFC that are allocated and apportioned to the subpart F income group. Preamble at 79-81; Prop. Reg. §1.960-2(b).

- *Proportionate share of subpart F group*. The amount of the CFC's current year taxes (in USD) allocated and apportioned to a subpart F income group within a section 904 category multiplied by a fraction (in functional currency), the numerator is the portion of the subpart F inclusion attributable to that subpart F income group, and the denominator is the total income in that subpart F income group. Thus, no tax is deemed paid by a corporate US shareholder with respect to a subpart F income group to which CFC current year taxes are allocated

and apportioned (including by reason of timing difference rule) but with respect to which no portion of a subpart F inclusion is attributable.

- *Interaction with section 952(c).* The numerator of the proportionate share fraction is reduced by a qualified deficit under section 952(c)(1)(B). The denominator of the fraction is reduced to reflect (i) the limitation in section 952(c)(1)(A) of CFC subpart F income to its current year E&P; and (ii) any reduction in CFC subpart F income for a chain deficit under section 952(c)(1)(C). Preamble at 73; Prop. Reg. §1.960-2(b)(3)(iii).

- *No deemed paid taxes for section 956 inclusions*. Taxes are treated as deemed paid under section 960(a) specifically with respect to subpart F inclusions because the inclusions are with respect to CFC "items of income". Because a section 951(a)(1)(B) is not an inclusion of a CFC "item of income" but instead an inclusion equal to an amount that is determined under the formula in section 956(a), no foreign income taxes are deemed paid under section 960(a) with respect to such inclusion. Preamble at 80-81; Prop. Reg. §1.960-2(b)(1).

ii. *GILTI Inclusion Amounts/section 960(d) credits*. A domestic corporate US shareholder is deemed to have paid an amount of foreign income taxes equal to 80 percent of the US shareholder's inclusion percentage multiplied by the sum of all tested foreign income taxes in the tested income group within each section 904 category of the CFCs. The amount of tested foreign income taxes that a US shareholder is deemed to pay under section 960(d) is computed with respect to the CFC income in each tested income group within a section 904 category; the amount *properly attributable* to each tested income group is equal to the proportionate share of the CFC's current year taxes. Preamble at 81; Prop. Reg. §1.960-2(c).

- *Proportionate share of CFC current year taxes* equals current year taxes (in USD) allocated and apportioned to a tested income group within a section 904 category in Step 2 multiplied by a fraction (in functional currency), the numerator is the portion of the CFC's tested income in the tested income group included in computing the domestic corporation's aggregate pro-rata share of CFC tested income under section 951A(c)(1)(A) and proposed §1.951A-1(c)(2)(i), and the denominator is the CFC's total income in the tested income group.

- The domestic corporation computes only a single inclusion percentage with respect to all of its tested income, regardless of the section 904 category to which the tested income is assigned. For a US shareholder that is a member of a consolidated group, the numerator of the inclusion percentage is computed using the GILTI inclusion amount of a US shareholder as determined under Reg. §1.1502-51. Preamble at 82; see Prop. Reg. §1.951A-1(c)(4).

iii. *Section 959(b) distributions/section 960(b)(2) credits*. If a distributing CFC makes a distribution to a recipient CFC and the distribution is, in whole or in part, a section 959(b) distribution from a PTEP group within a section 904 category, the recipient CFC is deemed to have paid the amount of the distributing

CFC's foreign income taxes that are *properly attributable* to the section 959(b) distribution from the PTEP group and that have not been deemed paid by a domestic corporation under section 960 for the current or any prior taxable year. Prop. Reg. §1.960-3(b)(2). Computational rules for determining foreign incomes taxes deemed paid with respect to section 959 distributions are detailed below.

e. Step 4 – Add subpart F and GILTI inclusions to annual PTEP group with PTEP account.

PTEP resulting from a subpart F or GILTI inclusion are added to an annual PTEP account and further assigned to the relevant PTEP groups within the account.

f. Step 5 – Repeat first 4 steps for each higher-tier CFC.

g. Step 6 – Calculate section 960(b)(1) deemed paid taxes.

With respect to the highest-tier CFC, the US shareholder computes its taxes deemed paid under section 960(b)(1) in connection with a receipt of a section 959(a) distribution.

i. If a CFC makes a distribution to a domestic corporation that is a US shareholder with respect to the CFC that is, in whole or in part, a section 959(a) distribution from a PTEP group within a section 904 category, the domestic corporation is deemed to have paid the amount of the CFC's foreign income taxes that are *properly attributable* to the such distribution from the PTEP group and that have not been deemed paid by a domestic corporation under section 960 for the current or any prior taxable year. Preamble at 87-88; Prop. Reg. §1.960-3(b)(1). Computational rules are detailed in below.

ii. Treasury acknowledged that a single section 959(a) distribution could be attributable to multiple PTEP groups with respect to multiple inclusion years of the distributing CFC, but the 960 Proposed Regulations do not provide rules for allocating distributions among different kinds of PTEP. However, Treasury stated it anticipates that future regulations under section 959 will provide ordering rules for determining the annual PTEP account and PTEP group to which a section 959 distribution is attributable. Preamble at 88.

4. Computational rules for taxes deemed paid with respect to section 959 distributions.

a. Properly attributable. Amount of foreign taxes properly attributable to a section 959 distribution from a PTEP group within a section 904 category is equal to the domestic corporation's or recipient CFC's proportionate share of PTEP group taxes with respect to the PTEP group. No other foreign income taxes are considered properly attributable to a section 959 distribution. Prop. Reg. §1.960-3(b)(3).

b. Proportionate share. A domestic corporation or recipient CFC's proportionate share of PTEP group taxes with respect to a PTEP group within a section 904 category is equal to the total PTEP group taxes with respect to the PTEP group multiplied by a fraction, the numerator is the amount of section 959 distribution from the PTEP group, and denominator is the total amount of PTEP in the PTEP group. Prop. Reg. §1.960-3(b)(4).

5. Domestic partnerships.

a. Subpart F inclusion/section 960(a) credit. If a domestic corporation owns a CFC interest through a domestic partnership, to the extent that such corporation is a US shareholder with respect to the CFC, that corporation is deemed to have paid the foreign taxes as if it had included the CFC income directly rather than as a distributive share of the partnership's income. Preamble at 90-91; Prop. Reg. §1.960-2(b)(4).

b. GILTI inclusion/section 960(d) credit. GILTI inclusion amount of a domestic corporation that is also a US shareholder of a CFC through its interest in a domestic partnership is generally determined at the partner level; thus, the rules in Prop. Reg. §1.960-2(c) apply in the same manner as if the domestic corporation included the GILTI inclusion amount directly. Preamble at 91; Prop Reg. §§1.960-2(c)(6); 1.951A-5(c).

c. Section 959(a) distribution/section 960(b)(1) credit. Domestic corporation's distributive share of a domestic partnership's receipt of a section 959(a) distribution is treated as a receipt by the domestic corporation directly for purposes of Prop. Reg. §1.960-3(b)(1). Preamble at 91; Prop. Reg. §1.960-3(b)(5).

6. Section 78 – Guidance related to treatment under section 245A.

a. Section 78 dividends are not treated as a dividend for purposes of section 245 or 245A and do not increase earnings and profits of the domestic corporation or decrease the earnings and profits of the foreign corporation. Prop. Reg. §1.78-1.

b. Applicability date. Taxable years of foreign corporations that begin after December 31, 2017 and taxable years of US shareholders in which or with which such taxable years of foreign corporations end. Also applies to section 78 dividends that are received after December 31, 2017 by reason of taxes deemed paid under section 960(a) with respect to a taxable year of a foreign corporation beginning before January 1, 2018.

c. Treasury believes applying this rule to section 78 dividends received after the effective date of section 245A (distributions made after December 31, 2017) and before the effective date of new section 78 (tax years beginning after December 31, 2017) is necessary to ensure similarly situated taxpayers do not have different tax consequences under section 245A with respect to section 78 dividends. Treasury noted there is no indication that Congress intended to treat a US shareholder of a fiscal year CFC differently than a US shareholder of a calendar year CFC with respect to the section 78 dividend, given that the purpose of the section 78 dividend – to prevent a taxpayer from obtaining both a credit under section 901 and a deduction with respect to the same foreign tax – is unrelated to the CFC's US taxable year. Preamble at 91-92.

E. Effect of Section 965(n) Election

1. **Overview.** Section 965(n) allows a taxpayer to exclude section 965(a) inclusions (reduced by section 965(c) deductions) and associated section 78 gross ups in determining the NOL carryover/carryback that is absorbed in the inclusion year. The proposed regulations previously issued under section 965 (August 9, 2018) provided procedural rules regarding the manner for making the election and clarifying the effect of the election, and these proposed regulations provide additional guidance on the election's effect. Preamble at 92-94; Prop. Reg. §1.965-7(e)(1)(i), (iv).

2. **No double counting**. Clarify that, if the election creates or increases a section 172 NOL, the taxable income in the election year cannot be less than the amount described in Reg. §1.965-7(e)(1)(ii) (i.e., sum of (A) section 965(a) inclusions less section 965(c) deductions and (B) any taxes deemed paid under section 960(a)(1) with respect to the section 965(a) inclusions that are treated as section 78 dividends). This is to prevent the same deduction from being taken into account in the election year and also used again to create a NOL that is deducted in a different taxable year.

3. **Deferred amount**. The amount of the deductions that create or increase a NOL for the taxable year by reason of the election (the "deferred amount") is not taken into account in computing taxable income or the FTC limitations under section 904 for that year.

4. **Effect of section 965(n) election – in general**. Clarify that the election applies solely for purposes of determining the NOL amount for the election year and the NOL amount carryover/carryback amount to that year.

5. **Ordering rule for allocation and apportionment of deductions for purposes of section 904 limitation**. The effect of an election with respect to a taxable year on the computation of the separate FTC limitations under section 904 is computed in the following order:

    a. Deductions that would have been allowed for the taxable year but for the election, other than the amount of any NOL carryover or carryback to that year by reason of the election, are allocated and apportioned under Reg. §§1.861-8 through 1.861-17 to the relevant statutory and residual groupings.

    b. The deferred amount (which is the corresponding addition to the NOL for the taxable year) comprises a ratable portion of all of the taxpayer's deductions (other than the section 965(c) deduction) allocated and apportioned to the relevant statutory and residual groupings.

    Taxable income and the separate FTC limitation under section 904 for the taxable year are computed without taking into account any deferred amount. Deductions allocated and apportioned to the statutory and residual groupings, to the extent deducted in the election year rather than deferred to create or increase a NOL, are combined with income in those groupings to determine the FTC limitations for the year. Deductions allocated and apportioned to the section 965(a) inclusions and associated section 78 gross ups therefore reduce income in the separate category (or US source residual category) to which those section 965 amounts are assigned, and are not re-allocated to reduce other income, other than by operation of the SLL and ODL allocation rules of section 904(f) and (g).