DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9882]

RIN 1545–BP19; 1545–BK55; 1545–AC09

Foreign Tax Credit Guidance Related to the Tax Cuts and Jobs Act, Overall Foreign Loss Recapture, and Foreign Tax Redeterminations

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 determination of the foreign tax credit under the Internal Revenue Code. The guidance relates to changes made to the applicable law by the Tax Cuts and Jobs Act, which was enacted on December 22, 2017. This document finalizes the proposed regulations published on December 7, 2018. This document also finalizes proposed regulations on overall foreign losses that were published on June 25, 2012, and finalizes certain portions of proposed regulations published on November 7, 2007, relating to a U.S. taxpayer's obligation to notify the IRS of a foreign tax redetermination.

DATES:

Effective Date: These regulations are effective on December 17, 2019.

Applicability Dates: For dates of applicability, see §§ 1.861–8(h), 1.861–9(k), 1.861–10(f), 1.861–11(h), 1.861–13(d), 1.861–17(i), 1.901(j)–1(b), 1.904–1(e), 1.904–2(k), 1.904–3(h), 1.904–4(q), 1.904–5(o), 1.904–6(d), 1.904(b)–3(f), 1.904(f)–12(j)(6), 1.904(g)–3(l), 1.905–3(d), 1.954–1(h), 1.960–7, 1.965–9(c), and 1.986(a)–1(f).

FOR FURTHER INFORMATION CONTACT: Concerning §§ 1.861–8 through 1.861–13, 1.861–17, and 1.904(b)–3, Jeffrey P. Cowan, (202) 317–4924; concerning §§ 1.901(j)–1, 1.904–1 through 1.904–6, 1.904(f)–12, 1.904(g)–3, 1.905–3, 1.954–1, 1.986(a)–1, Jeffrey L. Parry, (202) 317–4916, or Larry R. Pounders, (202) 317–5465; concerning § 1.960–1 through 1.960–7, Suzanne M. Walsh, (202) 317–4908; concerning §§ 1.965–5 and 1.965–9, Karen J. Cate, (202) 317–4667 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. Proposed Regulations Implementing the TCJA

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 relate to changes made by the Tax Cuts and Jobs Act (Pub. L. 115–97, 131 Stat. 2054, 2208 (2017)) (the ''TCJA'') and other foreign tax credit issues. Terms used but not defined in this preamble have the meaning provided in these regulations (the ''final regulations'').

A public hearing on the proposed regulations was scheduled for March 14, 2019, but it was not held because there were no requests to speak. The Treasury Department and the IRS also received written comments with respect to the 2018 FTC proposed regulations. Certain portions of the proposed regulations relating to §§ 1.78–1, 1.861–12(c)(2), and 1.965–7(e) were finalized as part of TD 9866, published in the **Federal Register** (84 FR 29288) on June 21, 2019. Comments received that do not pertain to the rules in the proposed regulations or that are otherwise outside the scope of this rulemaking are generally not addressed in this preamble but may be considered in future guidance projects addressing the issues discussed in the comments. All written comments received in response to the 2018 FTC proposed regulations are available at *www.regulations.gov* or upon request.

II. Proposed Regulations Relating to Overall Foreign Loss Recapture on Property Dispositions

On June 25, 2012, the **Federal Register** published a notice of proposed rulemaking at 77 FR 37837 (the ''2012 OFL proposed regulations'') proposing rules for the coordination of the rules for determining high-taxed income with capital gains adjustments and the allocation and recapture of overall foreign losses and overall domestic losses, as well as the coordination of the recapture of overall foreign losses on certain dispositions of property and other rules concerning overall foreign losses and overall domestic losses. One comment was received concerning the 2012 OFL proposed regulations. A public hearing was not requested and none was held.

III. Proposed and Temporary Regulations Under Sections 905(c) and 986(a)

On June 23, 1988, the **Federal Register** published a notice of proposed rulemaking by cross-reference to temporary regulations (TD 8210) (the ''1988 temporary regulations'') at 53 FR 23659 and 53 FR 23611, respectively, relating to a taxpayer's obligation under section 905(c) to notify the IRS of a foreign tax redetermination or to make adjustments to the pools of post-1986 undistributed earnings and foreign income taxes of the taxpayer's foreign subsidiaries. The 1988 temporary regulations also provided guidance regarding the civil penalty under section 6689 for failure to file the notice required under section 905(c). In response to the written comments received on the 1988 temporary regulations, on March 16, 1990, the Treasury Department and the IRS issued Notice 90–26, 1990–1 C.B. 336, which suspended the portion of the 1988 temporary regulations that provided rules for accounting for foreign tax redeterminations that affect the calculation of the indirect foreign tax credit under sections 902 and 960.

On May 15, 2006, the Treasury Department and the IRS issued Notice 2006–47, 2006–1 C.B. 892, which provides interim rules allowing a taxpayer that otherwise would be required to use an average exchange rate translation convention to elect to translate foreign income taxes into U.S. dollars (dollars) using the exchange rates when the taxes were paid, either for all foreign income taxes or only for those foreign income taxes denominated in nonfunctional currency that are attributable to qualified business units within the meaning of section 989(a) (QBUs) with dollar functional currencies.

On November 7, 2007, the **Federal Register** published new temporary regulations (T.D. 9362) (the ''2007 temporary regulations'') at 72 FR 62771 and published a partial withdrawal of the notice of proposed rulemaking relating to the 1988 temporary regulations and a new notice of proposed rulemaking by cross-reference to the 2007 temporary regulations at 72 FR 62805. Corrections to the temporary and proposed regulations were published on December 19, 2007, in the **Federal Register** (72 FR 71787 and 72 FR 71842, respectively). Comments were received concerning the 2007 temporary regulations. A public hearing was not requested and none was held. The 2007 temporary regulations expired on November 5, 2010.

As part of the TCJA, section 905(c) was amended to reflect the repeal of section 902, by eliminating the provisions allowing for adjustments to pools of post-1986 undistributed earnings and foreign income taxes. The TCJA made no changes to section 986(a) or 6689.

This Treasury decision adopts certain portions of the proposed regulations under sections 905(c) and 986(a) that were published in connection with the 2007 temporary regulations. References in this preamble to the 2007 temporary regulations are understood to refer to the corresponding provisions of the accompanying proposed regulations. In particular, this Treasury decision finalizes (1) the currency translation rules (which are moved from § 1.905–3T(b) to § 1.986(a)–1)), (2) the definition of foreign tax redetermination in § 1.905–3T(c), (3) the rules under § 1.905–3T(d)(1) requiring a redetermination of U.S. tax liability with respect to foreign income taxes other than those that are deemed paid under section 960, and (4) the rules in § 1.905–3T(e) relating to foreign income taxes imposed on foreign tax refunds. Portions of the 2007 temporary regulations relating to prospective pooling adjustments are not included in the final regulations in light of the TCJA's repeal of section 902 and related amendments to section 905(c).

Section 1.905–3T(d)(2), which addresses redeterminations that affect foreign taxes deemed paid under section 960, § 1.905–4T, which in general provides the procedural rules for how to notify the IRS of a foreign tax redetermination, and § 301.6689–1T, which provides rules for the penalty for failure to notify the IRS of a foreign tax redetermination, are not included in this Treasury decision. Although the underlying substantive rule requiring redeterminations of U.S. tax liability has not changed, in light of the elimination of prospective pooling adjustments (which in many cases obviated the need for U.S. tax redeterminations), the Treasury Department and the IRS anticipate that there will be significantly more instances in which taxpayers must redetermine their U.S. tax liability with respect to a prior taxable year by reason of a foreign tax redetermination with respect to a controlled foreign corporation (''CFC''). As a result, the Treasury Department and the IRS have determined that the rules under §§ 1.905–3T(d)(2), 1.905–4T, and 301.6689–1T should be reissued as a notice of proposed rulemaking in order to allow taxpayers an additional opportunity to comment on those rules. These regulations are available in a notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register** (the ''2019 FTC proposed regulations'').

IV. Technical Amendment to Regulations Issued Under Section 905

This Treasury Decision also makes a technical amendment to § 1.905–2(a)(2). Regulations issued under § 1.905–2 address the forms, information, and evidence required to claim a foreign tax credit. On December 31, 1964, the **Federal Register** published changes (T.D. 6789) at 29 FR 19241 to the then existing regulations under § 1.905–2, including a sentence at § 1.905–2(a)(2) providing that if a foreign receipt or return is in a foreign language, a certified translation thereof must be furnished by the taxpayer. On January 27, 1998, the **Federal Register** published additional changes (T.D. 8759) at 63 FR 3812 to § 1.905–2. However, the **Federal Register** inadvertently deleted the sentence in § 1.905–2(a)(2) requiring certified translations of a foreign receipt or return in a foreign language. This Treasury Decision restores the inadvertently deleted sentence to § 1.905–2(a)(2).

Summary of Comments and Explanation of Revisions

I. Overview

The final regulations retain the basic approach and structure of the 2018 FTC proposed regulations, with certain revisions. Parts I through III and V of this Summary of Comments and Explanation of Revisions discuss those revisions as well as comments received in response to the solicitation of comments in the 2018 FTC proposed regulations. Part III.I of this Summary of Comments and Explanation of Revisions discusses the revisions and comments received with respect to the 2012 OFL proposed regulations. Part IV of this Summary of Comments and Explanation of Revisions discusses the revisions with respect to the 2007 temporary regulations relating to sections 905(c) and 986(a). Finally, Part VI of this Summary of Comments and Explanation of Revisions addresses the applicability dates for the final regulations.

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

A. Allocation of Expenses to Section 951A Category

A taxpayer determines its foreign tax credit limitation under section 904, in part, based on the taxpayer's taxable income from sources without the United States. The 2018 FTC proposed regulations provide that, in general, the regulations under sections 861 through 865 that provide rules for allocating and apportioning deductions to determine the taxpayer's taxable income from sources without the United States apply to income described in section 904(d)(1)(A) (the ''section 951A category'').

Some comments requested that regulations provide that no expenses should be allocated to the section 951A category in order to ensure that income of a United States shareholder (''U.S. shareholder'') derived through a CFC would be effectively exempt from additional U.S. tax if the foreign effective tax rate is greater than or equal to a particular rate. These comments generally cite language in H.R. Rep. 115–466 (2017) (the ''Conference Report'') illustrating that no U.S. ''residual tax'' applies to foreign earnings subject to a foreign effective tax rate of 13.125 percent or more. These comments suggest that not requiring expenses to be allocated to the section 951A category allows GILTI to function as a ''minimum tax.'' Alternatively, some comments suggested that expense allocation be eliminated if the taxpayer establishes that net CFC tested income is subject to a minimum foreign effective tax rate of 13.125 percent, or that expense allocation to the section 951A category be eliminated until section 864(f)(1) (providing an election to allocate interest expense on a worldwide basis) becomes effective. One comment suggested a fundamentally different approach to expense allocation that would allow taxpayers to prorate the allocation of expenses to certain foreign source income based on a ratio of the foreign tax rate with the U.S. tax rate, and recalculate U.S. income tax liability after disallowing the prorated expenses allocated to foreign source income. One comment suggested that after the TCJA the United States no longer relies on the general principle of a foreign tax credit to relieve double taxation, and that allocation of any expenses to section 951A category income is therefore inconsistent with U.S. treaty obligations to exempt the income from U.S. tax. One comment agreed with the approach of the proposed regulations requiring expense allocation to the section 951A category, noting that the application of the expense allocation rules is important to minimize the potential for base erosion.

As explained in Part I of the Explanation of Provisions section of the 2018 FTC proposed regulations, the TCJA did not provide for any changes to how the generally applicable rules for computing taxable income within each separate category should apply with respect to the new section 951A category, and other provisions added in the TCJA are inconsistent with the notion that Congress intended effectively to exempt section 951A category income that was subject to a certain foreign effective tax rate. Therefore, the Treasury Department and the IRS have determined that the statute requires that expenses be allocated and apportioned to the section 951A category. This approach is also consistent with U.S. treaty obligations, which preserve the right of the United States to limit allowable foreign tax credits ''in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principles hereof) . . . '' See Article 23, Par. 2 of the 2016 U.S. Model Treaty.

This approach is confirmed by the Joint Committee on Taxation's Explanation of the TJCA, which states that Congress intended that the foreign tax credit limitation in the section 951A category, like any other separate category, is calculated by taking into account expenses allocable to income in that category. *See* Joint Comm. on Tax'n, General Explanation of Public Law 115–97, at 381 n. 1753 (''As under the law prior to enactment of the Act, U.S. shareholders are required to allocate expenses to foreign-source income for foreign tax credit limitation purposes based on principles applicable prior to the enactment of the Act.''). The Joint Committee's explanation also elaborates on the statement cited in the Conference Report that is cited by the comments, and clarifies that the ability to fully utilize foreign tax credits to eliminate U.S. tax liability at a foreign effective tax rate of 13.125 percent is possible only if it is assumed, ''among other things, . . . that the domestic corporation has no expenses.'' *Id.* at 381. The Explanation acknowledges that absent the assumption of there being no expenses, ''the results . . . may change.'' *Id.*

Accordingly, the final regulations do not alter the requirement under the Code for deductions to be allocated and apportioned to the section 951A category. However, the 2019 FTC proposed regulations provide certain additional rules under §§ 1.861–8 through 1.861–17, including rules that will have the effect of precluding the allocation and apportionment of certain research and experimentation expenses to the section 951A category. In addition, Part I.A.5 of the Explanation of Provisions of the 2019 FTC proposed regulations states that the Treasury Department and the IRS are studying whether further guidance with respect to the allocation and apportionment of interest expenses is necessary, and request comments on this topic.

B. General Rules Relating to the Allocation and Apportionment of Expenses

1. Definitions of Exempt Income and Exempt Asset

The 2018 FTC proposed regulations make certain clarifying changes to the definitions of exempt income and exempt asset in proposed § 1.861–8(d)(2)(ii). Additionally, those regulations address the treatment of the deduction under section 250(a)(1) (the ''section 250 deduction'') for purposes of the exempt income and assets rule. Under proposed § 1.861–8(d)(2)(ii)(C)(*1*), the portion of a domestic corporation's income that is foreign derived intangible income (''FDII'') or results from an inclusion under section 951A(a) (a ''GILTI inclusion''), and the corresponding amount treated as a dividend under section 78 (''section 78 dividend''), is treated as exempt income based on the amount of the section 250 deduction allowed to the U.S. shareholder. Proposed § 1.861–8(d)(2)(ii)(C)(*2*) treats an equivalent portion of the domestic corporation's assets that give rise to FDII, or the stock of the CFC that gives rise to the GILTI inclusion, as an exempt asset.

One comment argued that the full allocation of expenses to the section 951A is needed to prevent base erosion. The comment recommended that the rules in proposed § 1.861–8(d)(2)(ii)(C) that treat income offset by the section 250 deduction as exempt income and the assets that give rise to that income as exempt assets are inappropriate and should be withdrawn. Another comment agreed with the approach of the proposed regulations.

The Treasury Department and the IRS have determined that the treatment of the section 250 deduction as giving rise to exempt income is consistent with the legislative history, which states that Congress ''intends for the [section 250 deduction to] be treated as exempting the deducted income from tax.'' *See* Senate Committee on Finance, Explanation of the Bill, S. Prt. 115–20 at 376 n.1210 (November 22, 2017). The approach is also consistent with the treatment under section 864(e)(3) of certain deductions allowed under sections 243 and 245(a). Accordingly, the final regulations adopt the rules from the 2018 FTC proposed regulations regarding the treatment of the section 250 deduction for purposes of the exempt income and asset provisions. *See* § 1.861–8(d)(2)(ii)(C).

One comment requested that the final regulations clarify the requirement to identify assets that produce gross income included in FDII for purposes of determining the portion of a taxpayer's assets that are treated as exempt by reason of having FDII. In particular, the comment stated that it would be difficult to identify assets that produce FDII, and that tangible assets should be treated differently due to the exemption for qualified business asset investment (''QBAI'') under section 250(b)(2)(B). As a result, the comment recommended that FDII-related assets should not be treated as exempt assets. Alternatively, the comment recommended a formulary approach, which would take into account only basis of intangible assets that gave rise to either deduction eligible income (as defined in section 250(b)(3)) or foreign derived deduction eligible income (''FDDEI'') (as defined in section 250(b)(4)). Another comment suggested that the rule be modified to refer to assets that produce FDDEI rather than FDII.

Following the issuance of the 2018 FTC proposed regulations, the Treasury Department and the IRS issued rules under section 250 providing that the determination of FDDEI requires applying §§ 1.861–8 through 1.861–14T and 1.861–17 to allocate and apportion deductions between gross income derived from sales and services that are FDDEI (''gross FDDEI'') versus gross income that is not gross FDDEI. *See* proposed § 1.250(b)–1. In light of these changes, the Treasury Department and the IRS agree with the comment that proposed § 1.861–8(d)(2)(ii)(C)(*2*) should be revised to refer to assets that produce gross FDDEI. As a result of this change, the final regulations generally do not impose any additional requirements for identifying assets that produce gross FDDEI beyond what is necessary in order to determine the amount of the section 250 deduction. In addition, the final regulations do not limit application of the exempt asset rule to intangible assets because the effect of QBAI is already taken into account in determining the amount of the section 250 deduction and therefore reduces the fraction used in § 1.861–8(d)(2)(ii)(C)(*2*) to determine the portion of an asset that is exempt.

Under proposed § 1.861–8(d)(2)(ii)(C)(*1*), the amount of income treated as exempt as a result of the section 250 deduction is the amount of gross income offset by the section 250 deduction. In order to conform the exempt asset rule with respect to FDII to the exempt income rule, § 1.861–8(d)(2)(ii)(C)(*2*) provides that the portion of assets that produce gross FDDEI which is treated as exempt is determined by dividing the portion of the section 250 deduction relating to FDII by the taxpayer's gross FDDEI, instead of its FDII. This recognizes that gross FDDEI, and not FDII, reflects the gross income which the section 250 deduction is effectively exempting. The final regulations will have the effect of significantly reducing the portion of assets that are exempt by reason of FDII and, therefore, the revisions address the comments that the 2018 FTC proposed regulations' approach overstated the portion of assets that are exempt by reason of the section 250 deduction with respect to FDII.

The 2018 FTC proposed regulations also confirm that earnings and profits excluded from income under section 959 (''previously taxed earnings and profits'') do not result in any portion of the stock in a CFC being treated as an exempt asset. Proposed § 1.861–8(d)(2)(iv). One comment suggested adding the word ''solely'' to proposed § 1.861–8(d)(2)(iv) in order to clarify that stock that is not exempt by reason of earnings and profits described in section 959(c)(1) or (c)(2) can nonetheless be partially exempt under other rules. The adjustment to stock value in respect of earnings and profits under section 864(e)(4) and § 1.861–12(c)(2) precedes the application of the exempt asset rules of section 864(e)(3) and § 1.861–8(d)(2), and the determination of whether stock is exempt is unrelated to whether the value of the stock was adjusted by reference to previously taxed earnings and profits. Proposed § 1.861–8(d)(2)(iv) was merely intended to clarify existing law in order to preclude taxpayers from taking unreasonable positions inconsistent with section 864(e)(4), and the rule is clear that it is limited to precluding arguments that stock is exempt ''by reason of'' an adjustment under § 1.861–12(c)(2) for previously taxed earnings and profits. Therefore, the addition of the word ''solely'' is unnecessary, and the comment is not adopted.

2. Application to Insurance Companies in Connection With Certain Dividends and Tax-Exempt Interest

One comment to the 2018 FTC proposed regulations suggested that insurance companies reduce exempt income and assets to reflect prorated amounts of dividends and tax exempt interest. *See* sections 805(a)(4), 807, 812, and 832(b)(5)(B). This comment is addressed in Part I.A.4 of the Explanation of Provisions of the 2019 FTC proposed regulations.

3. Allocation and Apportionment of the Section 250 Deduction

Proposed § 1.861–8(e)(13) and (14) provide rules for allocating and apportioning (i) the portion of the section 250 deduction for FDII and (ii) the portion of the section 250 deduction for the GILTI inclusion and the amount of the section 78 dividend attributable to foreign taxes deemed paid with respect to the GILTI inclusion. In particular, proposed § 1.861–8(e)(13) provides that the portion of the section 250 deduction for FDII is treated as definitely related and allocable to the specific class of gross income that is included in the taxpayer's FDDEI, and that the deduction is apportioned between the statutory and residual grouping based on the FDDEI in each grouping.

A comment expressed concern that, to the extent that the portion of the section 250 deduction for FDII is allocated to foreign source income, it would reduce the ability to claim foreign tax credits. The comment recommended not apportioning this portion of the deduction to FDDEI. Under sections 861 and 862, a taxpayer must determine its taxable income by deducting from gross income the deductions properly apportioned or allocated thereto. Under § 1.861–8, deductions are generally allocated and apportioned based on a factual relationship between the deductions and gross income. Because a portion of the section 250 deduction for FDII is factually related to the taxpayer's FDDEI, under the principles of § 1.861–8 that portion of the section 250 deduction is allocated to that income, regardless of whether the FDDEI is U.S. or foreign source. Accordingly, this comment is not adopted.

4. Allocation and Apportionment of State Income Taxes

The 2018 FTC proposed regulations did not make any changes to the rules in § 1.861–8(e)(6) for allocating and apportioning state income taxes, which were finalized in 1991 (T.D. 8337). The final regulations also make no changes to these rules but remove *Examples 28* through *33* in § 1.861–8(g), which apply the rules in § 1.861–8(e)(6) to fact patterns involving foreign subsidiaries, pending further study by the Treasury Department and the IRS as to whether the rules in § 1.861–8(e)(6) should be revised. See Part II.B of the Explanation of Provisions to the 2019 FTC proposed regulations (requesting comments on § 1.861–8(e)(6)).

C. Allocation and Apportionment of Interest Expense

1. Special Rule for Specified Partnership Loans

The 2018 FTC proposed regulations included rules addressing the source and separate category of interest income and expense related to loans to a partnership by a U.S. person (or a member of its affiliated group) that owns an interest (directly or indirectly) in the partnership. These loans are referred to as specified partnership loans. Proposed § 1.861–9(e)(8)(vi)(C). Under proposed § 1.861–9(e)(8)(ii), the lender in these transactions is generally required to match the source and separate category of the interest income and expense by assigning the interest income to the same statutory and residual groupings from which the interest expense is deducted. The portion of the loan that corresponds to the matched income and expense is not taken into account for purposes of allocating and apportioning the lender's remaining interest expense. Proposed § 1.861–9(e)(8)(i). The 2018 FTC proposed regulations also include anti-avoidance rules to extend the application of these provisions to certain back-to-back loans or loans made through CFCs. *See* proposed § 1.861–9(e)(8)(iii) and (iv).

One comment suggested modifying the language in proposed § 1.861–9(e)(8)(ii) to clarify that the rules for specified partnership loans apply solely to match existing income and expense related to the loan, and therefore the rules do not create additional gross income. The final regulations clarify the language of the 2018 FTC proposed regulations consistent with the comment. *See* § 1.861–9(e)(8)(ii).

The same comment requested clarification with respect to the anti-avoidance rule in proposed § 1.861–9(e)(8)(iii). Proposed § 1.861–9(e)(8)(iii) provides that if instead of loaning directly to a partnership, a partner instead enters into a back-to-back loan structure through an unrelated person, then the series of loans will be recharacterized as a direct loan to the partnership if there was a principal purpose of avoiding the rules in proposed § 1.861–9(e)(8). A per se rule provides that a series of loans will be subject to the recharacterization rule without regard to the principal purpose test if the loan to the unrelated person would not have been made or maintained on substantially the same terms irrespective of the loan of funds by the unrelated person to the partnership. The comment requested that the per se rule be converted to an adverse factor in determining whether a principal purpose of avoidance exists.

The Treasury Department and the IRS have determined that a loan to an unrelated person that would not have been made or maintained on substantially the same terms if the unrelated person did not loan the funds to the partnership in which the original lender (or an affiliate of the original lender) has a direct or indirect interest is necessarily made with a principal purpose of avoiding the rules in § 1.861–9(e)(8). In addition, this rule is parallel to a similar anti-avoidance rule in § 1.861–11T(e)(3) that applies to loans between members of an affiliated group. The Treasury Department and the IRS have determined that a similar standard should apply in both cases. Therefore, the comment is not adopted.

The comment also requested clarification with respect to the anti-avoidance rule in proposed § 1.861–9(e)(8)(iv), which provides that certain loans to a partnership held by a CFC will be treated as held directly by the U.S. shareholder of the CFC if the loan was made or transferred with a principal purpose of avoiding the rules of proposed § 1.861–9(e)(8). The comment requested further guidance as to when a CFC loan to a partnership is considered to have a principal purpose of avoidance. The final regulations do not provide further guidance on the determination of principal purpose, which is a highly factual and case specific inquiry. The comment further requested clarification as to the tax consequences that arise when the loan is deemed to be held by the U.S. shareholder under the rule, and requested an example that would illustrate the operation of these rules. The final regulations clarify the operation of § 1.861–9(e)(8)(i), which generally requires that the U.S. person that owns a direct or indirect interest in the partnership disregard a portion of the loan receivable for purposes of allocating any other interest expense of the U.S. person. Where this anti-avoidance rule applies, the loan receivable is held by the CFC rather than its U.S. shareholder (which has the direct or indirect interest in the partnership), and thus merely disregarding the loan receivable would not affect the interest expense allocated by the U.S. shareholder because the relevant asset to the U.S. shareholder is the stock of the CFC that holds the loan receivable. Accordingly, the final regulations provide that appropriate adjustments are made to the value and characterization of the U.S. shareholder's stock in the CFC to reflect the amount of the loan that is disregarded under § 1.861–9(e)(8)(i). The final regulations also provide examples that illustrate the application of § 1.861–9(e)(8) in general. *See* § 1.861–9(e)(8)(vii).

Several comments requested that the rules for specified partnership loans be expanded to cover loans made by a partnership to a partner (''upstream partnership loans'') so that the treatment of loans by partners to partnerships and vice versa would be parallel for purposes of determining the source and separate category of the associated interest income and expense. The Treasury Department and the IRS agree that providing similar rules for upstream partnership loans is appropriate. Therefore, the 2019 FTC proposed regulations provide similar rules for determining the source and separate category of interest income and expense with respect to upstream partnership loans. These rules are being proposed in order to provide taxpayers an additional opportunity to comment on the rule. To better coordinate the terminology between § 1.861–9(e)(8) and the rules addressing upstream partnership loans in the 2019 FTC proposed regulations, all references in the final regulations to a specified partnership loan, or SPL, are changed to downstream partnership loan, or DPL, respectively.

2. Treatment of Limited Partners Under § 1.861–9(e)(4)

Proposed § 1.861–9(e)(4)(i) requires that limited partners and corporate general partners with less than 10 percent ownership in a partnership directly allocate their distributive share of partnership interest expense to their share of partnership gross income, which is generally treated as passive category income under proposed § 1.904–4(n)(1)(ii). One comment requested that the direct allocation rule be revised such that individuals that are partners with less than 10 percent ownership in a limited liability company or limited liability partnership be treated per se as limited partners.

Whether a partner is a general partner or limited partner is determined under general partnership law principles and therefore further guidance on this issue is outside the scope of the regulations. Accordingly, the comment is not adopted. *See also* Part III.E of this Summary of Comments and Explanation of Revisions for changes conforming the treatment of corporate and individual general partners.

3. Direct Allocation of Interest Expense for Certain Financing Companies

The general method to allocate and apportion interest expense, as provided in § 1.861–9T(a), is based on the principle that money is fungible and interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. *See* H.R. Rep. No. 99–426, at 374 (1986) (''With limited exceptions, the committee believes that it is appropriate for taxpayers to allocate and apportion interest expense on the basis that money is fungible.''). The 2018 FTC proposed regulations do not alter this approach. However, one comment requested that a finance company that borrowed money to fund loans to customers should be permitted to directly allocate the expense to the extent of interest income from the financing activity. The comment does not identify any reasons why debt of a financing company cannot be used to fund income of the entire group (either directly through the proceeds or by freeing up capital elsewhere in the group). To the extent the financing entity is a ''financial corporation,'' the rules in § 1.861–11T(d)(4) allow for separate treatment of income of financial corporations versus nonfinancial corporations. Therefore, the Treasury Department and the IRS have determined that an exception to the general rule of fungibility for finance companies is unwarranted.

4. Election To Use the Alternative Tax Book Value Method

One comment requested that the final regulations suspend restrictions on changing any elections under either the foreign tax credit or expense allocation rules, including any elections included in these final regulations, whether from year-to-year or a retroactive basis, for a three-year period beginning in 2018. The only election identified by the comment letter is the election to use the alternative tax book value method for apportioning interest expense.

Allowing annual or retroactive changes to the decision to use the alternative tax book value method would create significant compliance concerns for taxpayers and administrability concerns for the IRS because each change in method will require adjusting asset bases and depreciation schedules to reflect the new method. Therefore, the comment is not adopted. However, the final regulations provide additional time for taxpayers to change between the sales and gross income methods for purposes of allocating and apportioning research and experimental (''R&E'') expenditures. *See* Part II.D. of this Summary of Comments and Explanation of Revisions.

5. Valuation of Assets for Purposes of Apportioning Interest Expense

In general, under the tax book value method or alternative tax book value method of interest apportionment, a taxpayer must determine the value of its assets based on an average of the tax book value of the asset at the beginning and end of the year. *See* proposed § 1.861–9(g)(2)(i)(A). Before the TCJA, taxpayers could elect to use the fair market value method, which required a determination of the fair market value of the asset as of the last day of the year. However, the fair market value method was repealed as part of the TJCA. *See* section 864(e)(2). In order to provide transitional relief with respect to the TJCA's repeal of the fair market value method, proposed § 1.861–9(g)(2)(i)(A) provides that for the first taxable year beginning after December 31, 2017, a taxpayer that had been using the fair market value method may choose to determine asset values using an average of the end of the first quarter and the year-end values of its assets, provided that all the members of an affiliated group (as defined in § 1.861–11T(d)) make the same choice and no substantial distortion would result.

One comment requested that for a given asset, taxpayers be permitted to average the prior taxable year's end of year fair market value with the current year-end value, which would be based on tax book value. This approach, however, would be inconsistent with the repeal of the fair market value method for interest apportionment as part of the TCJA. Furthermore, because the fair market value and tax book value methods rely on different methodologies, this approach could lead to a substantial distortion. Therefore, the comment is not adopted.

Another comment requested either that taxpayers be permitted to rely solely on the year-end tax book value of assets (and thus not requiring averaging) or that taxpayers electing to use first quarter values be permitted to do so without the earnings adjustment under § 1.861–12(c)(2)(i)(A) when the asset being valued is stock in a 10 percent owned corporation. The comment argues that this is necessary because otherwise taxpayers would have to determine the amount of the earnings adjustment at the end of the taxpayer's first quarter, which would be burdensome to comply with. However, the regulations already provide that taxpayers do not need to determine the earnings adjustment described in § 1.861–12(c)(2)(i)(A) as of the end of the first quarter. Under proposed § 1.861–9(g)(2)(ii)(B), with respect to stock in a 10 percent owned corporation, the tax book value of the stock at the end of the first quarter is determined before the adjustment required by § 1.861–12(c)(2)(i)(A), and a single earnings and profits adjustment is made based on the earnings and profits determined as of the end of the taxable year. This rule is maintained in the final regulations.

6. Clarification of Application of the Asset Method Under § 1.861–9T(g)

Section 1.861–9T(g) provides rules for purposes of allocating and apportioning interest expense of a CFC under the asset method, which also apply to characterize the stock of a first-tier CFC under § 1.861–12 for purposes of allocating and apportioning expenses of the CFC's U.S. shareholders. Under the rules in § 1.861–12, the adjusted basis of the stock of the first-tier CFC is adjusted by the earnings and profits of the CFC and other lower-tier foreign corporations owned by the CFC.

One comment requested that the asset method under § 1.861–9T(g) be clarified to confirm that when applying § 1.861–9 at the level of a CFC, the rules in § 1.861–12 apply for purposes of characterizing stock owned directly and indirectly by the CFC, and that such rules apply for all operative sections, not just section 904. The Treasury Department and the IRS agree that in applying the asset method at the level of a CFC (including for purposes of characterizing CFC stock in applying section 904 as the operative section), the CFC must apply the rules in § 1.861–12(c) with respect to any lower-tier CFCs. For example, a CFC applying the asset method must make basis adjustments to reflect earnings and profits of lower-tier corporations when valuing and characterizing the assets of the CFC. Otherwise, the value of the lower-tier corporations would be under- or over-represented in characterizing the assets of the CFC. Furthermore, any lower-tier CFCs must also apply the same rules, starting with the lowest-tier CFC and moving up.

Therefore, the final regulations provide in § 1.861–9(g)(4) that § 1.861–12 applies to characterize lower-tier stock in the hands of a CFC. Consistent with the 2018 FTC proposed regulations, § 1.861–12(a) clarifies that the rules of that section apply for all operative sections and are not limited to section 904.

7. Treatment of Tested Income in Allocating and Apportioning Interest Expense of a CFC Under the Modified Gross Income Method

Section 1.861–9T(j)(2) provides rules for purposes of allocating and apportioning interest expense of a CFC under the modified gross income method, which also apply to characterize the stock of a first-tier CFC under § 1.861–12 for purposes of allocating and apportioning expenses of the CFC's U.S. shareholders. In general, § 1.861–9T(j)(2) requires each CFC in a chain of ownership, beginning with the lowest-tier CFC, to allocate and apportion its interest expense and then tier up its income (net of interest expense) to the next-highest CFC in the chain, which then allocates and apportions its interest expense. Under proposed § 1.861–9(j)(2)(ii), gross tested income (net of interest expense) of a lower-tier corporation does not tier up to a higher-tier corporation, which is consistent with how the rules applied to subpart F income before the TCJA. One comment recommended that the regulations be revised to allow upper-tier CFCs to take into account gross tested income (net of interest expense) of lower-tier CFCs, noting that this would be consistent with the group-based approach of section 951A, would minimize differences between the modified gross income method and the asset method in § 1.861–9T(g), and would eliminate distortions that could arise in the case of an upper-tier holding company. The Treasury Department and the IRS agree with the comment, and therefore § 1.861–9(j)(2)(ii) eliminates the rule that excludes gross tested income from tiering up to higher-tier corporations for purposes of allocating and apportioning interest expense of the CFC. Additionally, modifications were made to § 1.861–13(c)(3) (Example 3) to reflect this change.

8. Characterization of Stock of Certain Foreign Corporations Under Proposed §§ 1.861–12(c)(3) and 1.861–13

Proposed § 1.861–12(c)(3) provides rules for characterizing the stock of a CFC for purposes of allocating and apportioning expenses under an asset method. If the operative section is not section 904, the stock of a CFC is characterized under either the asset method or the modified gross income method. Proposed § 1.861–12(c)(3)(i)(A). Where section 904 is the operative section, proposed § 1.861–13 applies to characterize the stock of the CFC as producing foreign source income in the separate categories or as producing U.S. source income. Proposed § 1.861–

12(c)(3)(i)(B). Under proposed § 1.861–13(a)(1), the stock of the CFC is first characterized according to the described statutory groupings under the asset method or the modified gross income method. If the CFC owns stock in a noncontrolled 10-percent owned foreign corporation, the assets or income of the foreign corporation is assigned to a gross subpart F income grouping to the extent the income of the foreign corporation, when distributed to the CFC, would be gross subpart F income of the CFC. The stock of the CFC is then assigned to the section 951A category, a treaty category, or other separate category under subsequent steps. The stock of the CFC may be assigned, in whole or in part, to the section 951A category if the CFC has gross tested income, even if the CFC has a tested loss. *See* proposed § 1.861–13(a)(2).

One comment requested that proposed § 1.861–13 provide that stock of a noncontrolled 10-percent owned foreign corporation owned by a CFC is instead assigned to the groupings for specified foreign source general category income or specified foreign source passive category income (as described in proposed § 1.861–13(a)(1)(i)(A)(*9*)). The comment notes this would be appropriate because proposed § 1.861–13 characterizes stock based on the income to which the stock gives rise, and a distribution by a noncontrolled 10-percent owned foreign corporation to a CFC should be eligible for the dividends received deduction in section 245A (the ''section 245A deduction'') under § 1.952–2.

As noted in Part III.B of the Explanation of Provisions to the temporary regulations under section 245A, the Treasury Department and the IRS intend to address issues related to the application of § 1.952–2, taking into account various comments received in connection with the TCJA (including in connection with regulations issued under section 951A), in a future guidance project. *See* T.D. 9865; 84 FR 28405. This guidance will clarify that, in general, any provision that is expressly limited in its application to domestic corporations does not apply to CFCs by reason of § 1.952–2. The Treasury Department and the IRS continue to study whether, and to what extent, proposed regulations should be issued that provide that dividends received by a CFC are eligible for a section 245A deduction notwithstanding the fact that the deduction is only available to domestic corporations. Given that no proposed regulations have been issued, the Treasury Department and the IRS have determined that it is appropriate to continue to characterize the stock of a noncontrolled 10-percent owned foreign corporation as giving rise to subpart F income, and accordingly, the comment is not adopted. Any changes that may be necessary to § 1.861–13 if proposed regulations under section 245A are issued providing that dividends received by a CFC are eligible for a section 245A deduction will be considered as part of that guidance.

Another comment suggested that the gross income and assets of tested loss CFCs should be exempt from the expense apportionment rules due to the existence of special rules for tested loss CFCs in the context of calculating GILTI, including the disallowance of any foreign tax credits related to the tested loss under section 960(d)(3). Section 864(e)(2) requires that interest expense be apportioned on the basis of the adjusted bases of assets. Whether or not a CFC is profitable does not change the fact that a taxpayer's borrowings can fund the operations of the CFC. In addition, a CFC may be highly valuable (and have a large and positive amount of accumulated earnings and profits) even if it happens to be in a loss position for a particular year. Exempting the assets of tested loss CFCs would also result in distortive incentives whereby a CFC with a small amount of tested income would have an incentive to shift into a tested loss in order to have the entire value of the CFC be excluded for purposes of interest expense apportionment. Finally, the special treatment of tested losses in the determination of the GILTI inclusion is already accounted for by reducing the value of the stock of any CFC that is assigned to the section 951A category based on the inclusion percentage. *See* § 1.861–13(a)(2). Accordingly, this comment is not adopted.

Finally, the final regulations clarify in § 1.861–13(a)(1)(i) and (ii) that for purposes of characterizing the stock of a CFC in the various statutory groupings, the U.S. shareholder of the CFC must use the same method (either the asset method or modified gross income method) that the CFC uses to apportion its interest expense. This is consistent with the rule in existence before the 2018 FTC proposed regulations, which is still reflected in § 1.861–12(c)(3)(i)(A).

9. Assets Funded by Disallowed Interest

Under § 1.861–12T(f)(1), to the extent that interest expense is capitalized, deferred, or disallowed, the adjusted basis of an asset connected to the interest expense is reduced to account for the interest that was capitalized, deferred, or disallowed. One comment suggested a revision to clarify, and narrow, the scope of this rule. The Treasury Department and the IRS agree that this rule should be clarified and have proposed changes in the 2019 FTC proposed regulations.

D. Allocation and Apportionment of Research and Experimental Expenditures

Proposed § 1.861–17 provides a one-time exception to the five-year binding election period by allowing taxpayers to switch between the sales method and gross income method in the first taxable year beginning after December 31, 2017. This exception is finalized without change.

Comments requested revisions to the approach for allocating and apportioning R&D expenditures under § 1.861–17, which the 2018 FTC proposed regulations do not otherwise modify. These comments are discussed in the 2019 FTC proposed regulations, which propose changes to the application of the sales method and allow taxpayers that are on the sales method to rely on those changes for taxable years before the proposed rulemaking is in effect. In order to give taxpayers an additional opportunity after the 2019 FTC proposed regulations have been issued to switch to the sales method, the final regulations provide that taxpayers may change to the sales method up to their last taxable year that begins before January 1, 2020, without the prior consent of the Commissioner.

E. Section 904(b)(4)

Section 904(b)(4) makes certain adjustments to both the taxpayer's foreign source taxable income and the taxpayer's entire taxable income for purposes of computing the applicable foreign tax credit limitation, based on the foreign-source portion (as defined in section 245A(c)) of any dividend from a specified 10-percent owned foreign corporation (as defined in section 245A(b)) and the deductions allocated and apportioned to, in general, income with respect to stock of the foreign corporation that will generally be eligible for a section 245A deduction or the stock of the foreign corporation that gives rise to that income. Proposed § 1.904(b)–3(c)(1) and (2) provide rules for determining what amount of the stock of the foreign corporation gives rise to income that, if distributed, is generally eligible for a section 245A deduction. The rules subdivide a portion of the value of the stock into a section 245A subgroup and a non-section 245A subgroup within each separate category.

One comment requested that the regulations clarify the treatment of stock basis of a CFC that is associated with a hybrid instrument when the stock would give rise to dividends for which a deduction is disallowed under section 245A(e), and suggested that the amount of the basis of that stock should be assigned to the non-section 245A subgroup.

Under proposed § 1.861–13(a)(5), stock is assigned to a section 245A subgroup without regard to whether a dividend paid (either in the current or future year) with respect to the stock may actually qualify for a section 245A deduction (for example, the deduction could be disallowed due to section 245A(e) or section 246(c)). The Treasury Department and the IRS considered a rule that would assign a portion of stock to a section 245A subgroup only if the earnings and profits reflected in the stock's value were allowed (or would be allowed in the future) a section 245A deduction. However, taxpayers generally could not know in a current year whether a distribution of the current earnings and profits would be allowed a section 245A deduction in a future year, and a rule requiring taxpayers to recalculate their section 245A subgroups through amended returns would create compliance burdens for taxpayers and administrative burdens for the IRS. Therefore, the final regulations retain the rules in the 2018 FTC proposed regulations, which determine the amount of stock in a section 245A subgroup without regard to whether a section 245A deduction is or would be allowed with respect to dividends paid with respect to the stock.

The comment also suggested that stock associated with hybrid instruments owned directly by a U.S. shareholder should be assigned to the non-section 245A subgroup due to a concern that the value of stock assigned to a section 245A subgroup would be excluded for purposes of valuing the stock under the beginning- and end-of-year averaging rule in § 1.861–9(g)(2). However, neither § 1.861–13(a)(5) nor § 1.904(b)–3 provides that stock assigned to the section 245A subgroup is excluded. Instead, deductions allocated and apportioned to stock assigned to the section 245A subgroup are added back to the numerator and denominator determined under section 904(a). Therefore, contrary to the comment, the assignment of stock to the section 245A subgroup (as opposed to the non-section 245A subgroup) does not impact the calculation of the total value of stock under the beginning- and end-of-year averaging rule in § 1.861–9(g)(2). Thus, the comment is not adopted.

Another comment recommended that proposed § 1.904(b)–3 be amended to provide that the treatment of deductions allocated and apportioned to the section 245A subgroup not be added back to entire taxable income for purposes of applying section 904(a) to section 951A category income. The comment is not adopted. Section 904(b)(4) is clear that deductions described in that provision are disregarded for purposes of ''entire taxable income,'' which means that the computation under section 904(a) (which describes a fraction, the denominator of which is ''entire taxable income'') with respect to all separate categories, including the section 951A category, are affected by deductions allocated and apportioned to the section 245A subgroup. However, the amount of income in the section 951A category (the numerator of the section 904(a) fraction when section 904(a) applies to that category) is not affected by deductions allocated and apportioned to the section 245A subgroups of other separate categories.

III. Foreign Tax Credit Limitation Under Section 904

A. Transition Rules Accounting for New Separate Categories

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

The 2018 FTC proposed regulations provide transition rules for assigning carryforwards of unused foreign taxes paid or accrued, or deemed paid or accrued, in pre-2018 taxable years to post-2017 separate categories, which include new categories for section 951A category income and foreign branch category income. Proposed § 1.904–2(j)(1)(ii) provides that if unused foreign taxes paid or accrued or deemed paid with respect to a separate category of income are carried forward to a taxable year beginning after December 31, 2017, those taxes are allocated to the same post-2017 separate category as the pre-2018 separate category from which the unused foreign taxes are carried. Proposed § 1.904–2(j)(1)(iii) provides an exception that permits taxpayers to assign unused foreign taxes in the pre-2018 separate category for general category income to the post-2017 separate category for foreign branch category income to the extent they would have been assigned to that separate category if the taxes had been paid or accrued in a post-2017 taxable year. Any remaining unused taxes are assigned to the post-2017 separate category for general category income.

Several comments requested a simplified rule for assigning a portion of the pre-2018 unused foreign taxes to the post-2017 separate category for foreign branch category income. One comment recommended a simplified rule under which unused foreign taxes are assigned to the foreign branch category in the same proportions as foreign taxes paid or accrued by the taxpayer's foreign branches in the relevant pre-2018 year bear to all foreign taxes paid or accrued by the taxpayer in that year. Another comment recommended a simplified rule that assigns the pre-2018 unused foreign taxes to the post-2017 separate categories by reference to a single year. Another comment recommended either allowing taxpayers to allocate pre-2018 unused foreign taxes freely between the post-2017 separate categories for general category income and foreign branch category income, or in the alternative, using any reasonable method. Finally, one comment recommended that if the reconstruction option is maintained in the final regulations that it be simplified by not requiring taxpayers to reconstruct disregarded payments between a branch and its owner.

After considering the comments, the Treasury Department and the IRS agree that a simplified safe harbor option with respect to the reconstruction option should be provided. Section 1.904–2(j)(1)(iii)(B) provides a safe harbor that allocates unused foreign taxes from a particular pre-2017 taxable year to the post-2018 separate category for foreign branch category income based on a ratio equal to the amount of foreign income taxes that were paid or accrued by the taxpayer's foreign branches divided by the amount of all foreign income taxes assigned to the general category that were paid or accrued, or deemed paid by the taxpayer with respect to the taxable year. The Treasury Department and the IRS adopt this recommendation because it combines administrative convenience, a low potential for manipulation, and a reasonable approximation of a full reconstruction. Furthermore, in light of the addition of a safe harbor option, no changes are made to the requirements for reconstruction if the safe harbor option is not chosen. Taxpayers that do not choose the safe harbor must determine the unused foreign taxes with respect to foreign branch category income as if that separate category (and thus, all the rules in § 1.904–4(f)) had applied in the year the taxes were paid or accrued.

Another comment requested that when applying the reconstruction option, the final regulations provide that for purposes of determining whether excess credits relate to direct or indirect foreign taxes, taxpayers may treat indirect credits as having been used first. However, under the reconstruction option, taxpayers must allocate unused foreign taxes by applying the rules for foreign branch category income to the origin year and determining the amount of taxes that would have been unused foreign taxes and would have been allocated to foreign branch category income had the foreign branch category applied for that year. Because deemed paid taxes can never relate to the foreign branch category, no deemed paid taxes will be treated as giving rise to unused foreign taxes that would have been allocated to foreign branch category income. Therefore, the Treasury Department and the IRS have determined that no special rules are needed. *See* § 1.904–2(j)(1)(iii).

Another comment requested that taxpayers be allowed to apply the general category exception in proposed § 1.904–2(j)(1)(iii) to post-2017 tax years on a year-by-year basis, rather than to all post-2017 tax years. The Treasury Department and the IRS have determined that the use of different methods in different years could result in inconsistent allocations of the same foreign tax credit carryovers and create significant complexity for taxpayers and the IRS. Accordingly the comment is not adopted.

2. Separate Limitation Losses, Overall Foreign Losses, Overall Domestic Losses, and Net Operating Loss Carryforwards

Proposed § 1.904(f)–12(j) generally provides that any separate limitation loss (''SLL'') or overall foreign loss (''OFL'') accounts in a pre-2018 separate category remain in the same post-2017 separate category. However, to the extent there are any unused foreign taxes with respect to the pre-2018 separate category for general category income that are allocated between the post-2017 separate categories for general category income and foreign branch category income, then any SLL or OFL account in the pre-2018 separate category for general category income is allocated to those post-2017 separate categories in the same proportion that the unused foreign taxes were allocated. Similar rules were provided in the 2018 FTC proposed regulations with respect to the recapture of SLLs or overall domestic losses (each an ''ODL'') that reduced income in a separate category in a pre-2018 taxable year, as well as for foreign losses that are part of a net operating loss that is incurred in a pre-2018 taxable year and carried forward to post-2017 taxable years.

One comment suggested that it was not clear that the allocation of losses should follow the allocation of unused foreign taxes, and that it was inflexible not to allow an allocation of losses with respect to the pre-2018 separate category for general category income between the post-2017 separate categories for general category income and branch category income when there were no unused foreign taxes with respect to that category to be allocated. The comment suggested that a true reconstruction of the losses would be too complex, but requested that the Treasury Department and the IRS consider some other unspecified approach that was independent from the allocation of unused foreign taxes.

Another comment on the same issue requested that the Treasury Department and the IRS allow taxpayers to elect to reconstruct the losses. In other words, this approach would allow taxpayers to allocate a portion of loss accounts with respect to the pre-2018 separate category for general category income to the post-2017 separate category for foreign branch category income to the extent they were attributable to losses that either related to, or offset, pre-2018 general category income that would have been foreign branch category income if recognized in a post-2017 taxable year, regardless of the taxpayer's treatment of unused foreign taxes.

The Treasury Department and the IRS agree that additional options should be added under the transition rules for loss accounts that relate to the pre-2018 separate category for general category income. Accordingly, § 1.904(f)–12(j)(2) provides that a SLL or OFL account incurred in the pre-2018 separate category for general category income by default remains in the general category, but that the taxpayer may choose to reconstruct how much of the loss account would have been in the foreign branch category had that category been in effect before 2018. As an alternative to reconstruction, a safe harbor provides that the taxpayer may instead recapture the pre-2018 loss account by recharacterizing the first available income in the post-2017 separate category for either general category income or foreign branch category income. To the extent the income in both separate categories available for recapture exceeds the balance in the loss account, the loss account is recaptured proportionately from each separate category. An ordering rule provides that the balance in a pre-2018 loss account is recaptured before any post-2017 additions to the account. This safe harbor follows similar transition rules provided in § 1.904(f)–12(a) for pre-1987 loss accounts.

Similarly, § 1.904(f)–12(j)(3) provides that an SLL or OFL that reduced pre-2018 general category income is by default recaptured in post-2018 years as general category income, but that a taxpayer may choose to reconstruct how much of the balance in the loss account would have offset foreign branch category income had that separate category applied in the year the loss was incurred, and recapture that amount in post-2017 taxable years as income in the foreign branch category. As an alternative to reconstruction, the final regulations retain the rule in proposed § 1.904(f)–12(j)(3)(ii) as a safe harbor, which provides that the taxpayer may instead recapture the balance in the loss account in subsequent taxable years ratably as income in the taxpayer's post-2017 separate categories for general category and foreign branch category income based on the proportion in which any unused foreign taxes in the pre-2018 separate category for general category income are allocated under the transition rules in § 1.904–2(j)(1)(iii)(A) or (B).

Section 1.904(f)–12(j)(4) provides that foreign losses that are part of general category net operating losses incurred in pre-2018 taxable years which are carried forward to post-2017 taxable years are by default treated as general category net operating losses, but that the taxpayer may choose to reconstruct how much of that loss would have been attributable to the foreign branch category had that separate category applied in the year the net operating loss arose. As an alternative to reconstruction, a safe harbor provides that the taxpayer may instead choose to treat the net operating loss carryforward as attributable to the general category and foreign branch category to the extent of any general category income and foreign branch category income, respectively, that is available in the year to be offset by the net operating loss carryforward (the carryforward year). To the extent the net operating loss carryforward offsets any other income in the carryforward year, it is treated as attributable to the general category. If the sum of taxpayer's general category income and foreign branch category income in the carryforward year exceeds the amount of the net operating loss carryforward, then the amount of each type of separate category income that is offset by the net operating loss carryforward, and therefore the separate category treatment of the net operating loss carryforward, is determined on a proportionate basis. An ordering rule provides that a pre-2018 general category net operating loss is applied before any post-2017 general category net operating loss.

Finally, § 1.904(f)–12(j)(5) sets forth a coordination rule that provides that for purposes of applying the transition rules for unused foreign taxes or any of the rules for loss accounts, the choice whether to default to the general category or to reconstruct must be made consistently in all cases. However, if the taxpayer chooses to reconstruct, the choice to apply a safe harbor may be made independently under each set of transition rules.

B. Foreign Branch Category Income

1. Policy Considerations

Comments recommended that the final regulations, or preamble to the final regulations, include a discussion of the tax policy considerations relevant to proposed § 1.904–4(f). In general, proposed § 1.904–4(f) defines the term foreign branch category income, which affects both the limitation on foreign tax credits under section 904 and the deduction for FDII under section 250(a)(1)(A). Under section 904(d)(2)(J), foreign branch income is defined as the business profits attributable to one or more QBUs in one or more foreign countries, with the amount of business profits attributable to a QBU determined under rules established by the Secretary. Accordingly, the 2018 FTC proposed regulations provide guidance regarding the attribution of profits to a foreign branch.

The legislative history to the TCJA does not discuss the attribution of business profits to a QBU. In drafting the 2018 FTC proposed regulations, the Treasury Department and the IRS balanced various policy objectives, including: Attributing gross income to a foreign branch in a manner that is commensurate with its business activities; administrability for taxpayers and the IRS; conformity with local country tax law; and giving effect to the policies of sections 250(b)(3)(A)(i)(VI) and 904(d)(1)(B), which limit, respectively, the deduction under section 250 and the allowance of a credit under section 901 by reference to the amount of business profits attributable to a QBU.

The Treasury Department and the IRS have determined that the 2018 FTC proposed regulations' approach to attributing gross income to a foreign branch strikes the appropriate balance among those goals. In general, the 2018 FTC proposed regulations attribute gross income by reference to the books and records maintained with respect to a foreign branch, subject to certain adjustments (including adjustments to reflect Federal income tax principles). Proposed § 1.904–4(f)(2)(i). Reliance on a foreign branch's books and records promotes administrability for both taxpayers and the IRS. In addition, gross income reflected on the books and records of a foreign branch generally reflects payments for economic activity of that foreign branch, such that the proposed regulations' approach is broadly consistent with the policy of attributing gross income based on the relative economic activity of a foreign branch. Furthermore, the rule will promote conformity between the income attributed to a foreign branch under § 1.904–4(f) and the income subject to tax in the foreign jurisdiction.

To further those policies, the 2018 FTC proposed regulations also give effect to payments made in connection with certain transactions that are disregarded for Federal income tax purposes (such payments, ''disregarded payments''). Proposed § 1.904–4(f)(2)(vi). These payments are generally reflected on the books and records of a foreign branch, represent compensation for economic activity performed by or for a foreign branch, and are frequently given effect for foreign income tax purposes. Accordingly, giving effect to those transactions generally aligns with the policies furthered by the general rule for attributing gross income to a foreign branch. For additional discussion regarding the policies and rules relating to disregarded payments, see Part III.B.2 of this Summary of Comments and Explanation of Revisions.

2. Disregarded Payments

i. In General

Several comments were received regarding proposed § 1.904–4(f)(2)(vi), under which gross income attributable to a foreign branch that is not passive category income must be adjusted to reflect disregarded payments between a foreign branch and its foreign branch owner, and between foreign branches (the ''disregarded payment rule''). Some comments expressed support for the rule, while others indicated that they believed that proposed § 1.904–4(f) would be more administrable without the disregarded payment rule. As described in Part III.B.1 of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have determined that the disregarded payment rule furthers the various policies related to the attribution of gross income to a foreign branch. The disregarded payment rules are designed to utilize information that is already available to taxpayers, making the rule more administrable. Taking disregarded payments into account will also give effect to the economic activity of a foreign branch (or a foreign branch owner) while reducing mismatches between the amount of gross income attributable to a foreign branch and the foreign tax base. Accordingly, the final regulations retain the disregarded payment rule, subject to the modifications described in this Part III.B.2 of the Summary of Comments and Explanation of Revisions.

ii. Source and Character of Income Allocated in Connection With Disregarded Payments

Comments recommended that the character and source of gross income that is reattributed under the disregarded payment rule be determined by reference to the disregarded transaction giving rise to the reattribution. For example, if a foreign branch owner earned $50 of U.S. source royalty income, and made a $50 disregarded payment to its foreign branch for services performed that if regarded would be allocable to the royalty income under the 2018 FTC proposed regulations, the proposed regulations would attribute $50 of U.S. source royalty income to the foreign branch. Because attributing U.S. source royalty income to the foreign branch would not increase the taxpayer's limitation under section 904(d)(2)(B) (the foreign branch category), the comments recommended that the source and character of the reattributed gross income be determined by reference to the disregarded payment, such that the $50 of U.S. source royalty income would be converted to foreign source services income, potentially increasing the creditability of taxes attributable to the foreign branch (including taxes imposed by reason of the disregarded transaction).

The Treasury Department and the IRS have determined that it would be inappropriate to issue rules under section 904 converting the source and character, as opposed to the separate category, of a taxpayer's gross income. Generally, section 904(d) and the regulations under § 1.904–4(f) provide rules regarding the separate application of section 904 with respect to certain categories of regarded gross income of a taxpayer. The Treasury Department and the IRS have determined that section 904 does not provide for the redetermination of the character or source of a taxpayer's gross income. Converting U.S. source income to foreign source income would also be inconsistent with the purpose of section

904, which is to ensure that the foreign taxes may not be used as a credit against U.S. tax on U.S. source income. Finally, rules allowing taxpayers to increase foreign source income through transactions with foreign branches would be prone to significant manipulation. Accordingly, the final regulations do not include special rules for determining the source and character of gross income that is reattributed under the disregarded payment rule. Similarly, the final regulations clarify that § 1.904–4(f) does not affect the analysis of whether an amount of gross income can be resourced under an applicable bilateral tax treaty. Such analysis is based solely on the treaty text and related authorities.

iii. Netting of Disregarded Payments

Comments recommended that disregarded payments be netted before determining the amount of gross income attributable to a foreign branch and its owner. For example, under a netting rule, if a foreign branch made a $100 disregarded payment to its foreign branch owner, and the foreign branch owner made an $85 disregarded payment to the foreign branch during the same year, no more than $15 of the gross income reflected on the books and records of the foreign branch would be attributed to the foreign branch owner, regardless of the factual relationship between the two payments. Similarly, if a foreign branch owner made a $50 disregarded payment to one branch, and received a $50 disregarded payment from a second branch, none of the gross income reflected on the books and records of the second foreign branch would be attributed to its owner and none of the gross income earned by the foreign branch owner would be attributed to the first foreign branch.

The Treasury Department and the IRS have determined that disregarded payments should not be netted before making adjustments under the disregarded payment rule. As described in Part III.B.2.ii of this Summary of Comments and Explanation of Revisions, the disregarded payment rule affects only the separate category of gross income, and not the source or character of a taxpayer's gross income. Accordingly, when a disregarded payment is made between a foreign branch owner and a foreign branch, the payment must be allocated to gross income of the payor to determine the source and character of the amount that is reattributed. When there is an increase to the amount of gross income attributable to a foreign branch, for example, there must be a corresponding decrease to income of the foreign branch owner with the same source and character. Moreover, the disregarded payment rule only affects the assignment of gross income in the foreign branch category and the general category, or a specified separate category that is associated with the foreign branch or general categories. Passive income, for example, is always excluded from the foreign branch category. Thus, to the extent that a disregarded payment from a foreign branch owner to a foreign branch would be allocable to passive income of the foreign branch owner, there can be no adjustment as a result of that payment to the taxpayer's gross income in the passive category, even though the amount of passive category income that is attributable to the foreign branch (and the foreign branch owner) may change.

Netting disregarded payments would distort these rules by preventing the disregarded payment rule from accurately identifying the source and character of gross income that is attributable to the foreign branch and its owner, respectively. For example, if a foreign branch earned $100 of foreign source royalty income that was initially attributable to the foreign branch, and made a $90 disregarded payment to its foreign branch owner that if regarded would be allocable to that foreign source royalty income, only $10 of that foreign source royalty income should be treated as foreign branch category income. Under a netting rule, however, a $90 disregarded payment by the foreign branch owner to that foreign branch (or another foreign branch of the foreign branch owner) that would be allocable to U.S. source passive category income of the foreign branch owner would offset the payment, such that U.S. source passive category income that could not increase foreign branch category income itself would effectively increase foreign branch category income, by increasing the non-passive foreign source royalty income attributable to a foreign branch. Accordingly, to prevent this and similarly arbitrary outcomes under the disregarded payment rule, the final regulations do not include a rule netting disregarded payments between a foreign branch owner and its foreign branches.

A comment further recommended that disregarded payments between foreign branches should be disregarded, and stated that taking those transactions into account added administrative complexity to the 2018 FTC proposed regulations without changing the categorization of any item of gross income as foreign branch category income. The Treasury Department and the IRS have determined that this comment is incorrect, and the final regulations retain the 2018 FTC proposed regulations' rules regarding transactions between foreign branches. The items of gross income attributable to a particular foreign branch vary based on the nature of the disregarded transaction, which could include multiple back-to-back disregarded payments between foreign branches and the foreign branch owner; further, the amount, character, and source of gross income allocable to a particular foreign branch may vary, and knowing which gross income items are attributable to a particular foreign branch is necessary to determine the amount, character, and source of gross income that is attributed to a foreign branch or the foreign branch owner as the result of a particular disregarded payment. The final regulations clarify this point, including through clarifications to the ordering rule in § 1.904–4(f)(2)(vi)(F), and a new example illustrating the effects of transactions between foreign branches. *See* § 1.904–4(f)(4)(xi) (Example 11). However, the final regulations also clarify that in the case where there is no disregarded payment between the foreign branch and foreign branch owner, disregarded payments between foreign branches have no effect. *See* § 1.904–4(f)(2)(vi)(A).

iv. Interest and Other Financial Transactions

Under the proposed regulations, the disregarded payment rules do not apply to disregarded payments of interest or interest equivalents (''disregarded interest payments''). *See* proposed § 1.904–4(f)(2)(vi)(C)(*1*). The preamble to the 2018 FTC proposed regulations stated that, like remittances from a foreign branch or contributions to a foreign branch, disregarded interest payments reflect a shift of, or return on, capital. Several comments disagreed with that statement, arguing that disregarded interest payments reflect business profits with respect to the payee, particularly with respect to the financial services industry. Comments also indicated that distinguishing among different types of disregarded payments based on their character presented administrative challenges. Finally, a comment noted that failing to reattribute gross income on the basis of disregarded interest payments resulted in incongruities between the gross income attributed to a foreign branch for section 904 purposes and the gross income subject to tax under foreign law.

The final regulations adopt the 2018 FTC proposed regulations' approach to disregarded interest payments. The Treasury Department and the IRS have determined that a general rule reattributing gross income by reference to disregarded interest payments would be inappropriate. As one comment noted, reattributing gross income by reference to disregarded interest payments, but not by reference to remittances and contributions, would allow taxpayers to ''strip'' the foreign branch category, potentially resulting in manipulation of the limitations in sections 250(b)(3)(A)(i)(VI) and 904(d)(1)(B). Similarly, a taxpayer seeking to increase foreign branch category income could instead borrow money from the foreign branch and shift income from the general category through disregarded interest payments made to the foreign branch. However, as described in Part III.B.4.iii of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS are considering future guidance providing special rules for certain financial institutions, including rules that would provide for adjustments to the attribution of gross income by reference to disregarded interest payments.

v. Disregarded Transfers of Intangible Property

Proposed § 1.904–4(f)(2)(vi)(D) (the ''intangible property rule'') requires the use of section 367(d) principles to impute payments, over time, for certain transfers of intangible property in a disregarded transaction. Comments requested that the intangible property rule be withdrawn, either in whole or in part (for example, by limiting the application of the rule to transfers from a foreign branch owner to a foreign branch). The comments argued that (i) there is no compelling policy rationale for the intangible property rule; (ii) the intangible property rule undermines a legislative objective of the TCJA, which was to achieve neutrality as to whether to locate intellectual property in a domestic corporation or its foreign subsidiary; (iii) the anti-abuse rule in § 1.904–4(f)(2)(v) is sufficient to prevent abusive tax-avoidance through disregarded remittances or contributions; (iv) the absence of a similar rule for tangible property or money evidences the lack of a need for a special rule for certain intangible property; (v) the intangible property rule would result in mismatches between the gross income attributable to a foreign branch and the gross income of the foreign branch for foreign tax purposes; and (vi) the rule would present administrative and compliance challenges. Certain comments acknowledged that the intangible property rule may be theoretically accurate, but argued that the compliance burdens that the rule posed outweighed its benefits.

The Treasury Department and the IRS have determined that retaining the intangible property rule is appropriate, and that it should apply to any disregarded transfer between a foreign branch owner and a foreign branch, as well as to transfers between foreign branches. While the intangible property rule may increase compliance burdens and increase the disparity between the gross income attributable to a foreign branch and the gross income taxable by a foreign country, the Treasury Department and the IRS have determined that those concerns are outweighed by the benefits derived from the rule. In general, § 1.904–4(f)(2)(vi)(A) adjusts the attribution of gross income when disregarded payments are made between a foreign branch and a foreign branch owner, or between foreign branches. Disregarded remittances or contributions, however, do not result in the reattribution of gross income. Section 1.904–4(f)(2)(vi)(C)(*2*) and (*3*). Accordingly, when a disregarded transaction with a foreign branch may be structured as either a remittance or contribution, on the one hand, or as a sale, exchange, or license, on the other hand, the amount of gross income attributed to a foreign branch could be manipulated. This concern is heightened when the property in question is highly mobile and highly valuable, as is generally true of intangible property (and less frequently true of tangible property). In light of the higher risk of manipulation for transfers of intangible property, the Treasury Department and the IRS have determined that the anti-abuse rule in § 1.904–4(f)(2)(v) does not sufficiently protect against manipulation, necessitating the more specific and mechanical intangible property rule.

The Treasury Department and the IRS have, however, modified the intangible property rule in response to comments. First, comments recommended that the intangible property rule be limited to disregarded transfers occurring after the enactment of the TCJA, after the date on which the proposed regulations were issued, or after the date on which the final regulations become effective. In response to these comments, the final regulations provide that the intangible property rule does not apply to transfers that occurred before December 7, 2018 (the date on which the proposed regulations were published). Section 1.904–4(f)(2)(vi)(D)(*2*). The Treasury Department and the IRS have determined that limiting the application of the intangible property rule to transfers occurring on or after the date on which the rule was proposed strikes the appropriate balance between providing taxpayers with sufficient notice regarding the intangible property rule, on the one hand, and preventing manipulation of the amount of gross income attributable to a foreign branch, on the other hand.

Second, several comments indicated that the intangible property rule inappropriately captures transient ownership of intangible property that was neither developed nor exploited by the foreign branch (or foreign branch owner) before a transfer. For example, several comments suggested that the intangible property rule would apply to certain repatriations of intangible property from a foreign subsidiary that elected to be treated as a disregarded entity (within the meaning of § 1.904–4(f)(3)(iv)), and immediately thereafter distributed intangible property to its U.S. owner. The Treasury Department and the IRS have determined that the potential distortions that the intangible property rule addresses generally are not implicated in the situation described in the comments. Accordingly, the final regulations adopt the recommendation. Specifically, the final regulations provide that the intangible property rule does not apply to transfers by a foreign branch or foreign branch owner that owns the intangible property transitorily, subject to certain limitations. *See* § 1.904–4(f)(2)(vi)(D)(*3*)(*i*) through (*iii*). For this purpose, whether or not a foreign branch owner that is a transferor of intangible property is treated as satisfying the transitory ownership requirements is determined by reference to both the foreign branch owner transferor and any predecessor to the foreign branch owner. *See* § 1.904–4(f)(2)(vi)(D)(*3*)(*iv*).

Finally, comments requested additional guidance and examples illustrating the application of section 367(d) principles in the context of a remittance of intangible property from a foreign branch to the foreign branch owner. In response to the comments, the final regulations specify that if a foreign branch remits property described in section 367(d)(4) to its foreign branch owner, the foreign branch is treated as having sold the transferred property to the foreign branch owner in exchange for annual payments contingent on the productivity or use of the property, the amount of which are determined under the principles of section 367(d) and the regulations under that section. The final regulations also include an example illustrating the application of the intangible property rule to a remittance of intangible property from a foreign branch to a foreign branch owner. *See* § 1.904–4(f)(4)(xii) (Example 12). The final regulations do not address comments regarding the operation of section 367(d), which are outside of the scope of the final regulations.

vi. Special Rule for Certain Disregarded Payments

A comment recommended that the final regulations clarify that disregarded payments that would be capitalized into amortizable or depreciable basis may produce adjustments under § 1.904–4(f)(2)(vi) in the year or years that the amortization or depreciation deductions would be allowed if those payments had been regarded. The final regulations adopt this recommendation. *See* §§ 1.904–4(f)(2)(vi)(B)(*1*) (specifically including disregarded cost recovery deductions, such as depreciation and amortization, in the disregarded payment allocation rules) and 1.904–4(f)(2)(vi)(B)(*3*) (clarifying the timing of those reattributions).

The final regulations also provide additional guidance regarding certain disregarded payments that would, if regarded, not be deductible, including guidance regarding disregarded sales of property that reattribute gross income when basis would be recovered other than through depreciation, amortization, or other disregarded cost recovery deductions. Under these rules, for example, a foreign branch owner's sale of property with a zero basis to its foreign branch for $100, followed by a sale by the foreign branch of that property to a third party for $110, would generally result in $110 of income that is reflected on the books and records of a foreign branch. The final regulations clarify that, in this example, $100 of gross income must be attributed to the foreign branch owner. Specifically, the foreign branch would be treated as having an adjusted disregarded basis in the property of $100, resulting in $10 of gain from the sale of the property being attributed to the foreign branch, and $100 of adjusted disregarded gain being attributed to its foreign branch owner. *See* § 1.904–4(f)(2)(vi)(B)(*2*) (concerning disregarded sales of property). Attributions of income under this rule are adjusted to the extent that the basis would otherwise have been recovered by the transferee (for example, through a disregarded cost recovery deduction). *See* § 1.904–4(f)(3)(i) (defining adjusted disregarded basis).

vii. Certain Disregarded Transactions

The 2018 FTC proposed regulations provide for certain adjustments to the amount of gross income that would otherwise be attributed to a foreign branch under proposed § 1.904–4(f)(2)(i). For example, gross income attributable to a foreign branch generally does not include gain attributable to a sale of stock by the foreign branch. *See* proposed § 1.904–4(f)(2)(iii). The final regulations clarify that consistent adjustments must be made when attributing income under the disregarded payment rule. *See* § 1.904–4(f)(2)(vi)(C)(*4*). Thus, for example, a disregarded payment from a foreign branch owner to its foreign branch with respect to a disregarded sale of stock from the foreign branch to the foreign branch owner would not result in adjustments to the attribution of gross income between the foreign branch owner and the foreign branch.

3. Foreign Branch Definition

i. Trade or Business Requirement

The proposed regulations define a foreign branch by reference to the definition of a QBU in § 1.989(a)–1(b)(2)(ii) and (b)(3), which require that the branch maintain a separate set of books and records with respect to its activities and conduct of a trade or business outside of the United States (among other things). For this purpose, the trade or business standard described in § 1.989(a)–1(c) applies, subject to certain modifications. *See* proposed § 1.904–4(f)(3)(iii). The proposed regulations provide that activities conducted outside the United States that constitute a permanent establishment under the terms of an income tax treaty between the United States and the country in which the activities are carried out are presumed to constitute a trade or business conducted outside the United States for purposes of determining whether the activities meet the trade or business standard of the foreign branch definition.

A comment indicated that it is not clear when activities that constitute a permanent establishment should ever be treated as failing to satisfy this requirement. The Treasury Department and the IRS have determined that, consistent with the policy of promoting conformity between the gross income attributable to a foreign branch and the gross income subject to tax in a foreign jurisdiction, no exception to this rule is warranted. Accordingly, the final regulations provide that activities conducted outside the United States that constitute a permanent establishment under the terms of an income tax treaty between the United States and the country in which the activities are carried out constitute a trade or business conducted outside the United States for purposes of determining whether the activities meet the trade or business standard of the foreign branch definition, and do not adopt the presumption rule in the proposed regulations. § 1.904–4(f)(3)(vii)(B).

ii. Separate Set of Books and Records

The proposed regulations include a special rule treating a partnership as maintaining a separate set of books and records with respect to the activities of a foreign trade or business, whether or not a separate set of books and records was actually maintained. *See* proposed § 1.904–4(f)(3)(iii)(C)(*2*). Thus, for example, a foreign branch exists when a partnership records on a single set of books income from a trade or business conducted outside the United States and also income earned from unrelated investment activity. The proposed regulations deem the partnership to maintain a separate set of books and records with respect to the trade or business conducted outside the United States, and the taxpayer must determine, as the context requires, the items that would be reflected on such books and records. *Id.*

A comment recommended that the final regulations provide additional guidance regarding the attribution of income items to any deemed set of books and records. In particular, the comment recommended that the principles of sections 864(c)(2), (c)(4), and (c)(5) should apply in constructing any deemed books and records in a manner analogous to the approach taken under the dual consolidated loss regulations with respect to genuine branches (although the comment recommended that the rule apply whether the QBU was a genuine branch or was held in a disregarded entity). *See* § 1.1503(d)–5(c)(2)(i). The Treasury Department and the IRS agree that, when a foreign branch does not have a separate set of books and records, the regulations should include a standard to construct hypothetical books and records. Accordingly, the final regulations adopt the recommendation. *See* § 1.904–4(f)(3)(vii)(C)(*2*).

4. Other Comments and Revisions

i. Attribution of Gain or Loss on Disposition of a Foreign Branch

To the extent that gross income (as adjusted to conform to Federal income tax principles) is reflected on the books and records of a foreign branch, the 2018 FTC proposed regulations generally treat the income as attributable to a foreign branch. Thus, for example, gain from the sale of an asset held by a foreign branch that is reflected on the books and records of the foreign branch is generally attributable to the foreign branch under proposed § 1.904–4(f)(2)(i). Similarly, gain from the sale of all of the assets of a foreign branch would, to the extent reflected on the books and records of the foreign branch, generally be attributable to the foreign branch. By contrast, when a foreign branch owner sells its interests in a disregarded entity through which it operates a foreign branch, and the gain or loss is not reflected on the books and records of a foreign branch, the income would not generally be attributable to the foreign branch under proposed § 1.904–4(f)(2)(i). Furthermore, the regulations provide a special rule providing that gross income from the disposition of an interest in a partnership or other pass-through entity, or an interest in a disregarded entity, generally is not included in the foreign branch category. *See* proposed § 1.904–4(f)(2)(iv)(A).

Comments recommended that gain or loss from the disposition of a foreign branch be treated as attributable to a foreign branch whether or not the gain or loss is reflected on the books and records of a foreign branch, including the disposition of a foreign branch held through a disregarded entity. The Treasury Department and the IRS have determined that the rules for attributing gain from the sale of an interest in a foreign branch in the proposed regulations are appropriate. In general, the proposed regulations' treatment of the disposition of a foreign branch promotes conformity with local country taxation. Gain on the sale of assets properly reflected on the books of a foreign branch will generally be included in the taxable income of the foreign branch in its local country, and will generally reflect income associated with the trade or business activities of the foreign branch. In contrast, a foreign branch owner's sale of an entity that includes a foreign branch will not be reflected on the books of the foreign branch being sold, and will generally not give rise to local country tax on the transferred entity. Furthermore, proposed § 1.904–4(f)(2)(i), which relies on the books and records of a foreign branch, sets forth a rule that is administrable for taxpayers and the IRS.

In the case of a sale by a foreign branch of another entity that includes a foreign branch, the sale generally reflects gain that is not associated with the selling branch's trade or business activities, except when there is a sufficiently close business connection between the selling branch and the entity being sold. As described in Part III.B.4.ii of this Summary of Comments and Explanation of Revisions, the proposed and final regulations include an exception that allows gain or loss on the sale of another entity to be included in foreign branch category income when that connection exists.

The exception to this rule in proposed § 1.904–4(f)(2)(iv)(A) (excluding the disposition of certain interests reflected on the books and records of a foreign branch), appropriately prevents gain from the sale of interests unrelated to the trade or business conducted by a foreign branch from being treated as the ''business profits'' of the foreign branch. Accordingly, the final regulations adopt the rules set forth in the proposed regulations, subject to the modifications described in Part III.B.4.ii of this Summary of Comments and Explanation of Revisions.

ii. Ordinary Course of Business Exception

The proposed regulations provide that the disposition of an interest in a partnership or other pass-through entity is treated as occurring in the ordinary course of the foreign branch's active trade or business to the extent that the foreign branch ''engages in the same or a related trade or business as the partnership or other pass-through entity (other than through a less than 10 percent interest)'' (the ''same or related trade or business rule''). Proposed § 1.904–4(f)(2)(iv)(B). A comment suggested that the reference to a ''10 percent interest'' in the same or related trade or business rule is unclear. To address the comment, the final regulations clarify that the same or related trade or business rule applies only when the foreign branch owns 10 percent or more of the interests in the partnership or other pass-through entity, and the foreign branch directly engages in the same, or a related, trade or business as that partnership or other pass-through entity.

iii. Comments Outside the Scope of the Final Regulation; Future Guidance

Several comments to proposed § 1.904–4(f) were received that are outside the scope of this rulemaking, including: Comments related to the allocation of expenses to foreign branch category income; comments relating to the trade or business and books and records standards of § 1.989(a)–1(c) and (d); comments relating to the interaction of § 1.1502–13 with § 1.904–4(f); comments relating to the operation of section 367(d); and comments relating to the application of the step transaction doctrine. These comments are not addressed in this Summary of Comments and Explanation of Revisions, but may be considered in future guidance projects addressing the issues discussed in the comments.

In particular, the Treasury Department and the IRS intend to issue future guidance coordinating the allocation and apportionment of expenses with the determination of foreign branch category income. In particular, the Treasury Department and the IRS are considering proposing rules applicable to regulated financial institutions regarding the allocation of interest expense to foreign branch category income. Under one approach, interest expense on demand deposits of a foreign banking branch would be directly allocated to foreign branch category income that is denominated in the same currency. Interest expense with respect to U.S. dollar-denominated demand deposits could similarly be directly allocated to interest income earned on U.S. dollar-denominated assets. Assets and liabilities would then be adjusted and residual interest expense would be allocated fungibly under the generally-applicable rules. This approach would take account of the fact that regulated financial institutions typically invest foreign currency-denominated deposits in interest-bearing assets denominated in the same currency, in part because interest rates vary across different currencies and this practice is more likely to yield a predictable return.

Under another approach, interest expense would be allocated to the foreign branch category using an approach similar to the rules applicable to foreign corporations that are engaged in the conduct of a trade or business within the United States. Generally, those rules provide for the allocation of interest expense by reference to the liabilities reflected on the books and records of a branch, and make adjustments to the amount of interest expense allocable to a branch by reference to the leverage ratio of the taxpayer as a whole. *See generally* § 1.882–5. Under this approach to allocating interest expense to foreign branch category income, it is anticipated that the amount of interest expense allocated to the foreign branch category would take into account both regarded and disregarded transactions reflected on the books and records of the foreign branch. Furthermore, in connection with this approach, disregarded interest payments would be subject to the general disregarded payment rule, resulting in adjustments to the attribution of gross income by reason of disregarded interest payments.

The Treasury Department and the IRS also recognize that the existing expense allocation rules, including with respect to R&E expenditures, depreciation, or losses, when applied to allocate and apportion expenses to gross income that has been reattributed under the disregarded payment rule in § 1.904–4(f)(2)(vi), may lead to results that are inconsistent with the policy goal of identifying income attributable to the foreign branch that is commensurate with its business activities. The Treasury Department and the IRS are studying whether additional rules for allocating and apportioning expenses to foreign branch category income or limiting the amount of the adjustments to the attribution of gross income as a result of certain disregarded payments are appropriate.

The Treasury Department and the IRS welcome comments on issues relating to allocation and apportionment of expenses to the foreign branch category. Comments on this topic should be submitted as part of the notice and comment process for the 2019 FTC proposed regulations. See Part I.A.5 of the Explanation of Provisions to the 2019 FTC proposed regulations.

C. Section 951A and Passive Category Income

Proposed § 1.904–4(g) generally provides that section 951A category income means amounts included in the gross income of a United States person (''U.S. person'') under section 951A(a), but does not include passive category income. *See also* section 904(d)(1)(A). Additionally, proposed § 1.904–4(c)(1) provides that passive income that is considered to be high-taxed income under section 904(d)(2)(B)(iii)(II) (''the section 904 high-tax kickout'') is treated as general category income, foreign branch category income, section 951A category income, or income in a specified separate category, depending on the application of the general rules in § 1.904–4. One comment suggested that the regulations should provide that income included under section 951A is never assigned to the passive category. The comment also suggested that passive category income that qualifies for the section 904 high-tax kickout should never be assigned to the section 951A category. The comment assumed that all passive category income earned by a CFC was necessarily foreign personal holding company income and therefore could never be included under section 951A.

The Treasury Department and the IRS note that although it is generally unlikely that passive category income would be included under section 951A, nothing in section 904 eliminates this possibility. To the contrary, the parenthetical in section 904(d)(1)(A) contemplates that all or part of a GILTI inclusion could be passive category income by expressly excluding passive category income from the section 951A category. Further, to the extent that income included under section 951A is excluded from passive category income under the section 904 high-tax kickout, it is appropriate under the rules of section 904(d) and § 1.904–4 that the income be reclassified as section 951A category income rather than income in another separate category. The section 904 high-tax kickout does not specify the category to which high-taxed income is assigned; it merely specifies that the high-taxed income is not passive category income. Therefore, the comment is not adopted.

Additionally, under section 904(c) as amended by the TCJA, unused foreign taxes with respect to section 951A category income may not be carried back or carried forward. Proposed § 1.904–2(a) incorporated this statutory change into the regulations. One comment recommended that unused foreign taxes with respect to section 951A category income should be eligible to be carried back or carried forward. However, because the statutory language of section 904(c) is clear, the comment is not adopted.

D. Items Resourced Under Treaties

The 2018 FTC proposed regulations include rules regarding section 904(d)(6), which applies when a taxpayer elects the benefits of a treaty obligation to resource an item of income. Proposed § 1.904–4(k)(2) adopts a grouping methodology for purposes of section 904(d)(6) whereby the relevant portions of sections 904, 907, and 960 apply separately to the aggregate amount of items of income that are in a single separate category and resourced under a particular treaty rather than separately to each item resourced under the treaty. The proposed regulations also provide that § 1.904–6 applies to allocate foreign income taxes to a separate category determined under section 904(d)(6). The preamble to the 2018 FTC proposed regulations requested comments on whether special rules should apply to limit the taxes allocated to a separate category determined under section 904(d)(6) to taxes imposed by the foreign jurisdiction that was a party to the relevant treaty, or whether taxes imposed by a third-party jurisdiction should continue to be allocated to the separate category determined under section 904(d)(6).

One comment addressed the issue of foreign taxes imposed by third-party jurisdictions, noting that any rule that allocated such taxes away from the income on which it was imposed under § 1.904–6 would be a departure from the framework of the foreign tax credit regime, which generally aims to attribute foreign taxes to the income to which they relate. The Treasury Department and the IRS agree with the comment, and therefore the final regulations reaffirm that taxes imposed by a third-party jurisdiction should continue to be allocated to the separate category determined under section 904(d)(6) or 865(h). *See* § 1.904–4(k)(1)(iii) and (k)(2).

Another comment recommended that the final regulations apply the approach under section 904(d)(6) to income resourced under section 865(h). The comment indicated that there was no compelling reason why similar grouping rules should not also be extended to income subject to section 865(h). The Treasury Department and the IRS agree that consistent application of the similar rules in sections 865(h) and 904(d)(6) that assign items of income resourced under a treaty to a separate category is appropriate. Accordingly, the final regulations provide that, with respect to gains described in section 865(h)(2)(A), the provisions of section 904(a), (b), (c), (d), (f), and (g), and sections 907 and 960 are applied separately with respect to each treaty under which the taxpayer has claimed benefits and, within each treaty, to each separate category of income. *See* § 1.904–4(k)(2). Therefore, if a taxpayer recognizes gain described in section 865(h)(2)(A) from multiple sales and other U.S. source income that is resourced and subject to section 904(d)(6), the gains and other income are all passive category income, and the gains and other income are resourced under the same treaty, then the aggregate amount of the resourced gains are included in a single section 865(h) separate category for passive category income resourced under a tax treaty, and the other passive income is included in a single section 904(d)(6) separate category for passive category income resourced under a tax treaty. In addition, the high-taxed income rules of section 904(d) (including the grouping rules in § 1.904–4(c)) apply separately to the items of income included in each separate category for passive category income resourced under a particular tax treaty.

E. Distributive Shares of Partnership Income

Under former § 1.904–5(h) (as in effect before the final regulations) and proposed § 1.904–4(n), a partner's distributive share of partnership income is characterized as passive income to the extent that the distributive share is a share of income earned or accrued by the partnership in the passive category. However, this rule does not apply to any limited partner or corporate general partner that owns less than 10 percent of the value in a partnership. Instead, that partner's entire distributive share of partnership income is assigned to the passive category. The preamble to the proposed regulations requested comments on whether this rule should be modified. One comment stated that, if a general partner is a CFC, its distributive share should be characterized on a look-through basis by referencing the income earned or accrued by the partnership, regardless of whether the CFC owns 10 percent of the value in a partnership, and that consideration should be given to making this rule elective. The comment also suggested considering a look-through approach for all corporate general partners that own less than 10 percent of the partnership.

The Treasury Department and the IRS agree that in the case of corporate general partners in a partnership, the corporation's distributive share of income of the partnership should be characterized based on the income of the partnership regardless of the corporate partner's ownership threshold. The rule in former § 1.904–5(h) assigning income of a less than 10-percent partner to the passive category reflected the concern that partners would have difficulty obtaining information from the partnership in order to determine the partnership's income. However, the comment states that corporate general partners are generally able to obtain information to determine their distributive shares of the partnership's income. In addition, with respect to CFCs, section 951A requires the CFC to determine whether each item of partnership income is tested income, subpart F income, or excluded from tested income under section 951A(c)(2)(A)(i)(I) through (V) regardless of the CFC's ownership percentage in the partnership. Furthermore, with respect to individuals, the prior final regulations at § 1.904–5(h)(1) already provided that general partners with less than 10 percent ownership in the partnership apply a look-through approach. Therefore, there is minimal administrative benefit to assigning all of a less-than-10-percent corporate general partner's income to the passive category rather than following the general rule that assigns the distributive share based on the income of the partnership. Therefore, § 1.904–4(n)(1)(ii) provides that all general partners apply the general rule even if the partner owns less than 10 percent of the partnership. The same change is made to the expense allocation rules under § 1.861–9(e)(4), which provides rules for assigning partnership interest expense in the case of a less-than-10-percent limited partner or corporate general partner.

F. Look-Through Rules

1. Section 951A Category

The proposed regulations generally provide that the look-through rules under section 904(d)(3) provide look-through treatment solely with respect to payments allocable to the passive category. *See* proposed § 1.904–5. Other payments described in section 904(d)(3) are assigned to a separate category other than the passive category based on the general rules in § 1.904–4. Proposed § 1.904–5(b)(1). Accordingly, dividends, interest, rents, or royalties paid from a CFC to a U.S. shareholder are not assigned to the section 951A category, because only amounts included in the gross income of a U.S. shareholder under section 951A (and the related gross-up amount for foreign taxes deemed paid) are assigned to the section 951A category.

Comments requested that § 1.904–4 be revised to provide that the look-through rules under section 904(d)(3) apply to characterize interest, rents, and royalties paid by a CFC to a U.S. shareholder as income in the section 951A category. However, section 904(d)(3) provides that look-through payments not allocable to passive category income are not treated as passive category income, but does not assign the income to a particular category. Section 904(d)(1) generally defines the separate categories, and section 904(d)(1)(A) is clear that only amounts includible in gross income under section 951A are assigned to the section 951A category. Accordingly, under the clear terms of the statute, look-through payments cannot give rise to section 951A category income and must be assigned to other separate categories, such as the foreign branch category (if described in section 904(d)(1)(B)), a separate category for income described in section 901(j) or income resourced under a tax treaty, or the general category. Therefore, the comment is not adopted.

2. Treatment of Interest Deductions That Are Disallowed

Proposed § 1.861–9(c)(5) provides that if a taxpayer's deduction for business interest expense is disallowed under section 163(j) in a given year but permitted in a future taxable year, that the deduction for the business interest expense is apportioned under the rules of § 1.861–9 as though it were incurred in the year in which the expense is deductible. This is consistent with the existing general rule in § 1.861–9T(c) that in order for interest expense to be allocated and apportioned, the expense must be currently deductible. *See also* § 1.861–9T(c)(3) (applying the same rule to interest deductions deferred under section 163(d)).

One comment requested guidance on how to apply the look-through rules, which require allocating and apportioning interest expense under § 1.861–9 in order to match the interest with gross income of the payor, when the interest expense is not allowed as a deduction at the CFC level. The comment noted that the disallowance at the CFC level does not defer a recipient income inclusion that must be assigned to a separate category.

In response to the comment, the final regulations provide in § 1.904–5(c)(2)(i) that the allocation and apportionment rule described in § 1.904–5(c)(2)(ii) is applied in the year the interest income is taken into account even if the interest expense is not actually deductible by the CFC in that year.

G. Allocation and Apportionment of Foreign Taxes

Proposed § 1.904–6(a) provides rules for the allocation and apportionment of taxes to the separate categories of income. Consistent with section 904(d)(2)(H)(i), proposed § 1.904–6(a)(1)(iv) provides that foreign taxes imposed with respect to base differences are assigned to the separate category in section 904(d)(1)(B), which is the foreign branch category. Comments stated that Congress had inadvertently failed to revise the cross-reference in section 904(d)(2)(H)(i) and that the regulations should assign taxes associated with base differences to the general category, or should provide a rule assigning the taxes to the general category or the foreign branch category depending on the types of income that the taxpayer earns. Because the statute is clear that taxes associated with base differences are assigned solely to the foreign branch category, the final regulations confirm that such taxes are assigned to the category specified in section 904(d)(2)(H)(i).

Several comments to the 2018 FTC proposed regulations requested additional guidance clarifying the allocation and apportionment of foreign income taxes under § 1.904–6. These rules apply not only for purposes of assigning taxes to separate categories, but also apply under § 1.960–1(d) for purposes of associating foreign income taxes with income groups and PTEP groups in determining the amount of deemed paid credits under section 960. In particular, the comments requested additional rules clarifying the meaning of base and timing differences as well as new examples, and rules on assigning taxes incurred with respect to disregarded payments, and clarification on how those rules interact with the foreign branch category rules.

The Treasury Department and the IRS have determined that proposed § 1.904–6(a)(1)(iv) generally reflects the appropriate principles regarding what constitutes a base or timing difference, but agree that additional guidance regarding how those principles apply in specific fact patterns is warranted. In order to provide final rules for taxpayers to apply, while also providing an additional opportunity for taxpayers to comment on the new additional guidance, the final regulations finalize the rules in the 2018 FTC proposed regulations in § 1.904–6(a)(1)(iv). New rules relating to the allocation and apportionment of foreign income taxes are contained in the 2019 FTC proposed regulations.

H. Separate Limitation Loss and Overall Foreign Loss Rules Under Section 904(f)

Other than a provision coordinating the application of the adjustments in proposed § 1.904(b)–3 with the ordering rules for allocation and recapture of losses, including SLLs and OFLs, *see* proposed § 1.904(b)–3(d), the 2018 FTC proposed regulations did not make any changes to the rules governing SLLs and OFLs. However, a number of comments requested changes to the application of those rules with respect to the section 951A category.

One comment recommended that income in the section 951A category be excluded for purposes of the OFL recapture rule in § 1.904(f)–2(c)(1), which generally provides that the OFL recapture amount in a separate category is the lesser of the maximum recapture amount in that category (the lesser of the OFL account balance or income in that category) or 50 percent of total foreign source income. The comment suggested that for most taxpayers, GILTI inclusions will significantly exceed foreign source income in other separate categories and as a result the foreign source income in those other separate categories will always be fully subject to the recapture rule, up to the amount of the OFL account balance in that category. Comments also recommended that the final regulations provide that the separate limitation loss rules under section 904(f)(5) do not apply with respect to the section 951A category, that the ODL rules in section 904(g) do not apply to reduce income in the section 951A category, and that foreign tax credits assigned to the section 951A category that are not allowed by reason of a separate limitation loss or ODL ''hover'' until the loss is recaptured, at which time the ''hovering'' foreign tax credits would be allowed.

The current OFL recapture rule reflects the intended application of section 904(f)(1) as expressed in legislative history from 1986. In addition, section 904(f)(5) and (g) are clear that foreign source losses must be allocated to foreign source income in other separate categories before reducing U.S. source income and that ODLs reduce foreign source income in each separate category and must be recaptured out of income in those categories. The TCJA did not modify the operation of section 904(f) or (g) with respect to the section 951A category, nor is there any indication in the TCJA or legislative history that Congress intended the rules under section 904(f) and (g) to apply differently to section 951A category income as compared to other separate categories. In addition, no authority is provided in section 904 to allow taxes assigned to the section 951A category that accrue in one year to be deferred and claimed as a credit in a future year. Such a rule would be inconsistent with sections 901 and 905(a), which allow a foreign tax credit only when the foreign tax is paid or accrued (or deemed paid), and section 904(c) which, as amended by the TCJA, explicitly provides that foreign income taxes assigned to the section 951A category that are not credited in the current year cannot be carried to different taxable years. Accordingly, the comments are not adopted.

I. Overall Foreign Loss Recapture on Property Dispositions

The 2012 OFL proposed regulations revise the ordering rules under § 1.904(g)–3 that generally provide for the coordination of section 904(f) and (g) to include specific references for taking into account OFL recapture on property dispositions under section 904(f)(3). In the case of dispositions in which gain is recognized irrespective of section 904(f)(3), the proposed regulations provide that the OFL recapture is included in Step Five along with other general OFL recapture. In the case of dispositions in which gain would not otherwise be recognized on a disposition, the 2012 OFL proposed regulations add a new Step Eight to those ordering rules to address the recognition of the additional income under section 904(f)(3) and the corresponding recapture of the applicable OFL account. New Step Eight also provides that if the additional recognition of gain increases the allowable amount of the net operating loss deduction, then the recapture of the OFL account occurs first before the additional net operating loss carryover is taken into account to offset all or a portion of that gain.

Step Eight did not address the case where additional recognition of gain reduces the amount of a current year net operating loss. The final regulations revise the new Step Eight to provide that the allocation rules for additional net operating loss carryovers apply similarly to reductions in current year net operating losses, because both cases involve loss offsetting the additional recognized gain.

One comment was received with respect to the 2012 OFL proposed regulations, which recommended addressing dispositions that result in additional income recognition under branch loss recapture and dual consolidated loss recapture rules. The 2019 FTC proposed regulations provide a new Step Nine addressing branch loss recapture and dual consolidated loss recapture amounts. The new Step Nine is being proposed in order to provide taxpayers an additional opportunity to comment on the rule.

IV. Translation of Foreign Income Taxes and Foreign Tax Redeterminations

A. Currency Translation Rules

1. Relevant Taxable Year and Definition of the Term ''Two Years''

The 2007 temporary regulations provide currency translation rules to reflect the statutory changes made to sections 905(c) and 986(a) by the Taxpayer Relief Act of 1997 (Pub. L. 105–34, 111 Stat. 788 (1997)) and to section 986(a) by the American Jobs Creation Act of 2004 (Pub. L. 108–357, 118 Stat. 1418 (2004)). Consistent with section 986(a)(1)(A), § 1.905–3T(b)(1)(i) of the 2007 temporary regulations generally provides that accrued foreign income taxes are translated into dollars at the average exchange rate for the taxable year to which such taxes relate. The 2007 temporary regulations also provide, consistent with section 986(a), several exceptions to this rule, including that, under section 986(a)(1)(B), the exchange rate on the date the taxes are paid is used to translate accrued foreign income taxes that are paid before, or more than two years after the close of, the taxable year to which the taxes relate. Section 905(c)(1)(B) also provides that, if accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, the taxpayer must notify the IRS and redetermine its U.S. tax liability for the year or years in which it claimed a credit for such taxes.

Consistent with sections 905(c)(1)(B) and 986(a)(1)(A), § 1.905–3T(b)(1)(ii) and (c) of the 2007 temporary regulations use the term ''two years,'' raising the issue of whether the term refers to two taxable years or two calendar years (that is, 24 months). The Treasury Department and the IRS have determined that a short taxable year, such as could result from a restructuring or other event, should not reduce the period within which a taxpayer can pay an accrued tax without triggering a foreign tax redetermination and thereby requiring the tax to be translated into dollars at the exchange rate on the date of payment. Accordingly, the final regulations at §§ 1.986(a)–1(a)(2)(i) and (c) and 1.905–3(a) use the term ''24 months'' instead of the term ''two years.'' *See also* § 1.905–3(b)(1)(ii)(E) (Example 5).

The relevant taxable year of a partner or beneficiary that is legally liable for foreign income tax on a distributive share of income is the partner's or beneficiary's taxable year. On the other hand, in the case of a partnership that has legal liability under foreign law for foreign income tax and that uses a different U.S. taxable year than its partners who take their distributive shares of the partnership's tax into account under section 901(b)(5) and § 1.702–1(a)(6), the rules under § 1.905–3T(b)(1)(i) of the 2007 temporary regulations does not specify whether the taxable year of the partnership or of the partner is the relevant ''taxable year to which such taxes relate'' for purposes of determining the applicable exchange rate, including whether the tax is denominated in inflationary currency, as well as whether the tax is paid within two years. A similar issue may arise with respect to a beneficiary of a trust who takes into account a distributive share of foreign income taxes paid by the trust.

The Treasury Department and the IRS have determined that the relevant taxable year is that of the person, including a partnership or trust, that has legal liability for the tax within the meaning of § 1.901–2(f) (the ''section 901 taxpayer''). Measuring the period with reference to the taxable year of a partnership or trust that is the section 901 taxpayer is simpler and more administrable than a rule that would vary the applicable translation convention and determine whether a foreign tax has been redetermined by reference to the taxable year of each partner or beneficiary. It will also generally conform the average exchange rate translation convention used to translate the taxes with the translation rate used to translate the income out of which the tax is paid by using the same taxable year to determine the average rate for both purposes. See section 989(b)(4). Accordingly, the final regulations at § 1.986(a)–1(a)(1) and (2) clarify that the relevant taxable year to which the tax relates is that of the person that is considered to pay the tax under § 1.901–2(f).

2. Definition of Inflationary Currency

Under section 986(a)(1)(C) and section 986(a)(2), a foreign tax liability denominated in an inflationary currency (as determined under regulations) is translated into dollars at the exchange rate on the date of payment of the foreign tax. Section 1.905–3T(b)(1)(ii)(C) of the 2007 temporary regulations defines an inflationary currency as the currency of a country in which there is cumulative inflation of at least 30 percent during the 36-month base period immediately preceding the last day of the taxable year. The 2007 temporary regulations do not address which year or years are relevant to determining whether a currency in which a foreign tax liability is denominated is inflationary.

The purpose of the payment date translation rule for tax denominated in inflationary currency is to more accurately reflect the dollar cost of satisfying a foreign tax liability when the currency experiences significant inflation between the time the tax accrues and the date the tax is paid, including when the average exchange rate would otherwise apply because the tax is paid within 24 months of the close of the taxable year to which the tax relates. To avoid overstating the dollar cost of the foreign tax liability, the Treasury Department and the IRS have determined that it is appropriate to translate a foreign tax liability into dollars at the spot rate (as defined in § 1.988–1(d)) on the date of payment of the foreign taxes if the taxes are denominated in a currency that is inflationary in the accrual year or in any subsequent taxable year up to and including the taxable year of the section 901 taxpayer in which the tax is paid. *See* § 1.986(a)–1(a)(2)(iii).

The final regulations also reflect editorial changes to the definition of an inflationary currency that adopt the principles of § 1.985–1(b)(2)(ii)(D) as modified by cross-reference instead of restating the method described in that paragraph. No substantive change to the computation was intended as a result of this rephrasing of the rule.

3. Year-End Translation Rate

Section 1.905–3T(b)(1)(ii)(C) and (D) of the 2007 temporary regulations and § 1.986(a)–1(a)(2)(iii) and (a)(2)(iv)(A) of the final regulations provide that, in the case of accrued taxes, the liability for which is denominated in an inflationary currency, or in the case of a taxpayer that elects to translate accrued taxes into dollars using the spot rate as of the date of payment, any accrued but unpaid taxes are translated into dollars at the spot rate on the last day of the U.S. taxable year to which such taxes relate. If the currency is not inflationary in the accrual year, but is inflationary when paid, under the general rule of § 1.986(a)–1(a)(1) of the final regulations, the tax will be provisionally translated into dollars at the average rate for the year of accrual. In each of these cases, when the taxes are subsequently paid they are translated into dollars at the spot rate on the date of payment. If this amount differs from the provisional year-end rate or average rate initially used to assign a dollar value to the credit, the later payment of the tax will constitute a foreign tax redetermination requiring an adjustment to reflect the difference between the accrued amount and the actual dollar cost of paying the tax. See § 1.905–3T(c) of the 2007 temporary regulations and § 1.905–3(a) of the final regulations for the definition of a foreign tax redetermination. The final regulations at § 1.986(a)–1(a)(2)(iii) and (iv) include a cross reference to § 1.905–3 to clarify that there generally will be a foreign tax redetermination when the accrued tax is subsequently paid, which may result in a U.S. tax redetermination.

The 2007 temporary regulations effectively require that two returns be filed in the case of accrued taxes subject to § 1.905–3T(b)(1)(ii)(C) (inflationary currency) or (D) (spot rate election) that accrue in one taxable year and are paid in the next taxable year before the return for the accrual year has been filed: First, the original return on which the accrued but unpaid taxes are translated at the provisional year-end rate, and, second, an amended return, filed after such taxes are paid, on which such taxes are translated at the rate on the date of payment. To minimize compliance burdens for taxpayers, the final regulations at § 1.986(a)–1(a)(2)(iii) and (iv) provide that taxpayers may translate accrued but unpaid taxes (including foreign taxes deemed paid under section 960) into dollars using the spot rate on the date of payment, in lieu of the provisional year-end rate, on the original return for the year for which the credit is claimed if such taxes are paid before the due date (with extensions) of such original return and such return is timely filed.

4. Election To Translate Accrued Taxes Using the Rate on the Date of Payment

Section 1.905–3T(b)(1)(ii)(D) of the 2007 temporary regulations provides that, pursuant to section 986(a)(1)(D), a taxpayer that otherwise would be required to translate foreign taxes using the average exchange rate may elect to translate all foreign income taxes denominated in nonfunctional currency using the exchange rate as of the date of payment (spot rate election). Although using the spot rate on the date of payment most accurately reflects the dollar cost of paying the foreign income tax, the 2007 temporary regulations reflect the view that taxpayers should not be permitted to use hindsight to select the more favorable of the spot rate or average exchange rate conventions to translate nonfunctional currency taxes on a QBU-by-QBU basis. Rather, in addition to a spot rate election for all of a taxpayer's nonfunctional currency foreign income taxes, the 2007 temporary regulations also permit an election to use the spot rate to translate less than all of a taxpayer's nonfunctional currency foreign income taxes, but only in situations that would reduce compliance burdens or avoid a mismatch between the exchange rates used to translate creditable foreign taxes and the same nonfunctional currency amount of income used to pay the tax. As noted in the preamble to the 2007 temporary regulations, such a mismatch may occur in the case of a QBU that has a dollar functional currency (dollar QBU) if the average exchange rate is used to translate nonfunctional currency tax that is paid out of nonfunctional currency income earned by the dollar QBU, because in that case income from transactions involving foreign currency are accounted for using the spot rate on a transaction-by-transaction basis. Accordingly, § 1.905–3T(b)(1)(ii)(D) of the 2007 temporary regulations provides that a taxpayer may make a spot rate election for all foreign income taxes denominated in nonfunctional currency, or for only those foreign income taxes that are denominated in nonfunctional currency and are attributable to dollar QBUs.

Section 1.905–3T(b)(1)(ii)(D) of the 2007 temporary regulations refers only to a ''taxpayer'' and not also to a section 902 corporation (a qualified group member described in section 909(d)(5) before its repeal in the TCJA), raising a question whether a foreign corporation with a U.S. shareholder eligible to compute deemed paid taxes should be considered a separate ''taxpayer'' that is eligible to make the spot rate election. To address this issue, the final regulations at § 1.986(a)–1(a)(2)(iv)(A) and (B) provide that the taxpayer for purposes of making the spot rate election under section 986(a)(1)(D) is any individual or corporation, and revise the references to section 902 corporations to reflect the repeal of sections 902 and 909(d)(5). Accordingly, a foreign corporation that is a specified 10-percent owned foreign corporation may elect separately from any of its U.S. shareholders to translate either all of the foreign corporation's foreign income taxes denominated in nonfunctional currency, or only those nonfunctional currency taxes of the foreign corporation's dollar QBUs, using the spot rate on the date of payment. Section 1.986(a)–1(a)(2)(iv)(B) of the final regulations also clarifies that a spot rate election by a U.S. shareholder does not further require that the shareholder's foreign subsidiaries make a spot rate election.

Section 986(a)(1)(D)(i) provides that a spot rate election is available only for foreign taxes denominated in a taxpayer's nonfunctional currency. The final regulations clarify at § 1.986(a)–1(a)(2)(iv)(A) that whether a tax that is attributable to a QBU of a taxpayer is denominated in nonfunctional currency is determined by reference to the functional currency of the taxpayer (which includes a specified 10-percent owned foreign corporation), and not that of the QBU. Accordingly, taxes denominated in a QBU's functional currency that is a nonfunctional currency of the taxpayer are considered nonfunctional currency taxes for purposes of these rules.

The final regulations at § 1.986(a)–1(a)(2)(iv)(B) also confirm that, in the case of a taxpayer (including a specified 10-percent owned foreign corporation) that makes the spot rate election only with respect to nonfunctional currency taxes that are attributable to dollar QBUs, the election must be made for all of the taxpayer's dollar QBUs and cannot be made separately for each dollar QBU. Finally, the final regulations clarify that foreign tax is attributable to a dollar QBU for purposes of these rules if it is properly recorded on the books and records of the QBU in accordance with the regulations under sections 985 through 989. This rule will help ensure matching of the exchange rate used to determine the dollar amount of the credit with the exchange rate used to determine the dollar amount of income that is used to pay the tax.

The 2007 temporary regulations do not permit the spot rate election to be used to translate taxes that are denominated in a nonfunctional currency of the taxpayer and attributable to QBUs with non-dollar functional currencies (non-dollar QBUs), other than as part of an election to translate all foreign taxes at the spot rate on the date of payment. As noted, one of the rationales for providing an election for taxpayers to translate less than all of their nonfunctional currency taxes using the rate on the date of payment is to allow taxpayers to avoid a mismatch due to the use of different translation conventions in determining the translated dollar amount of foreign tax credit and the translated dollar amount of the foreign income used to pay the tax.

However, there is generally no mismatch between the translation rate for taxes on income earned through non-dollar QBUs and the income used to pay the taxes. Under sections 986(a)(1)(A), 987(2), and 989(b)(4), such taxes and income generally are translated into dollars at the average exchange rate, minimizing administrative and compliance burdens. Although § 1.987–3T(c)(2)(v), issued in 2016, requires section 987 income or loss equal to the creditable tax amount to be translated at the same exchange rate that is used to translate the creditable taxes for purposes of section 901, the Treasury Department and the IRS intend to amend the regulations under section 987, deferring the applicability date of § 1.987–3T(c)(2)(v) (along with other portions of the regulations under section 987). *See* Notice 2018–57. Because in the absence of applicable final regulations the spot rate election to translate taxes paid by non-dollar QBUs would generally create a mismatch between the translated dollar amount of the foreign tax credit and the translated dollar amount of the foreign income used to pay the tax, and would increase, rather than reduce, administrative burdens for the IRS and compliance burdens for taxpayers, the Treasury Department and the IRS have determined that it is inappropriate to allow selective use of the spot rate election for nonfunctional currency taxes attributable to non-dollar QBUs. Accordingly, the final regulations provide that the spot rate election may not be made for foreign income taxes attributable to non-dollar QBUs, except as part of an election to translate all taxes denominated in nonfunctional currency at the spot rate on the date of payment.

5. Section 988 Gain or Loss When There Is a Change in Functional Currency

The 2007 temporary regulations do not address how to determine section 988 gain or loss when there has been a change in functional currency between the time a tax is paid or accrued and when it is refunded. If a QBU receives a refund of nonfunctional currency tax that is denominated in a currency that was the functional currency of the QBU when the tax was claimed as a credit or added to PTEP group taxes, § 1.986(a)–1(e)(2) of the final regulations provides that the QBU uses the exchange rate used under § 1.985–5(c) when the QBU's functional currency changed to determine its basis in the refunded nonfunctional currency. If a QBU receives a refund of functional currency tax that was denominated in a nonfunctional currency when the tax was claimed as a credit or added to PTEP group taxes, § 1.986(a)–1(e)(3) of the final regulations provides that the QBU recognizes the section 988 gain or loss that would have been recognized under § 1.985–5(b) if the refund had been received immediately before the QBU's functional currency changed. The final regulations also add a cross-reference to these rules at § 1.988–2(a)(2)(iii)(C).

B. Accounting for Foreign Tax Redeterminations

1. Definition of a Foreign Tax Redetermination

Section 1.905–3T(c) of the 2007 temporary regulations defines a ''foreign tax redetermination'' as a change in the foreign tax liability that may affect a taxpayer's foreign tax credit, including accrued taxes that when paid differ from the amounts added to post-1986 foreign income taxes or claimed as credits by the taxpayer (such as corrections to overaccruals and additional payments); accrued taxes that are not paid before the date two years after the close of the taxable year to which such taxes relate; refunds of tax paid; and for accrued taxes translated into dollars when paid, a difference between the dollar value of the accrued tax and the dollar value of the tax paid attributable to fluctuations in the foreign currency's value.

Section 1.905–3(a) of the final regulations reflects several clarifying changes to what constitutes a foreign tax redetermination. First, a foreign tax redetermination includes certain situations covered by section 905(c) that do not involve a change in the foreign tax liability, such as the failure to pay accrued taxes within two years and the subsequent payment of any such accrued but unpaid taxes. Second, a foreign tax redetermination includes adjustments such as a correction to an accrual that determined the tax due with reasonable accuracy, but is revised after additional consideration to reflect the correct final tax liability. Third, the regulations clarify that a foreign tax redetermination occurs if any tax that is claimed as a credit or added to PTEP group taxes is subsequently refunded, regardless of whether the tax was properly treated as paid within the meaning of § 1.901–2(e) (which includes, among other requirements, that the tax was owed and not refundable) when claimed as a credit or added to PTEP group taxes. New examples at § 1.905–3(b)(1)(ii) of the final regulations illustrate these rules, including an example demonstrating that a foreign tax redetermination includes the accrual and payment of contested taxes following the resolution of a dispute with a foreign government.

Section 1.905–3T(c) of the 2007 temporary regulations, implementing section 905(c)(1)(B), states that a foreign tax redetermination includes ''accrued taxes that are not paid *before* the date two years after the close of the taxable year to which such taxes relate.'' (Emphasis added.) In contrast, the currency translation rule at § 1.905–3T(b)(1)(ii)(A) of the 2007 temporary regulations, implementing sections 986(a)(1)(B)(i) and 986(a)(2)(A), provides that, ''[a]ny foreign income taxes denominated in foreign currency that are paid *more than two years after* the close of the U.S. taxable year to which they relate shall be translated into dollars using the exchange rate as of the date of payment of the foreign taxes.'' (Emphasis added.)

If a calendar year taxpayer accrues foreign taxes at the close of calendar Year 1, ''the date two years after the close of the taxable year to which such taxes relate'' literally refers to December 31 of Year 3, rather than January 1 of Year 4. Thus, if the taxpayer has not paid the taxes before December 31 of Year 3, that is, on or before December 30, a foreign tax redetermination would occur on December 31 of Year 3 even if the tax was paid on December 31 of Year 3, and such payment would constitute a second foreign tax redetermination. Both foreign tax redeterminations generally would require translating the foreign taxes at the same average exchange rate, resulting in offsetting foreign tax redeterminations.

To better coordinate the application of the foreign tax redetermination and currency translation rules and to ease compliance burdens, the definition of a foreign tax redetermination has been revised to include ''accrued taxes that are not paid *on or* before the date 24 months after the close of the taxable year to which such taxes relate.'' (Emphasis added.)

The Treasury Department and the IRS also have determined that the foreign tax redetermination resulting from accrued taxes that remain unpaid after two years should be considered to occur on the date that is 24 months after the close of the taxable year to which the taxes relate. Accordingly, § 1.905–3(a) of the final regulations provides that if accrued taxes are not paid on or before the date that is 24 months after the close of the taxable year to which they relate, the resulting foreign tax redetermination will be accounted for as if the unpaid portion of the taxes were refunded on such date.

Finally, the final regulations clarify that taxes that first accrue after the date 24 months after the close of the taxable year to which such taxes relate may not be claimed as a credit or added to PTEP group taxes until they are paid. The final regulations also include a cross-reference to the rules of section 905(b) and the all-events test under § 1.461–4(g)(6)(iii)(B), which require the taxpayer to establish the amount of tax that was properly accrued.

2. Adjustments to Foreign Taxes Claimed as a Direct Credit

Section 1.905–3T(d)(1) of the 2007 temporary regulations provides that, in the case of a foreign tax redetermination with respect to taxes paid or accrued by a U.S. taxpayer, a redetermination of U.S. tax liability is required ''for the taxable year for which the foreign tax was claimed as a credit.'' The final regulations clarify how the rules apply when a U.S. taxpayer's foreign taxes exceed the applicable limitation under section 904(d) and the taxpayer carries its unused foreign taxes back or forward to another year under section 904(c). Section 1.905–3(b)(1)(i) of the final regulations provides that, if a foreign tax redetermination occurs with respect to foreign tax claimed as a direct credit, then a redetermination of U.S. tax liability is required for the taxable year in which the credit was claimed and any year to which unused foreign taxes from such year were carried under section 904(c).

Section 1.905–3T(d)(1) of the 2007 temporary regulations provides that a redetermination of U.S. tax liability is not required if the difference between the dollar value of the accrued tax and the tax paid is attributable to fluctuations in the value of the foreign currency and the amount of the foreign tax redetermination with respect to each foreign country is less than the lesser of $10,000 or two percent of the dollar amount of the foreign tax initially accrued with respect to that foreign country. The application of this rule was unclear in the case of foreign tax redeterminations occurring with respect to multiple foreign countries. The final regulations at § 1.905–3(b)(1)(i) clarify that the exception to a redetermination of U.S. tax liability applies only if the $10,000 or two percent threshold is satisfied with respect to each and every foreign country with respect to which a foreign tax redetermination occurs.

3. Foreign Tax Imposed on Refund

Section 1.905–3T(e) of the 1988 temporary regulations provided that tax imposed on a refund of foreign tax is considered to reduce the amount of the refund, and no other credit or deduction is allowed with respect to such tax imposed on such refund. This provision was carried over at § 1.905–3T(e) of the 2007 temporary regulations without change. Section 1.905–3(c) of the final regulations modifies this rule to clarify that it applies in the case of any section 901 taxpayer, which includes a specified 10-percent owned foreign corporation.

V. Deemed Paid Taxes Under Section 960

A. Scope of Current Year Taxes

Proposed § 1.960–2 deems a corporate U.S. shareholder of a CFC to pay certain of the CFC's current year foreign income taxes that are attributable to the CFC's income that the domestic corporation includes under sections 951(a)(1)(A) and 951A(a). Current year taxes are the foreign income taxes that a CFC pays or accrues in its current taxable year, which the rule defines as the U.S. taxable year of a CFC that either is an inclusion year or during which the CFC receives or makes a distribution that is described in sections 959(a) or (b). Proposed § 1.960–1(b)(3), (4). Proposed § 1.960–1(b)(4) preserves current law with respect to the timing of the accrual of foreign income taxes. Under current law, taxes accrue when all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. Therefore, in the case of taxes that are withheld from a payment, the withholding taxes accrue when the payment from which the tax is withheld is made. In the case of taxes that are imposed on net income that a taxpayer recognizes under foreign law with respect to a taxable period, the net income taxes accrue on the last day of the foreign taxable period. *See* § 1.446–1(c)(1)(ii) (a liability is incurred and taken into account for Federal income tax purposes in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability); § 1.461–4(g)(6)(iii)(B) (economic performance with respect to foreign income tax liability occurs when the requirements of the all events test other than economic performance are met). Therefore, under the 2018 FTC proposed regulations, if there is a difference between the U.S. and foreign taxable years, the foreign tax may accrue, for U.S. tax purposes, in a U.S. taxable year that does not include all the income to which the tax relates. The proposed regulations further provide that if current year taxes are imposed on an item of income that U.S. law recognizes in a different taxable year—in other words, if a difference in the foreign and U.S. taxable bases results from a timing difference—the taxes relate to the income group in a section 904 category of the CFC to which they would be assigned if the income item was recognized under U.S. law in the current year. Proposed §§ 1.960–1(c)(3)(ii)(B) and 1.904–6(a)(1)(iv).

Comments requested changes to the definition of ''current year taxes'' that address timing differences that arise when a CFC has different U.S. and foreign taxable years. Specifically, the comments suggested a number of approaches to match the foreign income taxes that the CFC pays or accrues with respect to a foreign taxable year with the income that it recognizes in a U.S. taxable year. For example, comments requested that the definition take into account foreign income taxes that relate to income recognized during the current taxable year but that are paid or accrued by a CFC with respect to a foreign taxable year that closes after the current taxable year. Comments suggested that a portion of the foreign income taxes could be allocated between U.S. taxable years on the basis of a ratable allocation of the foreign taxable income on which the taxes are imposed to the portion of a foreign taxable year of the CFC that corresponds to the two U.S. taxable years. The foreign income taxes that are allocated to the current taxable year under the proration would then be treated as current year taxes for purposes of computing deemed paid taxes under section 960(a) and section 960(d), even though a portion of the taxes do not accrue under section 461 and the all events test until after the close of the current taxable year. Comments also suggested modifying the current accrual rule for foreign income taxes to treat any foreign income taxes paid or accrued by a CFC that are allocated to a current taxable year under the proration as accruing in that year. In addition, comments suggested a ''closing of the books'' method for determining the foreign tax that is treated as either a current year tax or as accruing during the next U.S. taxable year, or other approaches such as a ''with-and-without'' calculation to determine taxes attributable to extraordinary transactions.

Differences in the timing of the accrual of foreign income taxes and the inclusion of income by a U.S. shareholder on which the taxes are imposed due to a CFC's differing U.S. and foreign taxable years will generally resolve over time because although the U.S. and foreign taxable years start and close on different dates, both taxable periods encompass profits earned over the same length of time. A comment noted that this mismatch might not resolve if there are differences in the type or amount of income that a CFC earns from year to year. Unless the CFC earns all of its income ratably every year for both U.S. and foreign tax purposes, however, any method for allocating foreign tax to a different U.S. taxable year may not mitigate or may even exacerbate an ongoing mismatch of the income recognized in the current U.S. taxable year with the foreign income tax that accrues after the close of that year. Moreover, as one comment acknowledged, a rule that relies on estimates of foreign income taxes that have not accrued because they are attributable to a foreign taxable year that closes after the U.S. taxable year would require the ongoing correction of inaccurate estimates through redeterminations under section 905(c) and the filing of amended returns.

A comment noted that § 1.901–2(f)(4) requires the allocation of certain foreign taxes to a U.S. taxable year and treats those taxes as accruing in that year. This rule, however, only applies to mismatches that occur with respect to a single foreign taxable year due to the transfer of a disregarded entity or a partnership interest. Section 1.901–2(f)(4) addresses these narrow fact patterns by treating the foreign taxes that accrue in one U.S. taxable year but that are imposed on foreign taxable income that is likely to be recognized for Federal income tax purposes in a different, short U.S. taxable year of a partnership due to a partnership termination, or in a different U.S. taxable year of an owner of a disregarded entity due to a transfer of a disregarded entity, as having accrued in that short U.S. taxable year or ownership period. In certain cases, the rule may require the filing of an amended return to reflect the allocation of a portion of foreign taxes that accrue under the all events test in one U.S. taxable year to a different U.S. taxable year. This rule is appropriate to resolve a one-time mismatch in the foreign and U.S. taxable years in connection with an ownership change and is not an appropriate mechanism to address ongoing mismatches in U.S. and foreign taxable years that will generally resolve over time. In light of the fact that providing an election to choose among a variety of allocation and accrual methods in respect of foreign income tax would create compliance burdens for taxpayers and administrative burdens for the IRS and may produce results that are no more and possibly less accurate than the current accrual rule, the final regulations do not adopt the comments requesting that taxpayers be allowed to treat foreign taxes as accruing in a taxable year other than the year in which the taxes actually accrue under current law.

One comment requested that the fourth sentence in § 1.960–1(b)(4), which provides that net basis foreign income taxes accrue on the last day of the foreign taxable year, be removed or qualified, because the comment asserted that the statement did not reflect current law regarding the accrual of these taxes. However, the comment did not identify any fact patterns in which net basis foreign income taxes could accrue before the last day of the foreign taxable year. By definition, net basis foreign income taxes can only be determined with reasonable accuracy after the foreign taxable year has closed and all income and deductions have been accrued for foreign tax purposes. Therefore, the fourth sentence in § 1.960–1(b)(4) reflects current law regarding when these taxes accrue and the comment is not adopted.

B. Other Changes Relating to Current Year Taxes Imposed on Timing Difference Items

1. Assignment of Current Year Taxes to Income Groups

One comment suggested that mismatches between the U.S. and foreign taxable years could be addressed by characterizing current year tax, and therefore allocating and apportioning it to an income group, based upon the earnings recognized under Federal income tax law for the current taxable year, regardless of whether that income was included in the foreign tax base upon which the current year tax was imposed. However, this change would nullify the § 1.904–6(a) rules as a mechanism for attributing a current year tax to a statutory grouping of income, namely, income items included under section 951A or 951(a) and distributions of previously taxed earnings and profits, and potentially associate current year taxes with income for section 960 purposes other than the income to which the tax would relate for purposes of section 904. Congress intended, however, that similar principles would apply to treat current year taxes as properly attributable to a statutory grouping of income for purposes of determining deemed paid taxes under section 960 as those that apply for purposes of assigning foreign income tax to a section 904 category. *See* Conference Report, at 628 (''It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place for purposes of determining the allocation of taxes to specific foreign tax credit baskets.''). In addition, this rule would be inconsistent with the statutory requirement that taxes be ''properly attributable'' to the income that was included, because no factual connection would exist between the taxes and the income to which the taxes would be assigned. Therefore, the comment is not adopted.

2. Current Year Taxes Assigned to Groups With No Current Year Income

Comments also requested changes that would address a broader range of timing differences, such as a difference in the timing of income recognition with respect to a particular transaction or difference in the timing of cost recovery, in addition to taxable year mismatches. Consistent with section 960(a) and (d), the 2018 FTC proposed regulations deem a corporate U.S. shareholder of a CFC to pay foreign income taxes of the CFC, which are allocated and apportioned to an income group under the principles of § 1.904–6, only if there is an inclusion under either section 951(a)(1)(A) or section 951A that is attributable to net income in the income group. *See* proposed § 1.960–2(b) and (c). A current year tax that is allocated and apportioned to an income group cannot therefore be deemed paid if there is no net income in a particular group due to a timing difference or a reduction of the net income under section 952(c) to reflect the earnings and profits limitation or a chain deficit. The comments requested various changes that would have the effect of preserving a current year tax that, applying the principles of § 1.904–6, would otherwise be allocated to an income group with no net income and not deemed paid under section 960.

Several comments addressed the ineligibility of a current year tax to be deemed paid because it is associated under the principles of § 1.904–6 with an income group that has no current year income or to which no inclusion is otherwise attributable. Comments requested that, in that circumstance, the current year tax be treated as properly attributable to previously taxed earnings and profits and deemed paid under section 960(b) upon a subsequent distribution of the previously taxed earnings and profits. A similar comment suggested that a current year tax that is assigned to an income group to which no inclusion is attributable nonetheless be treated as deemed paid under section 960 for the current taxable year as long as the income that was included in the foreign tax base either was previously recognized or will be recognized in the future under Federal income tax rules.

Section 960 requires an inclusion of subpart F income under section 951(a)(1) or of tested income under section 951A in order for foreign income taxes that are associated with that income to be deemed paid. *See* Conference Report at 628 (''Tax imposed on income that is not included in subpart F income, is not considered attributable to subpart F income.''). In the absence of an inclusion, only a distribution of previously taxed earnings and profits may cause a current year tax to be associated with previously taxed earnings and profits instead of current year earnings, and treated as deemed paid by the distribution recipient.

Congress intended for § 1.904–6 principles to apply to associate current year tax with those inclusions or distributions so that the taxes that are deemed paid with respect to an inclusion or distribution are also associated, for purposes of applying the limitation under section 904(d), with the separate category to which the inclusion or previously taxed earnings and profits is assigned. Congress also repealed section 902, which tracked multi-year amounts of a CFC's foreign income taxes and associated those amounts with multi-year amounts of its earnings and profits, in favor of a system that associates, within a single, current taxable year, the foreign income taxes that a CFC pays or accrues with the income it recognizes in that year. *See* H.R. Rep. No. 115–409, at 383 (''[O]ffering deemed paid foreign tax credits on a current year basis solely under section 960 reflects what the Committee believes to be a simpler and more appropriate application of the foreign tax credit regime in a 100 percent participation exemption system); Conference Report at 628 (''The provision eliminates the need for computing and tracking cumulative tax pools.''). In a current year system that relies on § 1.904–6 principles to associate taxes paid or accrued by a CFC with respect to a taxable year with its income for that taxable year, taxes that accrue in a taxable year but relate to income other than the income that is included by a U.S. shareholder in that year are not deemed paid. Section 1.960–1(d)(3)(ii)(B) carries out the legislative intent by assigning taxes under the timing difference rule to current items of income of the same type as the items included in the foreign tax base, even if the tax was factually associated with specific items of income that were recognized for U.S. tax purposes in a different taxable year.

Associating the tax with previously taxed earnings and profits rather than current year items of income would be inconsistent with Congress's intent to eliminate pooling and calculate deemed paid foreign tax credits on a current year basis rather than on a multi-year basis; the change requested by the comments, in other words, would circumvent Congress's intent that, in the absence of a distribution of previously taxed earnings and profits, the only event that causes a foreign income tax to be deemed paid by a domestic corporation is an inclusion of the income to which the foreign income tax that is paid or accrued by a CFC relates. Conference report at 628. Therefore, the comments are not adopted.

Comments also requested the allowance of carryovers or carrybacks at the CFC level if a current year tax is not deemed paid because it is imposed on a timing difference item to which no inclusion is attributable or if the inclusion amount is reduced to reflect the shareholder's qualified deficit. The requested changes to allow carryovers of foreign income taxes at the CFC level are inappropriate in light of the transition, discussed in this Part V.B, from a system based on multi-year pools of foreign income taxes to a current-year system. Moreover, Congress also expressly disallowed carryovers of section 951A category foreign income taxes paid, accrued, or deemed paid by a domestic corporation. *See* section 904(c). The allowance of carryovers by a CFC of current year taxes that are not deemed paid by a U.S. shareholder with respect to an inclusion would undermine Congress's intent to deem a U.S. shareholder to pay foreign income taxes with respect to inclusions only on a current year basis and to allow carryovers only of certain foreign income taxes. Therefore, the comments are not adopted.

One comment specifically referenced the rule in proposed § 1.960–2(c)(5) that provides for no deemed paid taxes under section 960(d) and proposed § 1.960–2(c)(1) when the taxpayer has no inclusion under section 951A(a) in arguing for a proportionate carryover of taxes not deemed paid in the current year. The comment noted that if there was no inclusion under section 951A(a) because the taxpayer had no net CFC tested income (as defined in § 1.951A–1(c)(2)) or had deemed tangible income return (as defined in § 1.951A–1(c)(3)) in excess of its net CFC tested income, the earnings associated with that income may not be eligible for the deduction under section 245A and therefore could be subject to double taxation.

In general, earnings and profits related to income that is not included under section 951(a) or section 951A(a) (including income that is not included because of the taxpayer's deemed tangible income return or a lack of net CFC tested income) are eligible for the dividends received deduction under section 245A when those earnings are distributed to a domestic corporation, if the holding period and other requirements under section 245A are met. Thus, excluding the taxes associated with those earnings from being deemed paid under proposed § 1.960–2(c)(5) does not result in double taxation as asserted by the comment. *See also* section 245A(d). Accordingly, no changes were made to proposed § 1.960–2(c)(5).

3. Current Year Taxes Attributable to Inclusion Reduced by Qualified Deficit

A comment requested an adjustment to the computation of deemed paid taxes if a domestic corporation's subpart F inclusion that is attributable to net income in a subpart F income group is reduced by the amount of the domestic corporation's share of a qualified deficit. The requested adjustment would cause all taxes in the subpart F income group to be deemed paid in the year the qualified deficit is used. Under the requested adjustment, the amount of the current year taxes allocated and apportioned to the group that would be deemed paid by the domestic corporation would be disproportionate to the portion of the subpart F income in the group that is included in income by the domestic corporation. Under section 952(c)(1)(B), a qualified deficit reduces the amount of subpart F income of a CFC that a U.S. shareholder includes in its gross income under section 951(a)(1)(A) but does not reduce the subpart F income of the CFC. In contrast, section 952(c)(1)(A) reduces the subpart F income of the CFC at the CFC level. In addition, whereas the current year E&P limitation in section 952(c)(1)(A) can give rise to recapture in a future taxable year of the reduced subpart F income amount, no such recapture occurs with respect to qualified deficits. Therefore, the final regulations retain the rule in § 1.960–2(b)(3)(ii) that reduces the amount of foreign income taxes deemed paid to the extent the U.S. shareholder reduces its subpart F inclusion by reason of a qualified deficit. Otherwise, taxpayers could be allowed a deemed paid credit in excess of the amount of foreign income taxes the CFC paid with respect to the income that was included.

4. Assignment of Current Year Taxes to Section 904 Categories and Income Groups Determined Under Federal Income Tax Law

Comments requested clarification on the application of the timing difference rule in the case of foreign income taxes incurred by a CFC after the enactment of section 951A but imposed on income included in the foreign tax base that may correspond to income recognized under Federal income tax law in a pre-enactment taxable year (including, for example, income of a CFC that was included in a U.S. shareholder's income under section 965). In particular, comments noted that the description in proposed § 1.960–1(d)(3)(ii)(B)(*2*) of the timing difference rule as applied to certain taxes with respect to previously taxed earnings and profits suggested that the taxes would relate to the category that existed in the inclusion year, rather than (if different) the category to which the previously taxed earnings and profits would have been assigned in the year in which the taxes are paid or accrued. The comments recommended the rules confirm that taxes incurred by a CFC after the enactment of section 951A can be assigned to a tested income group even if such taxes were imposed on income that accrued for U.S. tax purposes before section 951A was enacted.

Under § 1.904–6(a)(1)(iv), a tax imposed on an amount that is not included in U.S. taxable income in the current year is allocated and apportioned to the appropriate separate category or categories to which the tax would be allocated and apportioned if the income were recognized under Federal income tax principles in the year in which the tax was imposed. Therefore, in the context of proposed § 1.960–1(d)(3)(ii), which applies the principles of § 1.904–6, a tax imposed in a post-TCJA year with respect to pre-TCJA income is assigned to a tested income group if the pre-TCJA income, if recognized in the year the tax was imposed, would be tested income. Therefore, no further change to the regulations is necessary to achieve the result requested by the comments. However, the sentence in proposed § 1.960–1(d)(3)(ii)(B)(*2*) is revised to eliminate any inference that the timing difference rule assigns the tax on the basis of the separate categories that existed in the inclusion year.

One comment asked for clarifications regarding how current year taxes are allocated and apportioned under proposed § 1.960–1(d)(3)(ii) when the foreign corporation's U.S. and foreign taxable years do not match. In addition to the change to proposed § 1.960–1(d)(3)(ii)(B)(*2*) described in the previous paragraph, as requested by the comment certain changes were also made to proposed § 1.960–1(d)(3)(ii) to clarify the allocation and apportionment process that applies to associate a current year tax with a particular income group or PTEP group that is treated as an income group. These changes clarify that in order to allocate and apportion a current year tax to the section 904 categories and income groups within those categories, all of the foreign taxable income for the period with respect to which the tax is imposed under foreign law is characterized under Federal income tax law and assigned to the categories or groups as though that foreign taxable income were recognized under Federal income tax law in the year in which the tax is paid or accrued. *See* § 1.960(d)(3)(ii)(A) and (C). Additionally, as discussed in Part III.G of this Summary of Comments and Explanation of Revisions, further guidance relating to the allocation and apportionment of foreign income taxes is contained in the 2019 FTC proposed regulations.

C. Application of Section 960 to Inclusions Under Section 1293

Proposed § 1.960–1(a)(1) sets out the general scope of the rules providing for the determination of the foreign income taxes deemed paid by a domestic corporation under section 960. Comments requested that proposed § 1.960–1(a)(1) be modified to clarify that the regulations under section 960 do not preclude a credit under section 1293(f). The final regulations in § 1.960–1(a)(1) clarify that the regulations apply for purposes of any provision that treats a taxpayer as a domestic corporation that is deemed to pay foreign income taxes or treats a foreign corporation as a CFC for purposes of section 960, including for example, section 962(a)(2) or 1293(f).

D. Assigning Gross Income to Section 904 Categories and Income Groups

1. Separate Categories to Which Income May Be Assigned

With respect to a CFC, proposed § 1.960–1(d) provides rules for assigning gross income, and allocating and apportioning deductions and current year taxes, to section 904 categories and income groups for purposes of determining what taxes are properly attributable to, and therefore deemed paid with respect to, a subpart F inclusion, GILTI inclusion, or a distribution of previously taxed earnings and profits. Under proposed § 1.960–1(d)(2)(i), gross income is first assigned to a section 904 category. The rule also specifies that, other than gross income relating to a section 959(b) distribution, gross income of a CFC cannot be assigned to the section 951A category or foreign branch category.

One comment recommended changes to this language, in general, to specify that gross income relating to a section 959(b) distribution can be assigned to the section 951A category, but that gross income of a CFC can never be assigned to the foreign branch category. The Treasury Department and the IRS agree that the language could be clarified, and accordingly, the final regulations modify § 1.960–1(d)(2)(i) to omit any references to the foreign branch category. However, the Treasury Department and the IRS are studying whether in certain cases a CFC may have gross income that is assigned to the foreign branch category and therefore the final regulations do not preclude that possibility.

2. Scope of Subpart F Income Groups

After assignment of income to section 904 categories, proposed § 1.960–1(d)(2)(ii)(A) provides that the income is further assigned to income groups within the section 904 categories. Under proposed § 1.960–1(d)(2)(ii)(B), gross subpart F income is assigned to income groups based on the items of income determined under § 1.954–1(c)(1)(iii).

Comments requested that all subpart F income in a separate category be treated as a single item for purposes of determining what taxes are properly attributable to a subpart F inclusion. However, because the grouping rules in the 2018 FTC proposed regulations are necessary to properly coordinate the calculation of foreign taxes deemed paid under section 960(a) with the application of the subpart F high-tax exception and the section 904 high-tax kickout, the final regulations do not adopt these comments.

Section 960(a) requires a determination of the foreign income taxes that are attributable to ''any item of income . . . with respect to [a] controlled foreign corporation'' that is included in gross income of a domestic corporation under section 951(a)(1). However, under the subpart F high-tax exception, a taxpayer may exclude from a CFC's foreign base company income an ''item of income'' that is high-taxed. High-taxed income is excluded from foreign base company income, and therefore is not included in the U.S. shareholder's income under section 951(a)(1). The regulations under section 954(b)(4) identify items of gross foreign base company income within each section 904 category and allocate and apportion expenses (including foreign tax expense) among these items in order to compute the net items of foreign base company income and determine the foreign effective tax rate with respect to each item. The grouping rules in the section 954(b)(4) regulations further coordinate the application of the subpart F high-tax exception with the section 904 high-tax kickout by adopting the passive category grouping rules used in the section 904 regulations. See § 1.954–1(c)(1)(iii) and sections 904(d)(2)(B)(ii)(II) and 904(d)(2)(F), excluding from passive income any income with respect to which the foreign income taxes paid, accrued, and deemed paid exceed the highest U.S. tax rate.

By adopting the same grouping rules used to determine eligibility for the subpart F high-tax exception and the application of the section 904 high-tax kickout, the subpart F income groups of proposed § 1.960–1(d)(2)(ii)(B) ensure that the same amount of foreign tax is treated as attributable to a particular item of a CFC's foreign base company income for purposes of all three Code sections. This helps minimize the circumstances in which passive subpart F income could fail to qualify for the subpart F high-tax exception, but when included under section 951(a) by the U.S. shareholder with foreign taxes deemed paid trigger the similar (but not identical) section 904 high-tax kickout. Additionally, given that section 960(a) specifically refers to the foreign income taxes properly attributable to the ''item of income,'' which has historically been determined in this manner in applying the subpart F high-tax exception and the section 904 high-tax kickout, the Treasury Department and the IRS have determined that retaining the separate subpart F income groups as provided in the 2018 FTC proposed regulations is appropriate. Accordingly, the comments are not adopted.

E. Deemed Paid Credits for Inclusions Under Section 951(a)(1)(B)

Proposed § 1.960–2(b)(1) provides that no foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B), which is based on the amount determined under section 956 (a ''section 956 inclusion''). The preamble to the proposed regulations explains that a section 956 inclusion is not an inclusion of an ''item of income'' of the CFC but instead is an inclusion equal to an amount that is determined under the formula in section 956(a) and therefore section 960(a), which as amended by the TCJA computes deemed paid taxes by reference to foreign taxes attributable to an ''item of income,'' does not allow for a deemed paid credit. Comments noted that section 960(a) references section 951(a)(1), not merely subpart F inclusions under section 951(a)(1)(A), and argued that a section 956 inclusion is an item of income in respect of the U.S. shareholder and requested that the regulation be modified to allow for a deemed paid credit in connection with a section 956 inclusion. Additionally, comments argued that not allowing credits in respect of section 956 inclusions was inconsistent with the legislative history of the TCJA. However, one comment stated that the rule in proposed § 1.960–2(b)(1) represented sensible policy because, under a pre-TCJA regime that deferred U.S. taxation of a CFC's earnings until those earnings were repatriated through a dividend distribution, section 956 served the purpose of treating effective repatriations of CFC earnings in the form of investments in certain U.S. property in a manner similar to repatriations in the form of dividends. The TCJA allowed a dividend received deduction for dividends from subsidiary foreign corporations, and no foreign taxes are deemed paid under the TCJA with respect to dividends (including dividends that are not eligible for a deduction under section 245A).

The Treasury Department and the IRS disagree that the ''item of income'' reference in section 960(a) refers to the U.S. shareholder's inclusion under section 951(a)(1), rather than the item of income of the CFC that is included in the U.S. shareholder's income. If that were the case, then no foreign taxes of the CFC would be properly attributable to such item of income, since the foreign taxes are imposed on the items of income earned by the CFC and not on the U.S. shareholder's subpart F inclusion. Therefore, the items to which foreign tax can be properly attributed must refer to the CFC's income items in order for section 960(a) to allow for a deemed paid credit for foreign taxes paid or accrued by the CFC. Because a section 956 inclusion is not traceable to an item of income of the CFC, section 960(a) does not permit a deemed paid credit for section 956 inclusions. *See also Whitlock* v. *Comm'r,* 494 F.2d 1297 (10th Cir. 1974) (earnings that give rise to a section 956 inclusion are ''not an 'income' type item of the corporation'').

In addition, section 960(a) does not define what it means for taxes to be ''properly attributable'' to items of income. The legislative history provides that rules similar to § 1.904–6(a) should apply in attributing foreign income taxes to ''item[s] of subpart F income.'' H.R. Rep. No. 115–409, at 383. Section 1.960–1(d)(3)(ii) accordingly applies the principles of § 1.904–6(a) to allocate a CFC's current year taxes to the CFC's income items that comprise its subpart F income and other income earned in the current taxable year. Those principles require attributing foreign income taxes, which are paid or accrued by the CFC, to items of income of the CFC, not to an item of income of the U.S. shareholder, since an inclusion under section 951(a) with respect to the U.S. shareholder is not ''included in the [foreign] base upon which the [CFC's foreign income] tax is imposed.'' Section 1.904–6(a)(1). Furthermore, an inclusion under section 951(a) with respect to the U.S. shareholder is not an ''item of subpart F income,'' and subpart F income excludes earnings relating to section 956. *See* section 952(a) (defining ''subpart F income'').

The Treasury Department and the IRS have also determined that attributing any foreign income taxes to a section 956 inclusion would be inconsistent with the intent of Congress to eliminate the need for multi-year tracking of income and taxes and move to a foreign tax credit system based solely on current year taxes and income. H.R. Rep. No. 115–409, at 383 (''[O]ffering deemed paid foreign tax credits on a current year basis solely under section 960 reflects what the Committee believes to be a simpler and more appropriate application of the foreign tax credit regime in a 100 percent participation exemption system.''). Congress intended for the repeal of section 902 and the amendment of section 960 to ''eliminate[ ] the need for computing and tracking cumulative tax pools.'' *Id.* Allowing a deemed paid credit for inclusions under section 956, as requested by comments, would require the promulgation of complex rules for tracking annual layers of taxes that were associated with earnings that were not included under section 951(a)(1) or 951A, special ordering rules for determining which layer of taxes were deemed paid with respect to a section 956 inclusion relating to earnings from a prior year, and would also potentially require multifaceted rules to trace movements in layers as a result of distributions of earnings and profits or reorganizations of entities.

Therefore, consistent with the proposed regulations, the final regulations provide that no foreign income taxes are deemed paid under section 960(a) with respect to a section 956 inclusion.

F. PTEP Groups in Annual PTEP Accounts

Under proposed § 1.960–3(c)(1), a CFC must establish a separate, annual account (''annual PTEP account'') for its earnings and profits for its current taxable year to which subpart F or GILTI inclusions of U.S. shareholders are attributable. The previously taxed earnings and profits in each annual account are then assigned to one of ten possible groups of previously taxed earnings described in proposed § 1.960–3(c)(2) (each, a ''PTEP group''). After the proposed regulations were issued, the Treasury Department and the IRS released Notice 2019–01, 2019–2 I.R.B. 275, which announced the intention to issue regulations relating to foreign corporations with previously taxed earnings and profits. Notice 2019–01 affirmed the requirement to maintain annual PTEP accounts, but expanded the number of PTEP groups to 16, which included the original ten PTEP groups in the 2018 FTC proposed regulations as well as six additional groups. Notice 2019–01 provided that these rules would be coordinated with proposed §§ 1.960–1 and 1.960–3. Both the preamble to the 2018 FTC proposed regulations and Notice 2019–01 requested comments on possible ways to simplify the PTEP groups. While no comments made specific suggestions on how to combine or consolidate PTEP groups, one comment noted that the rules were complex and questioned whether tracking all the PTEP groups was necessary.

After evaluating the various limitations on the creditability of certain foreign income taxes and the application of the foreign currency rules under section 986(c) with respect to PTEP groups, the Treasury Department and the IRS have determined that it is possible to consolidate certain of the PTEP groups that were listed in Notice 2019–01. Accordingly, the final regulations update the list of the PTEP groups in § 1.960–3 to include ten PTEP groups. This list consolidates the PTEP groups that were included in the 2018 FTC proposed regulations with the PTEP groups that were included in Notice 2019–01. The updated list permits taxpayers to track fewer PTEP groups than those provided for in Notice 2019–01, while still permitting the application of the relevant foreign tax credit and foreign currency provisions. However, the Treasury Department and the IRS intend to issue more comprehensive regulations addressing the maintenance of annual PTEP accounts and the PTEP groups in a separate notice of proposed rulemaking under section 959. It is anticipated that, as part of that guidance, further changes may be made to § 1.960–3 in order to coordinate both sets of regulations.

G. Transition Rule for Foreign Income Taxes Deemed Paid With Respect to PTEP Groups

Proposed § 1.960–3(d)(3) provides rules for how to determine whether foreign income taxes that were paid or accrued by a CFC in a taxable year that began before January 1, 2018, with respect to PTEP groups that were established for an inclusion year beginning before January 1, 2018, are treated as PTEP group taxes for purposes of applying § 1.960–3. The rule requires that the foreign income taxes meet three conditions, including a condition that the taxes were paid or accrued in a taxable year of the CFC that began before January 1, 2018.

One comment noted that this condition could be read to provide that taxes imposed after 2017 on a distribution from a PTEP group from an inclusion year before 2018 are not treated as PTEP group taxes. The comment recommended eliminating this condition. The Treasury Department and the IRS agree with the comment that the condition inappropriately limited the foreign income taxes that could qualify as PTEP group taxes under the rule. Accordingly, the final regulations eliminate the requirement in proposed § 1.960–3(d)(3)(i). *See* § 1.960–3(d)(3).

H. Application of Section 960(c) to Inclusions Under Section 951A

If certain conditions are met, section 960(c)(1) and § 1.960–4 allow a taxpayer to increase its section 904 limitation in the year of receipt of previously taxed earnings and profits. Because a distribution of previously taxed earnings and profits is excluded from gross income under section 959(a), the distribution will not increase the taxpayer's section 904 limitation except to the extent of any foreign currency gain recognized under section 986(c). The lack of sufficient section 904 limitation could prevent the taxpayer from claiming a credit for foreign income tax, such as a withholding tax, imposed by reason of the distribution. Section 960(c)(1) and § 1.960–4 permit foreign tax on the distribution to be credited to the extent the taxpayer had excess limitation in the year of inclusion of the income under section 951A or section 951(a).

However, in order to limit the increase to the limitation attributable to the inclusion, the increase in the section 904 limitation is reduced by the amount which would have been the section 904 limitation in the inclusion year if the amounts had not been included in gross income under section 951(a) or 951A(a). *See* § 1.960–4(c) and proposed § 1.960–4(a)(1). The increase in the section 904 limitation also excludes any excess limitation in the year of the inclusion that was used to claim a credit for foreign taxes in addition to those paid, accrued, or deemed paid with respect to the inclusions under section 951(a) or section 951A. *See* § 1.960–4(d) and proposed § 1.960–4(a)(1).

A comment recommended that § 1.960–4(c) and (d) not apply to GILTI inclusions because GILTI inclusions are segregated in a separate category that cannot include any other income. However, the parenthetical in section 904(d)(1)(A) contemplates that all or part of a GILTI inclusion could be passive category income by expressly excluding passive category income from the section 951A category. Therefore, the comment is not adopted.

I. Application of Section 965(g) to Section 960(b)

Section 965(g) provides that no credit is allowed under section 901 for the applicable percentage of any taxes paid or accrued (or treated as paid or accrued) with respect to any amount for which a deduction is allowed under section 965(c). On August 9, 2018, the Treasury Department and the IRS published proposed regulations (REG–104226–18) in the **Federal Register** (83 FR 39514) (the ''section 965 proposed regulations''), which included a provision to disallow credits under section 901 for the applicable percentage of any foreign income taxes attributable to a distribution of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits. The section 965 proposed regulations included a rule for foreign taxes deemed paid under section 960(a)(3) and reserved a rule for foreign taxes deemed paid under section 960(b) in proposed § 1.965–5(c)(1)(iii). Subsequently, in December 2018, the 2018 FTC proposed regulations provided the rule in § 1.965–5(c)(1)(iii) to disallow credits for the applicable percentage of foreign income taxes deemed paid under section 960(b) with respect to distributions to the domestic corporation of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits, and provided a coordination rule with proposed § 1.960–3, which provides rules for section 960(b). On February 5, 2019, the **Federal Register** published final regulations under section 965 (T.D. 9846) at 84 FR 1838, and these regulations confirmed, under § 1.965–5(c)(1)(i), that no credit was allowed for the applicable percentage of foreign income taxes deemed paid under section 960(b) with respect to distributions of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits. The final regulations in this Treasury decision finalize the rule in § 1.965–5(c)(1)(iii) limiting the application of section 965(g) to distributions to domestic corporations in order to avoid multiple disallowances, and coordinating the application of § 1.965–5(c)(1)(i) with § 1.960–3.

In addition, the 2018 FTC proposed regulations provide a rule similar to the rule that applies to taxes deemed paid under section 960(a)(3) (as in effect on December 21, 2017) that is in § 1.965–5(c)(1)(ii) in the section 965 proposed regulations. In particular, foreign income taxes that would have been deemed paid under section 960(a)(1) (as in effect on December 21, 2017) with respect to the portion of a section 965(a) earnings amount that was reduced under § 1.965–1(b)(2) or § 1.965–8(b) are not eligible to be deemed paid under section 960(b) and § 1.960–3(b)(1) or any other section of the Code. *See* proposed § 1.965–5(c)(1)(iii).

A comment asserted that these taxes should be considered to meet the requirements of section 960(b) as they are income taxes ''properly attributable'' to section 965(b) previously taxed earnings and profits. The comment states that although such earnings are not included in income under section 951(a), they are effectively taxed upon distribution through the reduction of basis under section 961(b).

The Treasury Department and the IRS disagree with the comment for several reasons. First, any distribution of PTEP that reduces basis does not necessarily result in U.S. tax; rather, such distribution is excluded from income under section 959(a) to the extent there is sufficient basis. The reasoning suggested by the comment would require that when a U.S. shareholder has a section 951(a) inclusion that is not reduced under section 965(b)(4), a deemed paid credit would be allowed twice, once at the time of the section 951(a) inclusion and then again when a distribution of PTEP is made that results in a reduction of basis under section 961(b), which is plainly contrary to the text of section 960 and the purpose of the foreign tax credit.

Second, the comment argues that section 965(b)(4)(A) provides that section 965(a) earnings amounts offset by an aggregate foreign E&P deficit are treated as income previously included under section 951(a) ''solely'' for purposes of applying section 959, so that such earnings are not treated as previously included under section 951(a) for purposes of applying section 960. However, the application of section 959 is a precondition to the application of section 960(b); section 960(b) cannot result in deemed paid taxes other than with respect to a distribution that is excluded from income under section 959, and in order to be so treated the section 965(b) previously taxed earnings and profits are necessarily treated as previously included under section 951(a) for purposes of section 959. See also Part VI.B of the Summary of Comments and Explanation of Revisions to the final regulations under section 965 (T.D. 9846, published in the **Federal Register** (84 FR 1838) on February 5, 2019) (rejecting similar argument in the context of prior law under section 960(a)(3)).

Third, section 960(b) allows a credit for foreign income taxes paid by CFCs upon a subsequent distribution of the section 965(b) previously taxed earnings and profits through a chain of CFCs to the domestic corporate shareholder, but does not allow a credit for foreign income taxes that were previously deemed paid (or treated as deemed paid) under section 960(a) when the amounts were included (or treated as included) in income under section 951(a). As explained in Part VI.B of the Summary of Comments and Explanation of Revisions to the final regulations under section 965 (T.D. 9846, published in the **Federal Register** (84 FR 1838) on February 5, 2019), foreign income taxes attributable to a section 965(a) earnings amount that were offset by an aggregate foreign E&P deficit were treated as deemed paid under section 960(a) when those earnings were treated as included in income under section 951(a) for purposes of section 959. Therefore, such taxes are not available to be deemed paid again under section 960(b) upon a distribution of the section 965(b) previously taxed earnings and profits.

Finally, section 960(b) provides that only taxes that are ''properly attributable to'' a distribution of PTEP are treated as deemed paid. The comment does not explain why foreign income taxes that were paid or accrued in taxable years before the TCJA would be ''properly attributable'' to a distribution of PTEP in a later taxable year. The legislative history to the TCJA indicates that rules similar to § 1.904–6(a) should apply to determine the meaning of ''properly attributable.'' H.R. Rep. No. 115–409, at 383. Under § 1.904–6(a) as in effect at the time of the TCJA, foreign income taxes paid or accrued in a current year are allocated and apportioned to current year income in a separate category (taking into account timing differences under former § 1.904–6(a)(1)(iv)), and not to income in a different taxable year. Section 1.960–1(d)(3)(ii) implements this legislative intent by providing that only current year taxes imposed solely by reason of a distribution of PTEP are allocated and apportioned to PTEP groups. Because section 960(b) applies only to distributions of PTEP arising in taxable years covered by the TCJA, foreign income taxes paid or accrued in taxable years before the TCJA can never be ''properly attributable'' to a distribution of PTEP that is described in section 960(b).

Therefore, the final regulations provide that no credit is allowed under section 960(b) or any other provision of the Code for taxes attributable to section 965(a) earnings amounts offset by an aggregate foreign E&P deficit that would have been deemed paid under former section 960(a)(1) had the amounts actually been included in income under section 951(a).

J. Treatment of Section 78 Dividend

1. Taxes Deemed Paid Under Section 960(b)

Under section 78, as amended by the TCJA, an amount equal to the taxes deemed paid by a domestic corporation under section 960(a), (b), and (d) are treated as a dividend received from the foreign corporation. Section 960(b) addresses taxes deemed paid on distributions of previously taxed earnings and profits. Before the TCJA, section 78 did not reference former section 960(a)(3), which at the time addressed taxes deemed paid on distributions of previously taxed earnings and profits. This is consistent with the purpose of the section 78 dividend, which is to ensure that a U.S. shareholder cannot effectively both deduct and credit the foreign taxes paid by a foreign subsidiary that are deemed paid by the U.S. shareholder. *See* Elizabeth A. Owens & Gerald T. Ball, The Indirect Credit § 2.2B1a n.54 (1975); Stanley Surrey, ''Current Issues in the Taxation of Corporate Foreign Investment,'' 56 Columbia Law Rev. 815, 828 (June 1956) (describing the ''mathematical quirk'' that necessitated enactment of section 78). However, there is no deduction taken into account by the U.S. shareholder for U.S. tax purposes with respect to taxes deemed paid under either former section 960(a)(3) or section 960(b) that would need to be reversed by section 78.

One comment requested that the final regulations make clear that, notwithstanding the amendment of section 78, deemed paid taxes are not treated as a section 78 dividend to the extent that the taxes are related to previously taxed earnings and profits. The comment states that providing a section 78 dividend on these taxes is inappropriate given the purpose of section 78, and that no changes to the statutory language of section 78 should be needed to achieve this result based on the final regulations in effect before the enactment of the TCJA. Finally, the comment also requested changes to the example in proposed § 1.960–1(f) to show the computation of deemed paid taxes of a U.S. shareholder under section 960(b)(1) and the application of section 78 to the deemed paid taxes.

Because section 78 clearly states that taxes deemed paid under section 960(b) give rise to a section 78 dividend, the final regulations do not adopt the comment. Additionally, because an example of the application of section 960(b)(1) is already provided in § 1.960–3(e)(2), no changes were made to the example in proposed § 1.960–1(f) in the final regulations.

2. Inclusion in Foreign Oil Related Income

One comment requested clarification that a section 78 dividend associated with an inclusion under section 951A can be included in foreign oil related income under section 907(c)(3)(B). The

TCJA amended section 907(c)(3)(B) to delete references to section 902 and to refer to taxes deemed paid under section 960, instead of section 960(a). The comment requested amendments to § 1.907(c)–2(d)(5).

The Treasury Department and the IRS agree that section 78 dividends with respect to inclusions under section 951A can be included in foreign oil related income, and that section 907(c)(3)(B), as amended by the TCJA, clearly provides for this result notwithstanding the existence of outdated regulations. However, the final regulations do not contain revisions to the regulations under section 907, which is beyond the scope of the final regulations. The regulations under section 907 have not been revised since 1991 and substantial revisions are required to conform to statutory changes made since 1991. The Treasury Department and the IRS expect to revise the regulations under section 907 in a future guidance project. Comments are requested on what additional issues should be addressed as part of revising those regulations.

VI. Applicability Dates

In general, the 2018 FTC proposed regulations provide that the portions of the regulations that relate to statutory amendments made by the TCJA apply to taxable years beginning after December 31, 2017. *See* section 7805(b)(2). In the case of §§ 1.78–1, 1.861–12(c)(2), and 1.965–7(e), these regulations were finalized as part of TD 9866, published in the **Federal Register** (84 FR 29288) on June 21, 2019.

Other portions of the proposed regulations that do not relate to the TCJA apply to taxable years ending on or after December 4, 2018. *See* section 7805(b)(1)(B). Certain portions of the proposed regulations contain rules that relate to the TCJA as well as rules that do not relate to the TCJA. Those regulations generally apply to taxable years that satisfy both of the following two conditions: (1) The taxable year begins after December 31, 2017, and (2) the taxable year ends on or after December 4, 2018. *See* section 7805(b)(1)(B).

In general, no changes were made to the proposed applicability dates in the 2018 FTC proposed regulations in the final regulations. For §§ 1.904(b)–3 and 1.960–1 through 1.960–6, the applicability dates were revised to apply the regulations to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018, consistent with section 7805(b)(1)(B).

Section 1.904(g)–3, which finalizes the 2012 OFL proposed regulations, is applicable to taxable years ending on or after December 16, 2019.

Section 1.905–3, which finalizes proposed § 1.905–3 (other than proposed § 1.905–3(a)) is applicable to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019. See proposed § 1.905–3(b)(2) and § 1.905–5, contained in the 2019 FTC proposed regulations, for rules that apply to foreign tax redeterminations of foreign corporations.

Section 1.986(a)–1, which finalizes proposed § 1.905–3(a), applies to taxable years ending on or after December 16, 2019, and to taxable years of foreign corporations which end with or within a taxable year of a U.S. shareholder ending on or after December 16, 2019.

Special Analyses

I. Regulatory Planning and Review

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. For purposes of Executive Order 13771, this rule is regulatory.

The final regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. 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

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 the TCJA eliminated the U.S. tax on some foreign source income, the United States continues to provide foreign tax credits for foreign source income subject to U.S. tax. The changes made by TCJA to international taxation necessitate certain changes in this FTC regime.

In plain language, the FTC calculation is applied separately to different categories of income (a ''separate category''), a long-standing framework that is unchanged by TCJA.[1] This framework entails the taxpayer allocating income, expenses, and foreign income taxes paid or accrued to each separate category. Taxpayers who pay foreign taxes on income in one separate category cannot claim a credit against U.S. tax owed on income (more precisely, gross income minus deductions) in a different category. 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 ''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 a FTC for only $21 (21 percent of $100) of this liability, which is with respect to active foreign source income in the general category. The $21 represents what is referred to as the taxpayer's foreign tax credit limitation with respect to the general category. 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.

Expenses borne by U.S. parents and domestic affiliates that support foreign operations also generally follow this long-standing framework. Deductions that reduce foreign source taxable income in a particular category thereby reduce the allowable FTCs for that

[1] Prior to the enactment of the TCJA, these categories were primarily the passive and general categories. The TCJA added new separate categories for global intangible low-taxed income (the section 951A category) and foreign branch category income.

category. The rules for expense allocation need updating in light of the changes made by TCJA.

The TCJA added new separate categories for global intangible low-taxed income (the section 951A category) and foreign branch income. The addition of these new categories and other changes [2] necessitate practical guidance for implementation. The final regulations also update outdated portions of the existing regulations to help conform the existing regulations to the post-TCJA world. Finally, the final regulations address comments received on the 2018 FTC proposed regulations.

B. Overview of the Final Regulations

The final regulations specify the methodologies and approaches necessary to conform the existing regulations to the changes specified in the TCJA. The final regulations provide guidance for taxpayers to determine the amount of their foreign tax credits and how to compute their foreign tax credit limitation.

Most notably, the final regulations help interpret the statute by providing details regarding how income is assigned and expenses are apportioned to the new separate categories created by the TCJA. In particular, the final regulations specify that, for purposes of applying the expense allocation and apportionment rules, the portion of gross income related to FDII or a GILTI inclusion which is offset by the section 250 deduction is treated as exempt income, and the stock giving rise to GILTI that is offset by the section 250 deduction is treated as a partially exempt asset. Such treatment implies that fewer expenses will be allocated to the section 951A category as a result of this rule, leading to higher computed foreign source taxable income, a larger foreign tax credit limitation, and a larger foreign tax credit offset with respect to GILTI income. Because in the absence of these regulations, these expenses would generally be allocated to the section 951A category (which makes it more difficult to utilize FTCs related to GILTI), this rule will in general reduce the tax burden of U.S. multinational corporations with GILTI income and allocable expenses.

[2] TCJA repealed the fair market value method of asset valuation used to apportion interest expense to separate categories and amended Code sections that address deemed paid credits for subpart F income, global intangible low-taxed income (GILTI), and distributions of previously taxed earnings and profits. Further, because repatriated dividends are no longer taxable, the TCJA also repealed section 902 (which allowed a domestic corporation to claim FTCs with respect to dividends paid from a foreign corporation) and made other conforming changes.

The final regulations also address how FTC carryovers are allocated across the new separate categories. The formation of two new separate categories requires a determination regarding how the balance of FTC carryovers in existence upon enactment of TCJA are to be allocated across new and existing separate categories.

The final regulations also address certain potentially abusive borrowing arrangements, such as when a U.S. person lends money to a foreign partnership in order to artificially increase foreign source income (and therefore the FTC limitation) without affecting U.S. taxable income. In addition, they clarify the regulatory environment by updating inoperative language in §§ 1.904–1 through 1.904–3, parts of the regulations that have not previously been updated to reflect changes to section 904 made in 1978.

The final regulations also ease transitional administrative burdens associated with the implementation of the TCJA; for example, they allow an exception to the 5 year waiting period for the election of the gross income or sales method for R&E expense allocation, and provide added flexibility for when the average bases of assets is measured by taxpayers who are required to switch to the tax book method of valuation. The final regulations further clarify the § 1.904–6 rules concerning how allocation of taxes across separate categories should be calculated in the presence of base and timing differences and also fill technical gaps in how to implement the statute in practice, for example, by providing a clear rule for how to characterize the value of stock in each separate category in the context of the new separate categories.

C. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the 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

The final regulations provide certainty and clarity to taxpayers regarding the allocation of income, expenses, and FTC carryovers to the separate income categories. In the absence of the enhanced specificity provided by these regulations, similarly situated taxpayers might interpret the foreign tax credit provisions of the tax code differently, potentially resulting in inefficient patterns of economic activity. For example, because separate categories for GILTI and foreign branch income did not previously exist, one taxpayer might undertake a particular business activity, based on that taxpayer's interpretations of how that activity's income, expenses, and carryover foreign tax credits will be allocated across these categories, that another taxpayer, making a different interpretation of the tax treatment of these allocations, might forego. If this difference in interpretations confers a competitive advantage on the less profitable enterprise, U.S. economic performance may suffer. 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.

Because the TCJA is new, the Treasury Department and the IRS do not know with reasonable precision the tax interpretations that taxpayers might make in the absence of this guidance. To the extent that taxpayers would generally have interpreted the foreign tax credit rules as being less favorable to the taxpayer than the final regulations provide, these 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 U.S. economic activity abroad 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 final 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 these final regulations or under alternative regulatory approaches; (ii) the difference in economic decisions that taxpayers might make between the final regulations and the no-action baseline or alternative regulatory approaches; or (iii) how this difference in business activities will affect U.S. economic activity. 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 and I.C.4. of this Special Analyses.

3. Economic Effects of Important Provisions Revised From the 2018 FTC Proposed Regulations

i. Transition Rules Relating to Foreign Tax Credit Carryovers

a. Background

Under the Code, to the extent a taxpayer pays or accrues creditable foreign taxes in excess of its foreign tax credit limitation in a given year, the taxpayer can carry those excess credits back one year or forward ten years (FTC carryover). Because a taxpayer's FTC limitation is determined on a separate category basis, FTC carryovers are maintained on a separate category basis as well. When there are changes in the number of separate categories, transition rules are generally needed to deal with how to classify the existing FTC carryovers so that they can be allocated to the new separate categories. The TCJA expanded the existing separate categories by subdividing the general category into three categories: General, foreign branch, and section 951A. The TCJA did not, however, provide transition rules for the existing stock of FTC carryovers.

To deal with the transition issue, the 2018 FTC proposed regulations provided a default rule that kept FTC carryovers in the general category going forward. However, taxpayers could elect to reconstruct their FTC carryover with respect to the foreign branch (but not the section 951A) category. To do so, a taxpayer would need to determine what portion of its FTC carryover would be in the foreign branch category if the foreign branch category had existed in the year the carryover arose. No amount of the carryover was required to be allocated to the section 951A category because of the difficulty associated with the reconstruction and because under the TCJA carryovers are not allowed for the foreign tax credits in the section 951A category. The provision in the 2018 FTC proposed regulations not to require taxpayers that elected reconstruction to allocate FTC carryovers to the section 951A category is generally favorable to the affected taxpayers because otherwise taxpayers would have had carryover credits allocated to the section 951A category and those taxpayers would not have been allowed to utilize those credits.

b. Options Considered for the Final Regulations

The Treasury Department and the IRS considered several options to deal with FTC carryovers in response to taxpayer comments.[3] The first option was to adopt the rule from the 2018 FTC proposed regulations without modification. A second set of options was to adopt simplified rules to assist taxpayers with allocating the FTC carryovers to the different separate categories. The Treasury Department and the IRS considered three variants of simplified rules: (a) Allow taxpayers to assign FTCs to the foreign branch category proportionately according to the ratio of foreign taxes paid or accrued by the taxpayer's branches to total foreign taxes paid or accrued by the taxpayer (in that year); (b) allow taxpayers to assign FTCs based on any reasonable method; or (c) allow taxpayers to assign FTCs by reconstructing FTC carryforwards but do not require taxpayers to apply the disregarded payment rule in § 1.904–4(f)(2)(vi).

The final regulations adopt the first simplified rule, (a). Thus, taxpayers may keep FTC carryovers in the general category, allocate them to the foreign branch category in the same manner as they would have been allocated had the foreign branch category always existed, or allocate them to the foreign branch category proportionately. This simplified rule reduces complexity for some taxpayers and is not expected to result in a substantially different allocation of FTCs to the branch basket than full reconstruction. The final rule therefore minimizes the potential for the manipulation of allocations of income, expenses, and foreign taxes to the categories while minimizing taxpayer compliance and IRS administrative costs.

c. Number of Affected Taxpayers

This provision potentially affects any taxpayer with a general category FTC arising in a taxable year beginning before January 1, 2018, that is carried to a taxable year beginning on or after January 1, 2018. The Treasury Department and the IRS estimate that there are between 2 and 2.25 million individual and business taxpayers that would be affected by the transition rules related to FTC carryovers. This estimate is based on currently available counts of taxpayers with FTC carryovers reported on Form 1118 schedule B line 5 and Form 1116 part III line 10 for tax years 2015–2017.

[3] The 2018 FTC proposed regulations requested comments on whether a simplified safe harbor approach was appropriate and several comments requested such a rule.

ii. Transfers of IP for Purposes of the Foreign Branch Category

a. Background

The TCJA added a new separate category related to foreign branch income. The statute did not, however, provide specific guidance on what constitutes foreign branch income other than that it is business profits attributable to one or more qualified business units of the taxpayer in one or more foreign countries. To provide greater specificity over the definition of foreign branch income, the 2018 FTC proposed regulations generally determined the foreign branch income based on the U.S.-tax adjusted books and records of the foreign branch. However, certain adjustments were made to those books and records based on certain disregarded transactions that may have occurred between the foreign branch owner and the foreign branch. These adjustments were intended to get to a more accurate representation of the gross income attributable to the branch.

The issue of disregarded payments is particularly salient in the context of disregarded transfers of intellectual property (IP). The 2018 FTC proposed regulations included a rule that disregarded transfers of IP between a foreign branch and its owner would result in a deemed payment that reallocates income between the foreign branch category and the general category. This rule has the effect of preventing artificial manipulation of the foreign branch category through changes in ownership of IP between a foreign branch and its owner. This rule applied regardless of when the transfer of IP occurred and regardless of how long the IP remained in the foreign branch. Comments requested that the rule be withdrawn and cited, among other concerns, its administrative and compliance burdens. Other comments requested that the Treasury Department limit the applicability of the rule to a later date and also limit its applicability where ownership of the IP by the foreign branch is transitory.

b. Options Considered for the Final Regulations

The Treasury Department and the IRS considered three options with respect to the treatment of disregarded transfers of IP for purposes of determining foreign branch income. The first option was to withdraw the rule in its entirety and to provide no specific guidance for disregarded transfers of IP. The second option was to adopt the rule unchanged from the 2018 FTC proposed regulations. The third option was to adopt the rule with certain modifications that would alleviate some of the compliance and administrative burdens. These modifications include applying the rule to transfers that occurred after the date of publication of the 2018 FTC proposed regulations and providing exceptions for transfers involving transitory ownership by the foreign branch.

The final regulations adopt the third option. They retain the structure of the 2018 FTC proposed regulations but limit its applicability to transactions that occurred after the date of publication of the 2018 FTC proposed regulations, and included an exception for transitory ownership. The Treasury Department and the IRS recognize that this rule may result in higher compliance costs relative to the no-action baseline but project that this negative consequence is outweighed by concerns that taxpayers could otherwise structure highly valuable and mobile IP transfers to avoid the purpose of the rules. This avoidance would be difficult for the IRS to address absent the rule. In order to minimize the increase in compliance costs relative to withdrawing the rule (and simultaneously to reduce compliance costs relative to retaining the proposed regulations without change), the rule is limited to IP transfers that occurred after the publication of the 2018 FTC proposed regulations, when taxpayers were aware of the rule and how foreign branch category income would be determined. Furthermore, the Treasury Department and the IRS determined that cases where the foreign branch only owned the IP for brief periods of time were unlikely to pose the risk identified and thus should be excepted.

c. Number of Affected Taxpayers

This provision affects any taxpayer that transfers IP to or from a foreign branch on or after December 7, 2018. Because transfers of IP are not specifically identified on any tax forms, the Treasury Department and the IRS estimated the number of taxpayers who report nonzero gross income and allocable deductions with respect to a foreign branch as an upper bound on the group of taxpayers potentially affected by this rule. The Treasury Department and the IRS have determined that there were 1,500 unique taxpayers that meet these conditions in currently available data from taxable years 2015–2017. The number of these taxpayers that transfer IP is likely much smaller than this count because most taxpayers do not transfer IP in any given tax year.

iii. Treatment of GILTI for Purposes of the Interest Allocation Rules

a. Background

The Code provides rules for how the interest expense of a CFC is to be allocated for purposes of claiming the foreign tax credit. Under the Code, a CFC must allocate and apportion its interest expense among groups of income for purposes of determining its tested income, subpart F income, or other types of net foreign source income. At the same time, a U.S. taxpayer must characterize (in terms of separate categories) the value of its CFCs for purposes of allocating and apportioning its own interest expense. Existing rules allow a CFC to allocate its interest using one of two methods (the asset method or the modified gross income (MGI) method) and the U.S. taxpayer characterizes the stock of its CFC (for purposes of allocating its own interest) using the same method that the CFC used to allocate its interest. The MGI method treats subpart F income differently than other types of gross income with respect to interest allocations for tiered CFC ownership structures; in particular, subpart F income of lower tier CFCs is not accounted for by upper tier CFCs (that is, it does not ''tier up'') for purposes of interest expense allocation, whereas all other types of a CFC's income do tier up.

The 2018 FTC proposed regulations do not take into account gross tested income from a lower-tier CFC with respect to an upper-tier CFC for purposes of allocating the upper tier CFC's interest expense. A comment requested that gross tested income tier up to the upper-tier CFC under the MGI method in order to minimize differences between the results obtained under the asset method and the MGI method.

b. Options Considered for the Final Regulations

The Treasury Department and the IRS considered two options with respect to the treatment of interest expense allocation. The first option was to adopt the rule from the 2018 FTC proposed regulations. The second option was to adopt a rule that requires gross tested income to tier up for purposes of applying the MGI method.

The final regulations require tested income to tier up to the upper-tier CFC for purposes of allocating interest expense when applying the MGI method. This is an appropriate solution for several reasons. First, the section 951A rules do not have special rules for passive income similar to those present in the subpart F regime; the Treasury Department and the IRS have further determined that the existing rule accounts for the special rules that apply to subpart F income. Hence, an exception to the general tiering up rule is not needed for tested income. Second, the solution minimizes differences in the results obtained by taxpayers that elect the asset method rather than the MGI method, thus minimizing arbitrary differences in the tax treatment of similarly situated taxpayers. Finally, the solution is consistent with how the rules in section 951A apply for purposes of determining the CFC's tested income.

c. Number of Affected Taxpayers

The Treasury Department and the IRS determined that the group of taxpayers affected by the regulation consists of any taxpayer with at least one second-tier CFC that earns gross tested income. The Treasury Department and the IRS estimate that there are between 11,000 and 14,000 taxpayers that fit that profile based on tax filings for tax years 2015–2017.

4. Economic Effects of Provisions Not Substantially Revised From the 2018 FTC Proposed Regulations

i. Matching Interest Income Allocation to Interest Expense Allocation for Partnerships

The existing rules for the foreign tax credit generally specify how taxpayer income, expenses, and FTC carryovers are to be allocated to the separate categories. There remain, however, many allocation rules that would benefit from additional clarity. Regarding interest income and expenses in the case of partnership loan structures, the 2018 FTC proposed regulations specified that the taxpayer's interest income allocation is to be matched to its interest expense allocation, rather than specifying that the interest expense allocation be matched to the taxpayer's interest income allocation.

This rule reduces opportunities for taxpayers to increase their gross foreign source income based solely on a related party loan to a partnership. Such potentially abusive borrowing arrangements occur, for example, when a U.S. person lends money to a foreign partnership in order to artificially increase foreign source income (and therefore the FTC limitation) without affecting U.S. taxable income. This increase in the FTC limitation is accomplished, for example, by lending to a controlled partnership, which has no effect on U.S. taxable income because the interest income received from the partnership is offset by the lender's share of the interest expense incurred by the partnership. However, the transaction can increase foreign source income and allowable foreign tax credits, because the existing interest expense allocation rules do not generally allocate interest income and interest expenses similarly.

To prevent such artificial inflation of foreign tax credits, the final regulations specify that interest income attributable to borrowing through a partnership will be allocated across separate foreign tax credit categories in the same manner as the associated interest expense. Accordingly, the proposed matching rule achieves a more neutral foreign tax credit limitation result and better minimizes the impact of related party loans on a taxpayer's foreign tax credit limitation.

The final regulations are the same as the 2018 FTC proposed regulations in this regard except for minor technical modifications.

ii. Treatment of Income Associated With the Section 250 Deduction as Exempt Income and Treatment of Expenses Allocated to Section 951A Category as Exempt Expenses

The statute does not specify how income associated with the section 250 deduction is to be treated for purposes of claiming the FTC. To address this issue, the proposed regulations specified that the income associated with the section 250 deduction is treated as income that is partially exempt from income tax (based on the amount of the section 250 deduction allowed) for purposes of the foreign tax credit. As a result, the taxpayer's expenses are to be allocated and apportioned without taking into account this income.

The partially exempt treatment provided for section 250 income means that fewer expenses are allocated to the section 951A category than would have been if that income were not partially exempt (since the total gross income in the section 951A category would have been higher). The regulations therefore potentially increase the competitiveness of U.S. corporations relative to the no-action baseline, as described in Part I.3.B of this Special Analyses.

The 2018 FTC proposed regulations requested comment on the estimated impact of the reduced expense allocation to the section 951A category relative to specifying that no expenses may be allocated against this income. Most comments did not address this issue. One comment expressed the view that the increased incentive to over-allocate expenses to the United States (relative to the no-action baseline) might not be small, because expense allocation responds to effective tax rates rather than statutory rates, and post-TCJA effective tax rates might not have fallen as much as statutory rates. Estimates of post-TCJA marginal effective tax rates suggest that effective tax rates have fallen meaningfully, consistent with a reduced incentive to over-allocate interest expense to the United States.[4]

The final regulations are the same as the 2018 FTC proposed regulations in this regard except for minor technical modifications.

iii. Clarifications to the Look-Through Rules

Before the TCJA, dividends, interest, rents and royalties (''look-through payments'') paid to a United States shareholder by its CFC were generally allocated to the general category to the extent that they were not treated as passive category income. Because TCJA split the general category income into three categories, it created a question of how to assign look-through payments. To address this issue, the 2018 FTC proposed regulations specified that these look-through payments be assigned to the general category or foreign branch category. They may not be assigned to the section 951A category. This treatment is consistent with the fact that payments of dividends, interest, rents, and royalties made directly to a United States shareholder are not included in the new section 951A category. By contrast, certain interest, rents, and royalties earned by a foreign branch can meet the definition of foreign branch category income, and the general category is a residual category that encompasses all income that is not specifically assigned to any other category.

The Treasury Department and the IRS considered as an alternative not issuing guidance for the treatment of look-through payments but concluded that affected taxpayers and the overall U.S. economy would benefit from the issuance of final regulations on this issue.

The final regulations are the same as the 2018 FTC proposed regulations in this regard except for minor technical modifications.

II. Paperwork Reduction Act

The rules relating to foreign tax credits that were modified by the Act are reflected in several revised and new schedules added to existing forms discussed in this Part II of the Special Analyses. For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (''PRA''), the reporting burden associated with the revised and new schedules will be reflected in the PRA submission associated with the forms described in this Part II. Additionally, a revised collection of information is added with respect to section 986 in § 1.986(a)–1(a)(2)(iv).

The collection of information in § 1.986(a)–1(a)(2)(iv) is an election to translate foreign income taxes denominated in nonfunctional currency using the spot rate as of the date of payment (rather than the average exchange rate for the year). This election may be made by an individual or corporation and may be made on behalf of a foreign corporation by a U.S. shareholder. A pass-through entity cannot make this election. This election can be made for all foreign income taxes denominated in nonfunctional currency, or it can be made only with respect to all foreign income taxes denominated in nonfunctional currency that are recorded on the separate books and records of a dollar functional currency QBU of the taxpayer. This election, if made with respect to dollar functional currency QBUs, will match the exchange rate used to determine the dollar amount of the foreign tax credit with the exchange rate used to determine the dollar amount of income that is used to pay the tax. The election is made once and applies to all future years. The election is made by attaching a statement to a timely filed U.S. income tax return for the first year to which the election applies. For purposes of the PRA, the reporting burden associated with § 1.986(a)–1(a)(2)(iv) will be reflected in the PRA submission associated with the Form 1040 series and Form 1120 series.

Form 1118, Foreign Tax Credit—Corporations, has been revised to add new Schedule C (Tax Deemed Paid With Respect to Section 951(a)(1) Inclusions by Domestic Corporation Filing Return (Section 960(a)), Schedule D (Tax Deemed Paid With Respect to Section 951A Income by Domestic Corporation Filing the Return (Section 960(d)), and Schedule E (Tax Deemed Paid With Respect to Previously Taxed Income by Domestic Corporation Filing the Return (Section 960(b)). In addition, the existing schedules of Form 1118 have been modified to account for the two new separate categories of income under section 904(d); the repeal of section 902 indirect credits for foreign taxes deemed paid with respect to dividends from foreign corporations; modified indirect

[4] DeBacker, Jason, and Roy Kasher, ''Effective Tax Rates on Business Investment Under the Tax Cuts and Jobs Act'', May 2018.

credits under section 960 for inclusions under sections 951(a)(1) and 951A; the modified section 78 gross up with respect to inclusions under sections 951(a)(1) and 951A; the revised sourcing rule for certain income from the sale of inventory under section 863(b); the repeal of the fair market value method for apportioning interest expense under 864(e); new adjustments for purposes of section 904 with respect to expenses allocable to certain stock or dividends for which a dividends received deduction is allowed under section 245A; the election to increase pre-2018 section 904(g) Overall Domestic Loss (ODL) recapture; and limited foreign tax credits with respect to inclusions under section 965. For purposes of the PRA, the reporting burden associated with these changes is reflected in the PRA submission associated with Form 1118 (OMB control number 1545–0123, which represents a total estimated burden time, including all other related forms and schedules, of 3.157 billion hours and total estimated monetized costs of $58.148 billion).

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

Schedule B (Specifically Attributable Taxes and Income (Section 999(c)(2)) of the Form 5713, International Boycott Report, has also been revised to reflect the repeal of section 902. Schedule C (Tax Effect of the International Boycott Provisions) of the Form 5713 has been revised to account for the new section 904(d) categories of income. For purposes of the PRA, the reporting burden associated with these changes is reflected in the PRA submission associated with Schedules B and C of Form 5713 (OMB control number 1545–0216, which represents a total estimated burden time, including all other related forms and schedules, of 143,498 hours).

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

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

Form	Number of respondents * (estimated)
Form 1116	8,000,000
Form 1118	15,000
Form 1040	150,000,000
Form 1065	4,000,000
Form 1065 Schedule K–1	24,750,000
Form 1120	1,700,000
Form 1120–S	4,750,000
Form 1120–S Schedule K–1	7,500,000
Form 5471	28,000
Form 5471 Schedule E	10,000
Form 5471 Schedule J	25,500
Form 5713 Schedule B	<1,000
Form 5713 Schedule C	<1,000
Form 8865	14,500

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

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

The estimates for the number of impacted filers with respect to the collections of information described in this part II of the Special Analysis section are based on filers of U.S. income tax returns that file a Form 1040 or Form 1120 because only filers of these forms would be 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
§ 1.986(a)–1(a)(2)(iv).	1,625–3,250	Form 1040 series and Form 1120 series.

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

The current status of the PRA submissions related to foreign tax credits is provided in the following table. The burden estimates provided in the above narrative are aggregate amounts that relate to the entire package of forms associated with the OMB control numbers 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)), 1545–0074 (which represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.784 billion hours and total estimated monetized costs of $31.764 billion ($2017)), 1545–0216 (which represents a total estimated burden time, including all other related forms and schedules, of 143,498 hours), 1545–1668 (which represents a total estimated burden time, including all other related forms and schedules of 289,354 hours), and 1545–0121 (which represents a total estimated burden time, including all other related forms and schedules of 25,066,693 hours). The overall burden estimates provided for the OMB control numbers below are aggregate amounts that relate to the entire package of forms associated with the applicable OMB control number and will in the future include, but not isolate, the estimated burden of only the foreign tax credit-related forms that are included in the tables in this Part II. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by the regulations. These burdens have 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. No burden estimates specific to the forms affected by the 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 regulations. The Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates would capture both changes made by the Act 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 information collection burdens related to these final regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. Proposed revisions (if any) to these forms that reflect the information collections contained in these 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 1116	All other Filers (mainly trusts and estates) (Legacy system).	1545–0121	Published in the **Federal Register** on 3/23/17. Public comment period closed 5/22/18. Approved by OMB through 10/30/2020.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201704-1545-023.*		
	Business (NEW Model)	1545–0123	Published in the **Federal Register** on 10/8/18. Public Comment period closes on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
	Individual (NEW Model)	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission (all forms) scheduled in 3–2019. 60 Day **Federal Register** notice not published yet for full collection.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031.*		
Form 1118, 1065, 1065 Schedule K–1, 1120–S.	Business (NEW Model)	1545–0123	Published in the **Federal Register** on 10/8/18. Public Comment period closes on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
Form 5471 (including Schedules E, J).	Business (NEW Model)	1545–0123	Published in the **Federal Register** on 10/8/18. Public Comment period closes on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
	Individual (NEW Model)	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3–2019. 60 Day **Federal Register** notice not published yet for full collection.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031.*		
Form 5713 Schedules B, C	All other Filers (mainly trusts and estates) (Legacy system).	1545–0216	Published in the **Federal Register** on 3/28/18. Public Comment period closed 5/29/18. Renewal submitted on 10/11/18 for review to OIRA. New 2018 Forms not included in renewal to OIRA due to timing of submission.
	Link: *https://www.federalregister.gov/documents/2018/10/29/2018-23515/agency-information-collection-activities-submission-for-omb-review-comment-request-multiple-internal.*		
	Business (NEW Model)	1545–0123	Published in the **Federal Register** on 10/11/18. Public Comment period closed on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
	Individual (NEW Model)	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3–2019. 60 Day **Federal Register** notice not published yet for full collection.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031.*		
Form 8865	All other Filers (mainly trusts and estates) (Legacy system).	1545–1668	Published in the **Federal Register** on 10/1/18. Public Comment period closed on 11/30/18. ICR in process by Treasury as of 10/17/18.

Form	Type of filer	OMB No.(s)	Status
	Link: *https://www.federalregister.gov/documents/2018/10/01/2018-21288/proposed-collection-comment-request-for-regulation-project.*		
	Business (NEW Model)	1545–0123	Published in the **Federal Register** on 10/8/18. Public Comment period closed on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
	Individual (NEW Model)	1545–0074	Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3–2019. 60 Day **Federal Register** notice not published yet for full collection.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031.*		

In 2018, the IRS released and invited comments on drafts of the above forms in order to give members of the public advance notice and an opportunity to submit comments. The IRS received no comments on the portions of the forms that relate to foreign tax credits during the comment period. Consequently, the IRS made the forms available in late 2018 for use by the public. The IRS is contemplating making additional changes to the forms in order to implement final regulations.

III. Regulatory Flexibility Act

It is hereby certified that this final regulation 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 (RFA) (5 U.S.C. chapter 6).

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 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 provisions of the TCJA, such as the new separate foreign tax credit limitation category for foreign branch income and the repeal of the option to allocate and apportion interest expense on the basis of the fair market value (rather than tax basis) of a taxpayer's assets, might also affect domestic small business entities that operate in foreign jurisdictions. 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 will 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)(C), 1.861–10, 1.861–12, 1.861–13, 1.901(j)–1, 1.904–5, 1.904(b)–3, 1.954–1, 1.960–1 through 1.960–3, and 1.965–5(c)(1)(iii) 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. Because it takes significant resources and investment for a business to operate outside of the United States in corporate form, and in particular to own a CFC, the owners of such businesses will infrequently be domestic small business entities, as indicated by the Table.

FRACTION OF U.S. CORPORATE TAXPAYERS REPORTING CFC OWNERSHIP, BY GROSS RECEIPTS SIZE CLASS

Gross receipts size class	Percentage with a CFC
<1 mil	0.40
1–5 mil	0.80
5–10 mil	2.70
10–20 mil	4.50
20–30 mil	9.30
30–50 mil	12.00
50–100 mil	19.70
100–150 mil	26.80
150–200 mil	32.50
200–250 mil	37.40
250–500 mil	43.70
>=500 mil	63.50

* Data based on 2017 Statistics of Income sample for all 1120 returns except 1120–S (return type = 2) (1120–L, 1120–RIC, 1120–F, 1120–REIT, 1120–PC,1120, 1120–L Consolidated 1504c return (controlling industries 524142 and 524143),1120–PC Consolidated 1504C return (controlling industries 524156, 524159), and 1120 Section 594/1504c consolidated return (controlling industries not 524142, 524143, 524156, 524159), 1120 Non-consolidated return).

The Treasury Department and the IRS project that the final regulations are unlikely to affect a substantial number of domestic small business entities but data are unavailable to estimate with certainty and certify in accordance with RFA that the number of small entities affected will not be substantial.

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 2013, foreign tax credits as a percentage of three different tax-related measures of annual receipts (see Table for variables) by corporations are substantially less than the 3 to 5 percent threshold for significant economic impact. The amount of foreign tax credits in 2013 is an upper bound on the change in foreign tax credits resulting from the 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	0.03	0.00	0.00	0.01	0.01	0.03	0.09	0.56

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-Total Deductions)	0.48	0.03	0.04	0.26	0.22	0.51	1.20	9.00
FTC/Business Receipts	0.05	0.00	0.00	0.01	0.01	0.04	0.10	0.64

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

The collection of information in § 1.986(a)–1(a)(2)(iv) of the final regulations (relating to the election to translate creditable foreign taxes at the spot rate on the date of payment instead of the average exchange rate for the year) may affect some small business entities with significant foreign operations. The data to assess the number of small entities potentially affected by § 1.986(a)–1(a)(2)(iv) are not readily available. However, businesses with significant foreign operations are generally not small businesses, as indicated by the data above. Further, as demonstrated in the table in this Part III of the Special Analyses, foreign tax credits generally do not have a significant economic impact on small business entities. Therefore, the Treasury Department and the IRS have determined that a substantial number of domestic small business entities will not be subject to § 1.986(a)–1(a)(2)(iv). Consequently, the Treasury Department and the IRS have determined, and hereby certify, that § 1.986(a)–1(a)(2)(iv) 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–105600–18) 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. In 2019, that threshold is approximately $154 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This 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**. Notwithstanding this requirement, section 808(2) of the CRA allows agencies to dispense with the requirements of section 801 of the CRA when the agency for good cause finds that such procedure would be impracticable, unnecessary, or contrary to the public interest and that the rule shall take effect at such time as the agency promulgating the rule determines.

Pursuant to section 808(2) of the CRA, the Treasury Department and the IRS find, for good cause, that a 60-day delay in the effective date is unnecessary and contrary to the public interest. In general, the statutory provisions to which these rules relate were enacted on December 22, 2017, and apply to taxable years of foreign corporations beginning after 2017 and to the taxable years of U.S. persons in which or with which such taxable years of foreign corporations end. In many cases, these taxable years have already ended. This means that the statutory provisions are currently effective, and taxpayers may be subject to Federal income tax liability for their 2018 taxable year reflecting these provisions. In certain cases, taxpayers may be required to file returns reflecting this Federal income liability during the 60-day period that begins after this rule is published in the **Federal Register**.

These final regulations provide crucial guidance for taxpayers on how to apply the relevant statutory rules, compute their tax liability and accurately file their U.S. income tax returns. These final regulations resolve statutory ambiguity, prevent abuse, and grant taxpayer relief that would not be available based solely on the statute. As taxpayers must already comply with the statute, a 60-day delay in the effective date of the final regulations is unnecessary and contrary to the public interest. A delay would place certain taxpayers in the unusual position of having to determine whether to file U.S. income tax returns during the pre-effective date period based on final regulations that are not yet effective. If taxpayers chose not to follow the final regulations and did not amend their returns after the regulations became effective, it would place significant strain on the IRS to ensure that taxpayers correctly calculated their tax liabilities. For example, these final regulations provide significant guidance on foreign branch category income, a provision added by the TCJA along with a broad grant of regulatory authority to provide additional guidance. Therefore, the rules in this Treasury decision are effective on the date of publication in the **Federal Register** and apply in certain cases to taxable years of foreign corporations and U.S. persons beginning before such date.

The foregoing good cause statement only applies to the 60-day delayed effective date provision of section 801(3) of the CRA and is permitted under section 808(2) of the CRA. The Treasury Department and the IRS hereby comply with all aspects of the CRA and the Administrative Procedure Act (5 U.S.C. 551 *et seq.*).

Drafting Information

The principal authors of these regulations are Karen J. Cate, Jeffrey P. Cowan, Jeffrey L. Parry, Larry R. Pounders, and Suzanne M. Walsh of the Office of Associate Chief Counsel

(International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by:

■ 1. Revising the entries for §§ 1.861–8, 1.861–9 and 1.861–9T, 1.861–10(e), and 1.861–11.

■ 2. Adding entries for §§ 1.861–13, 1.861–17, 1.901(j)–1, 1.904–1, 1.904–2, and 1.904–3 in numerical order.

■ 3. Revising entries for §§ 1.904–4, 1.904–5, and 1.904–6.

■ 4. Adding entries for §§ 1.904(g)–3 and 1.905–3 in numerical order.

■ 5. Revising the entry for § 1.960–1.

■ 6. Adding entries for §§ 1.960–2, 1.960–3, 1.960–4, and 1.986(a)–1 in numerical order.

The revisions and additions read in part as follows:

Authority: 26 U.S.C. 7805.

* * * * *

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

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

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

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

* * * * *

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

* * * * *

Section 1.861–17 also issued under 26 U.S.C. 864(e)(7).

* * * * *

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

* * * * *

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

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

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

Section 1.904–4 also issued under 26 U.S.C. 250(c), 26 U.S.C. 865(j), 26. U.S.C. 904(d)(2)(J)(i), 26 U.S.C. 904(d)(6)(C), 26 U.S.C. 904(d)(7), and 26 U.S.C. 951A(f)(1)(B).

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

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

* * * * *

Section 1.904(g)–3 also issued under 26 U.S.C. 904(g)(4).

* * * * *

Section 1.905–3 also issued under 26 U.S.C. 989(c)(4).

* * * * *

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

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

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

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

* * * * *

Section 1.986(a)–1 also issued under 26 U.S.C. 986(a)(1)(C) and 26 U.S.C. 986(a)(1)(D)(ii).

* * * * *

■ **Par. 2.** Section 1.861–8 is amended by:

■ 1. In paragraph (a)(1), removing the last sentence.

■ 2. In paragraph (a)(4), removing the fourth through sixth sentences.

■ 3. Removing paragraph (a)(5).

■ 4. Revising paragraph (c)(2).

■ 5. Adding paragraph (c)(4).

■ 6. Revising paragraph (d)(2).

■ 7. In paragraph (e)(1), adding two sentences after the sixth sentence.

■ 8. In paragraph (e)(6)(i), adding a new first sentence and revising the new second sentence.

■ 9. Removing paragraph (e)(6)(iii).

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

■ 11. Removing paragraph (e)(12)(iv).

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

■ 13. Removing and reserving paragraph (f)(1)(i).

■ 14. Adding paragraph (f)(1)(ii).

■ 15. Revising paragraphs (f)(4)(ii) and (g).

■ 16. Adding paragraph (h).

The revisions and additions read as follows:

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

* * * * *

(c) * * *

(2) *Apportionment based on assets.* Certain taxpayers are required by paragraph (e)(2) of this section and § 1.861–9T to apportion interest expense on the basis of assets. A taxpayer may apportion other deductions based on the comparative value of assets that generate income within each grouping, provided that this method reflects the factual relationship between the deduction and the groupings of income and is applied in accordance with the rules of § 1.861–9T(g). In general, such apportionments must be made either on the basis of the tax book value of those assets or, except in the case of interest expense, on the basis of their fair market value. *See* § 1.861–9(h). Taxpayers using the fair market value method for their last taxable year beginning before January 1, 2018, must change to the tax book value method (or the alternative tax book value method) for purposes of apportioning interest expense for their first taxable year beginning after December 31, 2017. The Commissioner's approval is not required for this change. In the case of any corporate taxpayer that both uses tax book value or alternative tax book value, and owns directly or indirectly (within the meaning of § 1.861–12T(c)(2)(ii)(B)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote in any other corporation (domestic or foreign) that is not a member of the affiliated group (as defined in section 864(e)(5)), the taxpayer must adjust its basis in that stock in the manner described in § 1.861–12(c)(2). For the definition of related persons formerly contained in § 1.861–8T(c)(2), see paragraph (c)(4) of this section.

* * * * *

(4) *Cross-referenced definition of related persons.* The term related persons means two or more persons in a relationship described in section 267(b). In determining whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned by with the application of section 1563(e)(1), and stock owned by application of section 267(c). In determining whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(d) * * *

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

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

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

(C) *Foreign-derived intangible income and inclusions under section 951A(a)*—(*1*) *Exempt income.* The term ''exempt income'' includes an amount of a domestic corporation's gross income included in gross foreign-derived deduction eligible income (or gross FDDEI), and also includes an amount of a domestic corporation's gross income from an inclusion under section 951A(a) and the gross up under section 78 attributable to such an inclusion, in each case equal to the amount of the deduction allowed under section 250(a) for such gross income (taking into account the reduction under section 250(a)(2)(B), if any). Therefore, for purposes of apportioning deductions using a gross income method, gross income does not include gross income included in gross FDDEI, an inclusion under section 951A(a), or the gross up under section 78 attributable to an inclusion under section 951A(a), in an amount equal to the amount of the deduction allowed under section 250(a)(1)(A), (B)(i), or (B)(ii), respectively (taking into account the reduction under section 250(a)(2)(B), if any). The term *gross foreign-derived deduction eligible income,* or *gross FDDEI,* means the portion of the domestic corporation's gross income (determined without regard to the amounts described in section 250(b)(3)(A)(i)(I) through (VI)) that is derived from sales and services described in section 250(b)(4)(A) and (B).

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

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

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

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

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

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

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

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

(*4*) *Non-applicability to section 250(b).* Paragraphs (d)(2)(ii)(C)(*1*) through (*3*) of this section do not apply when apportioning deductions for purposes of determining deduction eligible income or foreign-derived deduction eligible income under the operative section of section 250(b).

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

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

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

(iii) *Income that is not considered tax exempt.* For further guidance, see § 1.861–8T(d)(2)(iii).

(A) For further guidance, see § 1.861–8T(d)(2)(iii)(A) and (B).

(B) [Reserved]

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

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

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

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

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

* * * * *

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

* * * * *

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

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

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

(f) * * *

(1) * * *

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

* * * * *

(4) * * *

(ii) *Example*—(A) *Facts.* USP, a domestic corporation, purchases and sells consumer items in the United States and foreign markets. Its sales in foreign markets are made to related foreign subsidiaries. USP reported $1,500,000x as sales during the taxable year of which $1,000,000x was domestic sales and $500,000x was foreign sales. USP took a deduction for expenses incurred by its marketing department during the taxable year in the amount of $150,000x. These expenses were determined to be allocable to both domestic and foreign sales and are apportionable between such sales. On audit of USP's return for the taxable year, the IRS adjusted, under section 482, USP's sales to related foreign subsidiaries by increasing the sales price by a total of $100,000x, thereby increasing USP's foreign sales and total sales by the same amount. Before the audit, USP allocated and apportioned the marketing department deduction as follows:

TABLE 1 TO PARAGRAPH (f)(4)(ii)(A)

To gross income from domestic sales: $150,000x × ($1,000,000x/$1,500,000x)	$100,000x
To gross income from foreign sales: $150,000x × ($500,000x/$1,500,000x)	50,000x
Total	150,000x

(B) *Analysis.* As a result of the section 482 adjustment, the apportionment of the deduction for the marketing department expenses is redetermined as follows:

TABLE 2 TO PARAGRAPH (f)(4)(ii)(B)

To gross income from domestic sales: $150,000x × ($1,000,000x/$1,600,000x)	$93,750x
To gross income from foreign sales: $150,000x × ($600,000x/$1,600,000x)	56,250x
Total	150,000x

* * * * *

(g) *Examples.* The following examples illustrate the principles of the rules in this section. In each example, unless otherwise specified, section 904 is the operative section. In addition, in each example, where a method of allocation or apportionment is illustrated as an acceptable method, it is assumed that such method is used by the taxpayers on a consistent basis from year to year. Further, it is assumed that each party named in each example operates on a calendar year accounting basis and, where the party is a U.S. taxpayer, files returns on a calendar year basis.

(1) through (18) [Reserved]

(19) *Example 19: Supportive expense*—(i) *Facts*—(A) USP, a domestic corporation, purchases and sells products both in the United States and in foreign countries. USP has no foreign subsidiary and no international department. During the taxable year, USP incurs the following expenses with respect to its worldwide activities:

TABLE 3 TO PARAGRAPH (g)(19)(i)(A)

Personnel department expenses	$50,000x
Training department expenses	35,000x
General and administrative expenses	55,000x
President's salary	40,000x
Sales manager's salary	20,000x
Total	200,000x

(B) USP has domestic gross receipts from sales of $750,000x and foreign gross receipts from sales of $500,000x and has gross income from such sales in the same ratio, namely $300,000x from domestic sources and $200,000x from foreign sources that is general category income.

(ii) *Analysis*—(A) *Allocation.* The above expenses are definitely related and allocable to all of USP's gross income derived from both domestic and foreign markets.

(B) *Apportionment.* For purposes of applying the foreign tax credit limitation, the statutory grouping is gross income from sources outside the United States in general category income and the residual grouping is gross income from sources within the United States. USP's deductions for its worldwide sales activities must be apportioned between these groupings. USP does not have a separate international division which performs essentially all of the functions required to manage and oversee its foreign activities. The president and sales manager do not maintain time records. The division of their time between domestic and foreign activities varies from day to day and cannot be estimated on an annual basis with any reasonable degree of accuracy. Similarly, there are no facts which would justify a method of apportionment of their salaries or of one of the other listed deductions based on more specific factors than gross receipts or gross income. An acceptable method of apportionment would be on the basis of gross receipts. The apportionment of the $200,000x deduction is as follows:

TABLE 4 TO PARAGRAPH (g)(19)(ii)(B)

Apportionment of the $200,000x expense to the statutory grouping of gross income: $200,000x × [$500,000x/($500,000x + $750,000x)]	$80,000x
Apportionment of the $200,000x expense to the residual grouping of gross income: $200,000x × [$750,000x/($500,000x + $750,000x)]	120,000x
Total apportioned supportive expense	200,000x

(20) *Example 20: Supportive expense*—(i) *Facts.* Assume the same facts as in paragraph (g)(19)(i) of this section (the facts in *Example 19*), except that USP's president devotes only 5% of his time to the foreign operations and 95% of his time to the domestic operations and that USP's sales manager devotes approximately 10% of her time to foreign sales and 90% of her time to domestic sales.

(ii) *Analysis*—(A) *Allocation.* The expenses incurred by USP with respect to its worldwide activities are definitely related, and therefore allocable to USP's gross income from both its foreign and domestic markets.

(B) *Apportionment.* On the basis of the additional facts it is not acceptable to apportion the salaries of the president and the sales manager on the basis of gross receipts. It is acceptable to apportion such salaries between the statutory grouping (gross income from sources without the United States) and residual grouping (gross income from sources within the United States) on the basis of time devoted to each sales activity. Remaining expenses may still be apportioned on the basis of gross receipts. The apportionment is as follows:

TABLE 5 TO PARAGRAPH (g)(20)(ii)(B)

Apportionment of the $200,000x expense to the statutory grouping of gross income:	
President's salary: $40,000x × 5%	$2,000x
Sales manager's salary: $20,000x × 10%	2,000x
Remaining expenses: $140,000x × [$500,000x/($500,000x + $750,000x)]	56,000x
Subtotal: Apportionment of expense to statutory grouping	60,000x
Apportionment of the $200,000x expense to the residual grouping of gross income:	
President's salary: $40,000x × 95%	38,000x
Sales manager's salary: $20,000x × 90%	18,000x
Remaining expenses: $140,000x × [$750,000x/($500,000x + $750,000x)]	84,000x
Subtotal: Apportionment of expense to residual grouping	140,000x
Total: Apportioned supportive expense	200,000x

(21) *Example 21: Supportive expense*—(i) *Facts.* FC, a foreign corporation doing business in the United States, is a manufacturer of metal stamping machines. FC has no U.S. subsidiaries and no separate division to manage and oversee its business in the United States. FC manufactures and sells these machines in the United States and in foreign countries A and B and has a separate manufacturing facility in each country. Sales of these machines are FC's only source of income. In Year 1, FC incurs general and administrative expenses related to both its U.S. and foreign operations of $100,000x. It has machine sales of $500,000x, $1,000,000x, and $1,000,000x on which it earns gross income of $200,000x, $400,000x, and $400,000x in the United States, Country A, and Country B, respectively. The income from the manufacture and sale of the machines in countries A and B is not effectively connected with FC's business in the United States.

(ii) *Analysis*—(A) *Allocation.* The $100,000x of general and administrative expense is definitely related to the income to which it gives rise, namely a part of the gross income from sales of machines in the United States, in Country A, and in Country B. The expenses are allocable to this class of income, even though FC's gross income from sources outside the United States is excluded income since it is not effectively connected with a U.S. trade or business.

(B) *Apportionment.* Since FC is a foreign corporation, the statutory grouping is gross income effectively connected with FC's trade of business in the United States, namely gross income from sources within the United States, and the residual grouping is gross income not effectively connected with a trade or business in the United States, namely gross income from countries A and B. Since there are no facts that would require a method of apportionment other than on the basis of sales or gross income, the amount may be apportioned between the two groupings on the basis of amounts of gross income as follows:

TABLE 6 TO PARAGRAPH (g)(21)(ii)(B)

Apportionment of general and administrative expense to the statutory grouping, gross income from sources within the United States: $100,000x × [$200,000x/($200,000x + $400,000x + $400,000x)]	$20,000x
Apportionment of general and administrative expense to the residual grouping, gross income from sources without the United States: $100,000x × [($400,000x + $400,000x)/($200,000x + $400,000x + $400,000x)]	80,000x
Total apportioned general and administrative expense	100,000x

(22) through (24) [Reserved]

(25) *Example 25: Income taxes*—(i) *Facts.* USP, a domestic corporation, is a manufacturer and distributor of electronic equipment with operations in states A, B, and C. USP also has a foreign branch, as defined in section 904(d)(1)(B) and § 1.904–4(f), in Country Y which manufactures and distributes the same type of electronic equipment. In Year 1, USP has taxable income from these activities, as described under the Code (without taking into account the deduction for state income taxes), of $1,000,000x, of which $200,000x is foreign source foreign branch category income and $800,000x is domestic source income. States A, B, and C each determine USP's income subject to tax within their state by making adjustments to USP's taxable income as determined under the Code, and then apportioning the adjusted taxable income on the basis of the relative amounts of USP's payroll, property, and sales within each state as compared to USP's worldwide payroll, property, and sales. The adjustments made by states A, B, and C all involve adding and subtracting enumerated items from taxable income as determined under the Code. However, in making these adjustments to taxable income, none of the states specifically exempts foreign source income as determined under the Code. On this basis, it is determined that USP has taxable income of $550,000x, $200,000x, and $200,000x in states A, B, and C, respectively. The corporate tax rates in states A, B, and C are 10%, 5%, and 2%, respectively, and USP has total state income tax liabilities of $69,000x ($55,000x + $10,000x + $4,000x), which it deducts as an expense for Federal income tax purposes.

(ii) *Analysis*—(A) *Allocation.* USP's deduction of $69,000x for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since the statutes of states A, B, and C do not specifically exempt foreign source income (as determined under the Code) from taxation and since, in the aggregate, states A, B, and C tax $950,000x of USP's income while only $800,000x is domestic source income under the Code, it is presumed that state income taxes are imposed on $150,000x of foreign source income. The deduction for state income taxes is therefore related and allocable to both USP's foreign source and domestic source income.

(B) *Apportionment.* For purposes of computing the foreign tax credit limitation, USP's income is comprised of one statutory grouping, foreign source foreign branch category gross income, and one residual grouping, gross income from sources within the United States. The state income tax deduction of $69,000x must be apportioned between these two groupings. Corporation USP calculates the apportionment on the basis of the relative amounts of foreign source foreign branch category taxable income and U.S. source taxable income subject to state taxation. In this case, state income taxes are presumed to be imposed on $800,000x of domestic source income and $150,000x of foreign source general category income.

TABLE 7 TO PARAGRAPH (g)(25)(ii)(B)

State income tax deduction apportioned to foreign source foreign branch category income (statutory grouping): $69,000x × ($150,000x/$950,000x)	$10,895x
State income tax deduction apportioned to income from sources within the United States (residual grouping): $69,000x × ($800,000x/$950,000x)	58,105x
Total apportioned state income tax deduction	69,000x

(26) *Example 26: Income taxes*—(i) *Facts.* Assume the same facts as in paragraph (g)(25)(i) of this section (the facts in *Example 25*), except that the language of state A's statute and the statute's operation exempt from taxation all foreign source income, as determined under the Code, so that foreign source income is not included in adjusted taxable income subject to apportionment in state A (and factors relating to USP's Country Y branch are not taken into account in computing the state A apportionment fraction).

(ii) *Analysis*—(A) *Allocation.* USP's deduction of $69,000x for state income taxes is definitely related and thus allocable to the gross income with respect to which the taxes are imposed. Since state A exempts all foreign source income by statute, state A is presumed to impose tax on $550,000x of USP's $800,000x of domestic source income. USP's state A tax of $55,000x is allocable, therefore, solely to domestic source income. Since the statutes of states B and C do not specifically exclude all foreign source income as determined under the Code, and since states B and C impose tax on $400,000x ($200,000x + $200,000x) of USP's income of which only $250,000x ($800,000x − $550,000x) is presumed to be domestic source, the deduction for the $14,000x of income taxes imposed by states B and C is related and allocable to both foreign source and domestic source income.

(B) *Apportionment*—(*1*) For purposes of computing the foreign tax credit limitation, USP's income is comprised of one statutory grouping, foreign source foreign branch category gross income, and one residual grouping, gross income from sources within the United States. The deduction of $14,000x for income taxes of states B and C must be apportioned between these two groupings.

(*2*) Corporation USP calculates the apportionment on the basis of the relative amounts of foreign source foreign branch category income and U.S. source income subject to state taxation.

TABLE 8 TO PARAGRAPH (g)(26)(ii)(B)(*2*)

States B and C income tax deduction apportioned to foreign source foreign branch category income (statutory grouping): $14,000x × ($150,000x/$400,000x)	$5,250x
States B and C income tax deduction apportioned to income from sources within the United States (residual grouping): $14,000x × ($250,000x/$400,000x)	8,750x
Total apportioned state income tax deduction	14,000x

(*3*) Of USP's total income taxes of $69,000x, the amount allocated and apportioned to foreign source foreign branch category income equals $5,250x. The total amount of state income taxes allocated and apportioned to U.S. source income equals $63,750x ($55,000x + $8,750x).

(27) *Example 27: Income tax*—(i) *Facts.* Assume the same facts as in paragraph (g)(25)(i) of this section (the facts in *Example 25*), except that state A, in which USP has significant income-producing activities, does not impose a corporate income tax or other state tax computed on the basis of income derived from business activities conducted in state A. USP therefore has a total state income tax liability in Year 1 of $14,000x ($10,000x paid to state B plus $4,000x paid to state C), all of which is subject to allocation and apportionment under paragraph (b) of this section.

(ii) *Analysis*—(A) *Allocation*—(*1*) USP's deduction of $14,000x for state income taxes is definitely related and allocable to the gross income with respect to which the taxes are imposed. However, in these facts, an adjustment is necessary before the aggregate state taxable incomes can be compared with U.S. source income on the Federal income tax return in the manner described in paragraphs (g)(25)(ii) and (g)(26)(ii) of this section (the analysis in *Examples 25* and *26*). Unlike the facts in paragraphs (g)(25)(i) and (g)(26)(i) of this section (the facts in *Examples 25* and *26*), state A imposes no income tax and does not define taxable income attributable to activities in state A. The total amount of USP's income subject to state taxation is, therefore, $400,000x ($200,000x in state B and $200,000x in state C). This total presumptively does not include any income attributable to activities performed in state A and therefore cannot properly be compared to total U.S. source taxable income reported by USP for Federal income tax purposes, which does include income attributable to state A activities.

(*2*)(*i*) Accordingly, before applying the method used in paragraphs (g)(25)(ii) and (g)(26)(ii) of this section (the analysis in *Examples 25* and *26*) to the facts of the example in this paragraph (g)(27), it is necessary first to estimate the amount of taxable income that state A could reasonably attribute to USP's activities in state A, and then to reduce federal taxable income by that amount.

(*ii*) Any reasonable method may be used to attribute taxable income to USP's activities in state A. For example, the rules of the Uniform Division of Income for Tax Purposes Act (''UDITPA'') attribute income to a state on the basis of the average of three ratios that are based upon the taxpayer's facts—property within the state over total property, payroll within the state over total payroll, and sales within the state over total sales—and, with adjustments, provide a reasonable method for this purpose. When applying the rules of UDITPA to estimate U.S. source income derived from state A activities, the taxpayer's UDITPA factors must be adjusted to eliminate both taxable income and factors attributable to a foreign branch. Therefore, in the example in this paragraph (g)(27) all taxable income as well as UDITPA apportionment factors (property, payroll, and sales) attributable to USP's Country Y branch must be eliminated.

(*3*)(*i*) Since it is presumed that, if state A had had an income tax, state A would not attempt to tax the income derived by USP's Country Y branch, any reasonable estimate of the income that would be taxed by state A must exclude any foreign source income.

(*ii*) When using the rules of UDITPA to estimate the income that would have been taxable by state A in these facts, foreign source income is excluded by starting with federally defined taxable income (before deduction for state income taxes) and subtracting any income derived by USP's Country Y branch. The hypothetical state A taxable income is then determined by multiplying the resulting difference by the average of USP's state A property, payroll, and sales ratios, determined using the principles of UDITPA (after adjustment by eliminating the Country Y branch factors). The resulting product is presumed to be exclusively U.S. source income, and the allocation and apportionment method described in paragraph (g)(26) of this section (*Example 26*) must then be applied.

(*iii*) If, for example, state A taxable income were determined to equal $550,000x, then $550,000x of U.S. source income for Federal income tax purposes would be presumed to constitute state A taxable income. Under paragraph (g)(26) of this section (*Example 26*), the remaining $250,000x ($800,000x − $550,000x) of U.S. source income for Federal income tax purposes would be presumed to be subject to tax in states B and C. Since states B and C impose tax on $400,000x, the application of Example 25 would result in a presumption that $150,000x is foreign source income and $250,000x is domestic source income. The deduction for the $14,000x of income taxes of states B and C would therefore be related and allocable to both foreign source and domestic source income and would be subject to apportionment.

(B) *Apportionment.* The deduction of $14,000x for income taxes of states B and C is apportioned in the same manner as in paragraph (g)(26) of this section (*Example 26*). As a result, $5,250x of the $14,000x of state B and state C income taxes is apportioned to foreign source foreign branch category income ($14,000x × $150,000x/$400,000x), and $8,750x ($14,000x × $250,000x/$400,000x) of the $14,000x of state B and state C income taxes is apportioned to U.S. source income.

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

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

■ 1. Revising paragraphs (c)(2) and (d)(2)(ii)(A).

■ 2. Redesignating paragraphs (d)(2)(ii)(B)(*1*) and (*2*) as paragraphs (d)(2)(ii)(B)(*1*)(*i*) and (*ii*).

■ 3. Designating paragraph (d)(2)(ii)(B) introductory text as paragraph (d)(2)(ii)(B)(*1*) introductory text.

■ 4. Designating the undesignated paragraph following newly redesignated paragraph (d)(2)(ii)(B)(*1*)(*ii*) as paragraph (d)(2)(ii)(B)(*2*).

■ 5. Adding paragraph (d)(2)(ii)(C).

■ 6. Adding the word ''and'' at the end of paragraph (d)(2)(iii)(B).

■ 7. Revising paragraph (d)(2)(iii)(C).

■ 8. Removing and reserving paragraph (d)(2)(iii)(D) and adding reserved paragraph (d)(2)(iii)(E).

■ 9. Revising paragraph (d)(2)(iv).

■ 10. Removing paragraphs (e)(3) through (f)(1)(i), (f)(1)(ii), and (f)(1)(iii) through (g).

■ 11. Adding paragraph (e)(3), reserved paragraphs (e)(4) through (15), paragraph (f), and reserved paragraph (g).

The revisions and additions read as follows:

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

* * * * *

(c) * * *

(2) *Apportionment based on assets.* For further guidance, see § 1.861–8(c)(2).

* * * * *

(d) * * *

(2) * * *

(ii) * * *

(A) *In general.* For further guidance, see § 1.861–8(d)(2)(ii)(A).

* * * * *

(C) *Foreign-derived intangible income and inclusions under section 951A(a).* For further guidance, see § 1.861–8(d)(2)(ii)(C).

(iii) * * *

(C) For further guidance, see § 1.861–8(d)(2)(iii)(C) through (E).

(D) and (E) [Reserved]

(iv) *Value of stock attributable to previously taxed earnings and profits.* For further guidance, see § 1.861–8(d)(2)(iv).

(e) * * *

(3) *Research and experimental expenditures.* For further guidance, see § 1.861–8(e)(3) through (15).

(4) through (15) [Reserved]

(f) *Miscellaneous matters.* For further guidance, see § 1.861–8(f) through (g).

(g) [Reserved]

* * * * *

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

■ 1. Revising the section heading.

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

■ 3. Adding paragraph (a), reserved paragraph (b), and paragraphs (c), (d), and (e)(1).

■ 4. Removing the last sentence in paragraphs (e)(2) and (3).

■ 5. Removing paragraphs (e)(4) through (f)(3)(i).

■ 6. Adding paragraphs (e)(4) through (10), (f) heading, (f)(1) and (2), (f)(3) heading, and (f)(3)(i).

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

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

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

■ 10. Revising paragraph (f)(4)(iii).

■ 11. Removing paragraphs (f)(5) through (h)(3).

■ 12. Adding paragraphs (f)(5), (g), (h) introductory text, and (h)(1) and reserved paragraphs (h)(2) and (3).

■ 13. Revising paragraph (h)(5).

■ 14. In paragraph (i)(2)(i):

■ i. Revising the first and second sentences.

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

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

The revisions and additions read as follows:

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

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

(b) [Reserved]

(c) *Allowable deductions.* For further guidance, see § 1.861–9T(c) introductory text.

(1) *Disallowed deductions.* For further guidance, see § 1.861–9T(c)(1) through (4).

(2) through (4) [Reserved]

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

(d) *Apportionment rules for individuals, estates, and certain trusts.* For further guidance, see § 1.861–9T(d).

(e) *Partnerships*—(1) *In general—aggregate rule.* For further guidance, see § 1.861–9T(e)(1).

* * * * *

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

(ii) *Other interest expense of the partner.* For further guidance, see § 1.861–9T(e)(4)(ii).

(5) *Tiered partnerships.* For further guidance, see § 1.861–9T(e)(5) through (7).

(6) and (7) [Reserved]

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

(ii) *Treatment of interest expense and interest income attributable to a downstream partnership loan.* If a DPL lender (or any other person in the same affiliated group as the DPL lender) takes into account a distributive share of downstream partnership loan interest expense (DPL interest expense), the DPL lender must assign an amount of DPL interest income corresponding to the matching income amount for the taxable year that is attributable to the same loan to the same statutory and residual groupings as the statutory and residual groupings of gross income from which the DPL interest expense is deducted (or would be deducted, without regard to any limitations on the deductibility of interest, such as section 163(j)) by the DPL lender (or any other person in the same affiliated group as the DPL lender).

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

(iv) *Anti-avoidance rule for loans held by CFCs.* A loan receivable held by a controlled foreign corporation with respect to a loan to a partnership in which a United States shareholder (as defined in § 1.904–5(a)(4)(vi)) of the controlled foreign corporation owns an interest, directly or indirectly through one or more other partnerships or other pass-through entities (as defined in § 1.904–5(a)(4)(iv)), is recharacterized as a loan receivable held directly by the United States shareholder with respect to the loan to such partnership for purposes of this paragraph (e)(8) if the loan was made or transferred with a principal purpose of avoiding the rules in this paragraph (e)(8). An appropriate amount of income derived by the United States shareholder (or any other person in the same affiliated group as the United States shareholder) from the controlled foreign corporation is treated as DPL interest income. Appropriate adjustments must be made to the value and characterization of the stock of the controlled foreign corporation under §§ 1.861–9 and 1.861–12 in order to reflect the portion of the downstream partnership loan held by the controlled foreign corporation that is disregarded under paragraph (e)(8)(i) of this section.

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

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

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

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

(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, either by a person that owns an interest, directly or indirectly through one or more other partnerships or other pass-through entities, in the partnership, or by any person in the same affiliated group as that person.

(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)).

(E) *Downstream partnership loan interest income (DPL interest income).* The term *downstream partnership loan interest income,* or *DPL interest income,* means an item of gross interest income received or accrued with respect to a downstream partnership loan.

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

(vii) *Examples.* The following examples illustrate the application of the rules in this paragraph (e)(8).

(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, US1 loans $1,000x to PRS. For Year 1, US1 has $100x of interest income with respect to the loan and PRS has $100x of interest expense with respect to the loan. US1's distributive share of the interest expense is $60x. Under paragraph (e)(2) of this section, $45x of US1's distributive share of the interest expense is apportioned to U.S. source income and $15x is apportioned to foreign source foreign branch category income. Under paragraph (h)(4)(i) of this section, the total value of the loan between US1 and PRS is $1,000x.

(*2*) *Analysis.* The loan by US1 to PRS is a downstream partnership loan and US1 is a DPL lender. Under paragraph (e)(8)(vi)(B) of this section, the matching income amount is $60x, the lesser of the DPL interest income included by US1 with respect to the loan for the taxable year ($100x) and US1's distributive share of the DPL interest expense ($60x). Under paragraph (e)(8)(ii) of this section, US1 assigns $45x of the DPL interest income to U.S. source income and $15x of the DPL interest income to foreign source foreign branch category income. The source and separate category of the remaining $40x of US1's DPL interest income is determined under the generally applicable rules. Under paragraph (e)(8)(i) of this section, the disregarded portion of the downstream partnership loan is $600x ($1,000x × $60x/$100x).

(B) *Example 2*—(*1*) *Facts.* The facts are the same as in paragraph (e)(8)(vii)(A)(*1*) of this section (the facts in *Example 1*), except that US1 and US2 are part of the same affiliated group, US2's distributive share of the interest expense is $40x, and under paragraph (e)(2) of this section, $30x of US2's distributive share of the interest expense is apportioned to U.S. source income and $10x is apportioned to foreign source foreign branch category income.

(*2*) *Analysis.* The loan by US1 to PRS is a downstream partnership loan and US1 is a DPL lender. Under paragraph (e)(8)(vi)(B) of this section, the matching income amount is $100x, the lesser of the DPL interest income included 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 DPL interest expense ($100x). Under paragraph (e)(8)(ii) of this section, US1 assigns $75x of the DPL interest income to U.S. source income and $25x of the DPL interest income to foreign source foreign branch category income. Under paragraph (e)(8)(i) of this section, the disregarded portion of the downstream partnership loan is $1,000x ($1,000x × $100x/$100x).

(C) *Example 3*—(*1*) *Facts.* US1, a domestic corporation, owns 80% of PRS, a foreign partnership that is not engaged in a U.S. trade or business. The remaining 20% of PRS is 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, US1 loans $3,000x to Bank and Bank loans $3,000x to PRS. US1 makes the loan to Bank with a principal purpose of avoiding the rules in this paragraph (e)(8). For Year 1, US1 has $150x of interest income with respect to the loan to Bank and PRS has $175x of interest expense with respect to the loan from Bank. US1's distributive share of the interest expense is $140x. Under paragraph (e)(2) of this section, $126x of US1's distributive share of the interest expense is apportioned to U.S. source income and $14x is apportioned to foreign source foreign branch category income. Under paragraph (h)(4)(i) of this section, the total value of the loan between US1 and PRS is $3,000x.

(*2*) *Analysis.* Under paragraph (e)(8)(iii) of this section, because the loan from US1 to Bank is made with a principal purpose of avoiding the rules of this paragraph (e)(8), the rules of this paragraph (e)(8) apply as if the loan by US1 to Bank was made directly to PRS. Accordingly, the loan by US1 to Bank is a downstream partnership loan and US1 is a DPL lender. Under paragraph (e)(8)(vi)(B) of this section, the matching income amount is $140x, the lesser of the DPL interest income included by US1 with respect to the loan for the taxable year ($150x) and US1's distributive share of the DPL interest expense ($140x). Under paragraph (e)(8)(ii) of this section, US1 assigns $126x of the DPL interest income to U.S. source income and $14x of the DPL interest income to foreign source foreign branch category income. The source and separate category of the remaining $10x of US1's DPL interest income is determined under the generally applicable rules. Under paragraph (e)(8)(i) of this section, the disregarded portion of the downstream partnership loan is $2,800x ($3,000x × $140x/$150x).

(D) *Example 4*—(*1*) *Facts.* US1, a domestic corporation, directly owns all of the outstanding stock of CFC, a controlled foreign corporation, and 90% of PRS, a foreign partnership that is not engaged in a U.S. trade or business. The remaining 10% of PRS is owned by US2, a domestic corporation that is unrelated to US1 and CFC. US1, US2, and PRS all use the calendar year as their taxable year. In Year 1, US1 loans $900x to CFC and CFC loans $900x to PRS. CFC makes the loan with a principal purpose of avoiding the rules in this paragraph (e)(8). For Year 1, CFC has $90x of interest income and $90x of interest expense with respect to the loan to PRS, and US1 has $90x of interest income with respect to the loan to CFC. PRS has $90x of interest expense with respect to the loan, and US1's distributive share of the interest expense is $81x. Under paragraph (e)(2) of this section, $54x of US1's distributive share of the interest expense is apportioned to U.S. source income and $27x is apportioned to foreign source foreign branch category income. Under paragraph (h)(4)(i) of this section, the total value of the loan between CFC and PRS is $900x.

(*2*) *Analysis.* Under paragraph (e)(8)(iv) of this section, because the loan from CFC to PRS is made with a principal purpose of avoiding the rules of this paragraph (e)(8), the loan from CFC to PRS is recharacterized as a loan receivable held directly by US1, and an appropriate amount of income derived by US1, in this case, the $90x of interest income from the loan to CFC, is treated as DPL interest income. Accordingly, the loan from CFC to PRS is a downstream partnership loan and US1 is a DPL lender. Under paragraph (e)(8)(vi)(B) of this section, the matching income amount is $81x, the lesser of the DPL interest income included by US1 ($90x) and US1's distributive share of the DPL interest expense ($81x). Under paragraph (e)(8)(ii) of this section, US1 assigns $54x of the DPL interest income to U.S. source income and $27x of the DPL interest income to foreign source foreign branch category income. The source and separate category of the remaining $9x of US1's interest income is determined under the generally applicable rules. Under paragraph (e)(8)(i) of this section, the disregarded portion of the downstream partnership loan is $810x ($900x x $81x/$90x). Appropriate adjustments are made to the value and characterization of the stock of CFC under §§ 1.861–9 and 1.861–12 in order to reflect the $810x disregarded portion of the downstream partnership loan.

(9) [Reserved]

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

(f) *Corporations*—(1) *Domestic corporations.* For further guidance, see § 1.861–9T(f)(1).

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

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

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

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

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

(A) *Facts.* X is a domestic corporation that operates B, a branch doing business in a foreign country. B is a section 987 QBU (as defined in § 1.987–1(b)(2)) as well as a foreign branch (as defined in § 1.904–4(f)(3)(iii)). In 2020, without regard to B, X has gross domestic source income of $1,000x and gross foreign source general category income of $500x and incurs $200 of interest expense. Using the tax book value method of apportionment, X, without regard to B, determines the value of its assets that generate domestic source income to be $6,000x and the value of its assets that generate foreign source general category income to be $1,000x. Applying the translation rules of section 987, X (through B) earned $500 of gross foreign source foreign branch category income and incurred $100x of interest expense. B incurred no other expenses. For 2020, the average functional currency book value of B's assets that generate foreign source foreign branch category income translated at the year-end rate for 2020 is $3,000x.

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

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

(j) of this section, subject to the rules of paragraphs (f)(3)(ii) and (iii) of this section.

* * * * *

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

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

(5) *Other relevant provisions.* For further guidance, see § 1.861–9T(f)(5).

(g) *Asset method*—(1) *In general.* (i) For further guidance, see § 1.861–9T(g)(1)(i).

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

(iii) [Reserved]

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

(v) [Reserved]

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

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

(ii) *Special rule for qualified business units of domestic corporations with functional currency other than the U.S. dollar*—(A) *Tax book value method.* For further guidance, see § 1.861–9T(g)(2)(ii)(A).

(*1*) *Section 987 QBU.* For further guidance, see § 1.861–9T(g)(2)(ii)(A)(*1*).

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

(B) *Fair market value method.* For further guidance, see § 1.861–9T(g)(2)(ii)(B).

(iii) *Adjustment for directly allocated interest.* For further guidance, see § 1.861–9T(g)(2)(iii).

(iv) *Assets in intercompany transactions.* For further guidance, see § 1.861–9T(g)(2)(iv).

(3) *Characterization of assets.* For further guidance, see § 1.861–9T(g)(3).

(4) *Characterization of lower tier entities at the level of a CFC.* In the case of a controlled foreign corporation that is applying the asset method, see for example § 1.861–12T(c)(3)(ii) (requiring the application of § 1.861–9T(g) at the level of the controlled foreign corporation) or paragraph (f)(3)(i) of this section, the controlled foreign corporation (and any lower-tier controlled foreign corporations) must characterize stock of a lower-tier 10 percent owned corporation by applying § 1.861–12 and treating the controlled foreign corporation as the relevant taxpayer for such purposes. In the case of a controlled foreign corporation that owns stock in one or more lower-tier corporations, in applying the asset method, the first-tier controlled foreign corporation must take into account the stock in the lower-tier corporations. Therefore, the controlled foreign corporation (and any lower-tier controlled foreign corporations) must make basis adjustments in lower-tier 10 percent owned corporations under § 1.861–12(c)(2) for purposes of valuing and characterizing the assets of such controlled foreign corporation. For purposes of this paragraph (g)(4), the stock of each such lower-tier corporation is characterized by reference to the assets owned during the lower-tier corporation's taxable year that ends during the first-tier controlled foreign corporation's taxable year. The analysis of assets under this paragraph (g)(4) and § 1.861–12 of a controlled foreign corporation that is in a chain of 10 percent owned corporations must begin at the lowest-tier 10 percent owned corporation and proceed up the chain to the first-tier controlled foreign corporation. *See also* § 1.861–12T(c)(3)(ii).

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

(1) *Determination of values.* For further guidance, see § 1.861–9T(h)(1) through (3).

(2) and (3) [Reserved]

* * * * *

(5) *Characterizing stock in related persons.* Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of § 1.861–12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under § 1.861–9T(h)(2) shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904–4(b)).

* * * * *

(i) * * *

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

* * * * *

(j) *Modified gross income method.* For further guidance, see § 1.861–9T(j) introductory text.

(1) For further guidance, see § 1.861–9T(j)(1).

(2) For further guidance, see § 1.861–9T(j)(2) introductory text.

(i) *Step 1.* For further guidance, see § 1.861–9T(j)(2)(i).

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

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

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

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

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

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

■ **Par. 5.** Section 1.861–9T is amended by:

■ 1. Adding paragraph (c)(5).

■ 2. Revising paragraph (e)(4)(i).

■ 3. Adding paragraph (e)(8) and reserved paragraphs (e)(9) and (10).

■ 4. Revising paragraph (f)(2) and removing the undesignated paragraph and example paragraphs following paragraph (f)(2)(ii).

■ 5. Removing and reserving paragraph (f)(3)(i).

■ 6. Revising paragraphs (f)(4) and (g)(1)(ii).

■ 7. Removing and reserving paragraphs (g)(1)(iii) through (v) and (g)(2)(i).

■ 8. Revising paragraph (g)(2)(ii)(A)(*2*).

■ 9. Removing and reserving paragraph (g)(2)(v).

■ 10. Revising paragraphs (h) introductory text and (j)(2)(ii).

■ 11. Removing the undesignated paragraph following paragraph (j)(2)(ii)(B).

The additions and revisions read as follows:

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

* * * * *

(c) * * *

(5) *Section 163(j).* For further guidance, see § 1.861–9(c)(5).

* * * * *

(e) * * *

(4) * * *

(i) *Partnership interest expense.* For further guidance, see § 1.861–9(e)(4)(i).

* * * * *

(8) *Special rule for downstream partnership loans.* For further guidance, see § 1.861–9(e)(8) through (10).

(9) and (10) [Reserved]

(f) * * *

(2) *Section 987 QBUs of domestic corporations.* For further guidance, see § 1.861–9(f)(2) through (f)(3)(i).

* * * * *

(4) *Noncontrolled 10-percent owned foreign corporations.* For further guidance, see § 1.861–9(f)(4).

* * * * *

(g) * * *

(1) * * *

(ii) For further guidance, see § 1.861–9(g)(1)(ii) through (g)(2)(i).

* * * * *

(2) * * *

(ii) * * *

(A) * * *

(*2*) *U.S. dollar approximate separate transactions method.* For further guidance, see § 1.861–9(g)(2)(ii)(A)(*2*).

* * * * *

(h) *Fair market value method.* For further guidance, see § 1.861–9(h).

* * * * *

(j) * * *

(2) * * *

(ii) *Step 2.* For further guidance, see § 1.861–9(j)(2)(ii).

* * * * *

■ **Par. 6.** Section 1.861–10 is amended by:

■ 1. Revising paragraph (e)(8)(vi).

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

■ 3. Adding paragraph (f).

The revisions and addition read as follows:

§ 1.861–10 Special allocations of interest expense.

* * * * *

(e) * * *

(8) * * *

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

* * * * *

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

■ **Par. 7.** Section 1.861–10T is amended by revising paragraph (e) to read as follows:

§ 1.861–10T Special allocations of interest expense (temporary).

* * * * *

(e) *Treatment of certain related group indebtedness.* For further guidance, see § 1.861–10(e).

* * * * *

■ **Par. 8.** Section 1.861–11 is amended by:

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

■ 2. Adding paragraphs (a), (b), and (c).
■ 3. Removing the language '', except that section 936 corporations are also included within the affiliated group to the extent provided in paragraph (d)(2) of this section'' from the first sentence of paragraph (d)(1).
■ 4. Removing and reserving paragraph (d)(2).
■ 5. Adding paragraph (h).

The revisions and addition read as follows:

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

(a) *In general.* For further guidance, see § 1.861–11T(a).

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

(2) *Nonapplication of section 864(e)(1) and (5) (concerning the definition and treatment of affiliated groups).* For further guidance, see § 1.861–11T(b)(2).

(c) *General rule for affiliated corporations.* For further guidance, see § 1.861–11T(c).

* * * * *

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

■ **Par. 9.** Section 1.861–11T is amended by revising paragraph (b)(1) to read as follows:

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

* * * * *

(b) * * *

(1) *Application of section 864(e)(1) and (5) (concerning the definition and treatment of affiliated groups).* For further guidance, see § 1.861–11(b)(1).

* * * * *

■ **Par. 10.** Section 1.861–12 is amended by:
■ 1. Removing paragraphs (a) through (c)(1).
■ 2. Adding paragraphs (a), (b), and (c)(1).
■ 3. Revising paragraphs (c)(3) and (4).
■ 4. Removing paragraph (c)(5) and paragraphs (d) through (j).
■ 5. Adding paragraphs (d) and (e) and reserved paragraphs (f) through (j).

The revisions read as follows:

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

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

(b) *Inventories.* For further guidance, see § 1.861–12T(b).

(c) *Treatment of stock*—(1) *In general.* For further guidance, see § 1.861–12T(c)(1).

* * * * *

(3) *Characterization of stock of controlled foreign corporations*—(i) *Operative sections*—(A) *Operative sections other than section 904.* For purposes of applying this section to an operative section other than section 904, stock in a controlled foreign corporation (as defined in section 957) is characterized as an asset in the relevant groupings on the basis of the asset method described in paragraph (c)(3)(ii) of this section, or the modified gross income method described in paragraph (c)(3)(iii) of this section. Stock in a controlled foreign corporation whose interest expense is apportioned on the basis of assets is characterized in the hands of its United States shareholders under the asset method described in paragraph (c)(3)(ii) of this section. Stock in a controlled foreign corporation whose interest expense is apportioned on the basis of modified gross income is characterized in the hands of its United States shareholders under the modified gross income method described in paragraph (c)(3)(iii) of this section.

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

(ii) *Asset method.* For further guidance, see § 1.861–12T(c)(3)(ii).

(iii) *Modified gross income method.* Under the modified gross income method, the taxpayer characterizes the tax book value of the stock of the first-tier controlled foreign corporation based on the gross income, net of interest expense, of the controlled foreign corporation (as computed under § 1.861–9T(j) to include certain gross income, net of interest expense, of lower-tier controlled foreign corporations) within each relevant category for the taxable year of the controlled foreign corporation ending with or within the taxable year of the taxpayer. For purposes of this paragraph (c)(3)(iii), however, the gross income, net of interest expense, of the first-tier controlled foreign corporation includes the total amount of gross subpart F income, net of interest expense, of any lower-tier controlled foreign corporation that was excluded under the rules of § 1.861–9(j)(2)(ii)(B).

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

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

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

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

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

* * * * *

■ **Par. 11.** Section 1.861–12T is amended by:

■ 1. Revising paragraph (a).

■ 2. Removing paragraphs (c)(2)(vi).

■ 3. Revising paragraph (c)(3)(i) and removing the undesignated paragraph following paragraph (c)(3)(i)(B).

■ 4. Revising paragraph (c)(3)(iii).

■ 5. Removing paragraph (c)(5).

■ 6. Revising paragraph (d)(2).

■ 7. Removing and reserving paragraph (j).

The revisions read as follows:

§ 1.861–12T Characterization rules and adjustments for certain assets (temporary).

(a) *In general.* For further guidance, see § 1.861–12(a).

* * * * *

(c) * * *

(3) * * *

(i) *Operative sections.* For further guidance, see § 1.861–12(c)(3)(i).

* * * * *

(iii) *Modified gross income method.* For further guidance, see § 1.861–12(c)(3)(iii).

* * * * *

(d) * * *

(2) *Characterization of related controlled foreign corporation notes.* For further guidance, see § 1.861–12(d)(2).

* * * * *

■ **Par. 12.** § 1.861–13 is added to read as follows:

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

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

(1) *Step 1: Characterize stock as generating income in statutory groupings under the asset or modified gross income method*—(i) *Asset method.* A United States shareholder of a controlled foreign corporation that apportions its interest expense on the basis of assets must characterize stock of the controlled foreign corporation using the asset method described in § 1.861–12T(c)(3)(ii) to assign the assets of the controlled foreign corporation to the statutory groupings described in paragraphs (a)(1)(i)(A)(*1*) through (*10*) and (a)(1)(i)(B) of this section. If the controlled foreign corporation owns stock in a lower-tier noncontrolled 10-percent owned foreign corporation, the assets of the lower-tier noncontrolled 10-percent owned foreign corporation are assigned to a gross subpart F income grouping to the extent such assets generate income that, if distributed to the controlled foreign corporation, would be gross subpart F income of the controlled foreign corporation. *See also* § 1.861–12(c)(4).

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

(*1*) Foreign source gross tested income;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(3) *Gross tested income.* The term *gross tested income* has the meaning provided in § 1.951A–2(c)(1).

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

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

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

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

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

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

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

(C) CFC1 also owns all of the stock of CFC2, a controlled foreign corporation. The tax book value of CFC1's stock in CFC2 is $6,000x. CFC2 owns the following assets with the following values as determined under §§ 1.861–9(g)(2) and 1.861–9T(g)(3): Assets that generate income described in the foreign source gross subpart F income statutory grouping within the general category ($2,250x) and assets that generate specified foreign source general category gross income ($750x).

(ii) *Analysis*—(A) *Step 1*—(*1*) *Characterization of CFC2 stock.* CFC2 has total assets of $3,000x, $2,250x of which are in the foreign source gross subpart F income statutory grouping within the general category and $750x of which are in the specified foreign source general category gross income statutory grouping. Accordingly, CFC2's stock is characterized as $4,500x ($2,250x/$3,000x × $6,000x) in the foreign source gross subpart F income statutory grouping within the general category and $1,500x ($750x/$3,000x × $6,000x) in the specified foreign source general category gross income statutory grouping.

(*2*) *Characterization of CFC1 stock.* CFC1 has total assets of $16,000x, $4,000x of which are in the foreign source gross tested income statutory grouping within the general category, $5,500x of which are in the foreign source gross subpart F income statutory grouping within the general category (including the portion of CFC2 stock assigned to that statutory grouping), $4,500x of which are in the specified foreign source gross general category income statutory grouping (including the portion of CFC2 stock assigned to that statutory grouping), and $2,000x of which are in the foreign source gross subpart F income statutory grouping within the passive category. Accordingly, CFC1's stock is characterized as $5,000x ($4,000x/$16,000x × $20,000x) in the foreign source gross tested income statutory grouping within the general category, $6,875x ($5,500x/$16,000x × $20,000x) in the foreign source gross subpart F income statutory grouping within the general category, $5,625x ($4,500x/$16,000x × $20,000x) in the specified foreign source gross general category income statutory grouping, and $2,500x ($2,000x/$16,000x × $20,000x) in the foreign source gross subpart F income statutory grouping within the passive category.

(B) *Step 2.* The value of the portion of the stock of CFC1 that is general category gross tested income stock is $5,000x. USP's inclusion percentage is 70%. Accordingly, under paragraph (a)(2) of this section, $3,500x of the stock of CFC1 is assigned to the section 951A category and a portion thereof may be treated as an exempt asset under § 1.861–8(d)(2)(ii)(C)(*2*)(*ii*). The remainder, $1,500x, remains a general category asset.

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

(D) *Step 4*—(*1*) *General category stock.* The total value of the portion of the stock of CFC1 that is general category stock is $14,000x, which is equal to $1,500x (the value of the portion of the general category stock of CFC1 that was not assigned to the section 951A category in paragraph (c)(1)(ii)(B) of this section (Step 2)) plus $6,875x (the value of the portion of the stock of CFC1 assigned to the foreign source gross subpart F income statutory grouping within the general category) plus $5,625x (the value of the portion of the stock of CFC1 assigned to the specified foreign source gross income statutory grouping within the general category).

(*2*) *Passive category stock.* The total value of the portion of the stock of CFC1 that is passive category stock is $2,500x.

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

(E) *Step 5*—(*1*) *General category stock.* Under paragraph (a)(5)(ii) of this section, the value of the portion of the stock of CFC1 assigned to the section 245A subgroup of general category stock is $7,125x, which is equal to $1,500x (the value of the portion of the general category stock of CFC1 that was not assigned to the section 951A category in paragraph (c)(1)(ii)(B) of this section (Step 2)) plus $5,625x (the value of the portion of the stock of CFC1 assigned to the specified foreign source general category gross income statutory grouping). Under paragraph (a)(5)(v) of this section, the remainder of the general category stock of CFC1, $6,875x, is assigned to the non-section 245A subgroup of general category stock.

(*2*) *Passive category stock.* No portion of the passive category stock of CFC1 is in the foreign source gross tested income statutory grouping or the specified foreign source passive category gross income statutory grouping. Accordingly, under paragraph (a)(5)(iii) of this section, no value of the portion of the stock of CFC1 is assigned to the section 245A subgroup of passive category stock. Under paragraph (a)(5)(v) of this section, the passive category stock of CFC1, $2,500x is assigned to the non-section 245A subgroup of passive category stock.

(*3*) *Section 951A category stock.* Under paragraph (a)(5)(v) of this section, all of the section 951A category stock, $3,500x, is assigned to the non-section 245A subgroup of section 951A category stock.

(F) *Summary.* For purpose of the allocation and apportionment of expenses, $14,000x of the stock of CFC1 is characterized as general category stock, $7,125x of which is in the section 245A subgroup and $6,875x of which is in the non-section 245A subgroup; $2,500x of the stock of CFC1 is characterized as passive category stock, all of which is in the non-section 245A subgroup; and $3,500x of the stock of CFC1 is characterized as section 951A category stock, all of which is in the non-section 245A subgroup.

(2) *Example 2: Asset method with noncontrolled 10-percent owned foreign corporation*—(i) *Facts.* The facts are the same as in paragraph (c)(1)(i) of this section (the facts in *Example 1*), except that CFC1 does not own CFC2 and instead owns 20% of the stock of FC2, a foreign corporation that is a noncontrolled 10-percent owned foreign corporation. The tax book value of CFC1's stock in FC2 is $6,000x. FC2 owns assets with the following values as determined under §§ 1.861–9(g)(2) and 1.861–9T(g)(3): Assets that generate specified foreign source general category gross income ($3,000x). All of the assets of FC2 generate income that, if distributed to CFC1 as a dividend, would be foreign source gross subpart F income in the general category to CFC1.

(ii) *Analysis*—(A) *Step 1*—(*1*) *Characterization of FC2 stock.* All of the assets of FC2 generate income that, if distributed to CFC1, would be foreign source gross subpart F income in the general category to CFC1. Accordingly, under paragraph (a)(1)(i) of this section, all of CFC1's stock in FC2 ($6,000x) is characterized as in the foreign source gross subpart F income statutory grouping within the general category.

(*2*) *Characterization of CFC1 stock.* CFC1 has total assets of $16,000x, $4,000x of which are in the foreign source gross tested income statutory grouping within the general category, $7,000x of which are in the foreign source gross subpart F income statutory grouping within the general category (including the FC2 stock assigned to that statutory grouping), $3,000x of which are in the specified foreign source general category gross income statutory grouping, and $2,000x of which are in the foreign source gross subpart F income statutory grouping within the passive category. Accordingly, CFC1's stock is characterized as $5,000x ($4,000x/$16,000x × $20,000x) in the foreign source gross tested income statutory grouping within the general category, $8,750x ($7,000x/$16,000x × $20,000x) in the foreign source gross subpart F income statutory grouping within the general category, $3,750x ($3,000x/$16,000x × $20,000x) in the specified foreign source general category gross income statutory grouping, and $2,500x ($2,000x/$16,000x × $20,000x) in the foreign source gross subpart F income statutory grouping within the passive category.

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

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

(D) *Step 4*—(*1*) *General category stock.* The total value of the portion of the stock of CFC1 that is general category stock is $14,000x, which is equal to $1,500x (the value of the portion of the general category stock of CFC1 that was not assigned to the section 951A category in paragraph (c)(2)(ii)(B) of this section (Step 2)) plus $3,750x (the value of the portion of the stock of CFC1 assigned to the specified foreign source gross income statutory grouping within the general category general category) plus $8,750x (the value of the portion of the stock of CFC1 assigned to the foreign source gross subpart F income statutory grouping within the general category).

(*2*) *Passive category stock.* The analysis is the same as in paragraph (c)(1)(ii)(D)(*2*) of this section (the analysis of Step 4 in *Example 1*).

(E) *Step 5*—(*1*) *General category stock.* Under paragraph (a)(5)(ii) of this section, the value of the stock of CFC1 assigned to the section 245A subgroup of general category stock is $5,250x, which is equal to $1,500x (the value of the portion of the general category stock of CFC1 that was not assigned to the section 951A category in paragraph (c)(2)(ii)(B) of this section (Step 2)) plus $3,750x (the value of the portion of the stock of CFC1 assigned to the specified foreign source general category gross income statutory grouping). Under paragraph (a)(5)(v) of this section, the remainder of the general category stock of CFC1, $8,750x, is assigned to the non-section 245A subgroup of general category stock.

(*2*) *Passive category stock.* The analysis is the same as in paragraph (c)(1)(ii)(E)(*2*) of this section (the analysis of Step 5 in *Example 1*).

(*3*) *Section 951A category stock.* The analysis is the same as in paragraph (c)(1)(ii)(E)(*3*) of this section (the analysis of Step 5 in *Example 1*).

(F) *Summary.* For purpose of the allocation and apportionment of expenses, $14,000x of the stock of CFC1 is characterized as general category stock, $5,250x of which is in the section 245A subgroup and $8,750x of which is in the non-section 245A subgroup; $2,500x of the stock of CFC1 is characterized as passive category stock, all of which is in the non-section 245A subgroup; and $3,500x of the stock of CFC1 is characterized as section 951A category stock, all of which is in the non-section 245A subgroup.

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

(B) CFC1 earns $1,500x of foreign source gross tested income within the general category and $500x of foreign source gross subpart F income within the passive category. CFC1 incurs $1,000x of interest expense.

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

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

(*2*) *Determination of CFC1 gross income (net of interest expense).* Before including the gross income consisting of subpart F income (net of interest expense) of CFC2, CFC1 has total gross income of $4,000x, including $1500x of CFC2's foreign source gross tested income within the general category and $500x of CFC2's specified foreign source general category gross income which are combined with CFC1's items of gross income under § 1.861–9(j)(2)(ii). CFC1's $1,000x of interest expense is apportioned among the statutory groupings of gross income of CFC1 to determine the gross income (net of interest expense) of CFC1 in each statutory grouping. As a result, $750x ($3,000x/$4,000x × $1,000x) of interest expense is apportioned to foreign source gross tested income within the general category, $125x ($500x/$4,000 × $1,000x) to foreign source gross subpart F income within the passive category, and $125x ($500x/$4,000x × $1,000x) to specified foreign source general category gross income. Accordingly, CFC1 has the following amounts of gross income (net of interest expense) before including the gross income consisting of subpart F income (net of interest expense) of CFC2: $2,250x ($3,000x − $750x) of foreign source gross tested income within the general category, $375x ($500x − $125x) of foreign source gross subpart F income within the passive category, and $375x ($500 − $125x) of specified foreign source general category gross income. After including the gross income consisting of subpart F income (net of interest expense) of CFC2, CFC1 has the following amounts of gross income (net of interest expense): $2,250x of foreign source gross tested income within the general category, $1,000x of foreign source gross subpart F income within the general category, $375x of specified foreign source general category gross income, and $375x of foreign source gross subpart F income within the passive category.

(*3*) *Characterization of CFC1 stock.* CFC1 is considered to have a total of $4,000x of gross income (net of interest expense) for purposes of characterizing the stock of CFC1. Accordingly, CFC1's stock is characterized as $56,250x ($2,250x/$4,000x × $100,000x) in the foreign source gross tested income statutory grouping within the general category, $25,000x ($1,000x/$4,000x × $100,000x) in the foreign source gross subpart F income statutory grouping within the general category, $9,375x ($375x/$4,000x × $100,000x) in the specified foreign source general category gross income statutory grouping, and $9,375x ($375x/$4,000x × $100,000x) in the foreign source gross subpart F income statutory grouping within the passive category.

(B) *Step 2.* The value of the portion of the stock of CFC1 that is general category gross tested income stock is $56,250x. USP's inclusion percentage is 100%. Accordingly, under paragraph (a)(2) of this section, all of the $56,250x of the stock of CFC1 is assigned to the section 951A category and a portion thereof may be treated as an exempt asset under § 1.861–8(d)(2)(ii)(C)(*2*)(*ii*).

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

(D) *Step 4*—(*1*) *General category stock.* The total value of the portion of the stock of CFC1 that is general category stock is $34,375x, which is equal to $25,000x (the value of the portion of the stock of CFC1 assigned to the subpart F income statutory grouping within the general category income statutory grouping) plus $9,375x (the value of the portion of the stock of CFC1 assigned to the specified foreign source general category gross income statutory grouping).

(*2*) *Passive category stock.* The total value of the portion of the stock of CFC1 that is passive category stock is $9,375x.

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

(E) *Step 5*—(*1*) *General category stock.* All of the value of the general category gross tested income stock of CFC1 was assigned to the section 951A category in paragraph (c)(3)(ii)(B) of this section (Step 2). Accordingly, under paragraph (a)(5)(ii) of this section, the value of the stock of CFC1 assigned to the section 245A subgroup of general category stock is $9,375x, which is equal to the value of the portion assigned to the specified foreign source general category gross income statutory grouping. Under paragraph (a)(5)(v) of this section, the remainder of the general category stock of CFC1, $25,000x, is assigned to the non-section 245A subgroup of general category stock.

(*2*) *Passive category stock.* No portion of the passive category stock of CFC1 is in the foreign source gross tested income statutory grouping or the specified foreign source passive category gross income statutory grouping. Accordingly, under paragraph (a)(5)(iii) of this section, no value of the portion of the stock of CFC1 is assigned to the section 245A subgroup. Under paragraph (a)(5)(v) of this section, the passive category stock of CFC1, $9,375x, is assigned to the non-section 245A subgroup of passive category stock.

(*3*) *Section 951A category stock.* Under paragraph (a)(5)(v) of this section, all of the section 951A category stock, $56,250x, is assigned to the non-section 245A subgroup of section 951A category stock.

(F) *Summary.* For purposes of the allocation and apportionment of expenses, $56,250x of the stock of CFC1 is characterized as section 951A category stock, all of which is in the non-section 245A subgroup; $34,375x of the stock of CFC1 is characterized as general category stock, $9,375x of which is in the section 245A subgroup and $25,000x of which is in the non-section 245A subgroup; and $9,375x of the stock of CFC1 is characterized as passive category stock, all of which is in the non-section 245A subgroup.

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

§ 1.861–14 [Amended]

■ **Par. 13.** Section 1.861–14 is amended by:

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

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

■ **Par. 14.** Section 1.861–17 is amended by:

■ 1. Adding paragraph (e)(3).

■ 2. Removing and reserving paragraph (g).

■ 3. Adding paragraph (i).

The additions and revisions read as follows:

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

* * * * *

(e) * * *

(3) *Change of method for taxable years beginning after December 31, 2017, and before January 1, 2020.* A taxpayer otherwise subject to the binding election described in paragraph (e)(1) of this section may change its method for each taxable year beginning after December 31, 2017, and before January 1, 2020, without the prior consent of the Commissioner. The taxpayer's use of a new method constitutes a binding election to use the new method for its return filed for its last year that begins before January 1,

2020, and for four taxable years thereafter.

* * * * *

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

■ **Par. 15.** Section 1.901(j)–1 is added to read as follows:

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

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

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

§ 1.904–0 [Removed]

■ **Par. 16.** § 1.904–0 is removed.

■ **Par. 17.** § 1.904–1 is revised to read as follows:

§ 1.904–1 Limitation on credit for foreign taxes.

(a) *In general.* For each separate category described in § 1.904–5(a)(4)(v), the total credit for taxes paid or accrued (including those deemed to have been paid or accrued other than by reason of section 904(c)) 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.

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

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

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

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

■ **Par. 18.** Section 1.904–2 is amended by:

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

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

■ 3. Removing and reserving paragraph (g).

■ 4. Revising paragraphs (h) and (i).

■ 5. Adding paragraphs (j) and (k).

The revisions and additions read as follows:

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

(a) *Credit for foreign tax carryback or carryover.* A taxpayer who chooses to claim a credit under section 901 for a taxable year is allowed a credit under that section not only for taxes otherwise allowable as a credit but also for taxes deemed paid or accrued in that year as a result of a carryback or carryover of an unused foreign tax under section 904(c). However, the taxes so deemed paid or accrued are not allowed as a deduction under section 164(a). Foreign tax paid, accrued, or deemed paid under section 960 with respect to section 951A category income, including section 951A category income that is reassigned to a separate category for income resourced under a treaty, may not be carried back or carried forward or deemed paid or accrued under section 904(c). See § 1.904–6 for rules for allocating and apportioning taxes to separate categories. For special rules regarding these computations in case of taxes paid, accrued, or deemed paid with respect to foreign oil and gas extraction income or foreign oil related income, see section 907(f).

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

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

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

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

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

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

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

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

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

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

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

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

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

* * * * *

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

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

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

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

(iii) *Exception for certain general category unused foreign taxes*—(A) *In general.* To the extent any unused foreign taxes with respect to general category income are carried forward to a taxable year beginning after December 31, 2017, a taxpayer may choose to allocate those taxes to the taxpayer's post-2017 separate category for foreign branch category income to the extent the unused foreign taxes would have been allocated to the taxpayer's post-2017 separate category for foreign branch category income, and would have been unused foreign taxes with respect to foreign branch category income if that separate category had applied in the year or years the unused foreign taxes arose. Any remaining unused foreign taxes paid or accrued or deemed paid with respect to general category income carried forward to a taxable year beginning after December 31, 2017, are allocated to the taxpayer's post-2017 separate category for general category income.

(B) *Safe harbor.* In lieu of applying paragraph (j)(1)(iii)(A) of this section, the taxpayer may choose to allocate the unused foreign taxes with respect to general category income in a taxable year beginning before January 1, 2018, to the taxpayer's post-2017 separate category for foreign branch category income based on a ratio equal to the amount of foreign income taxes assigned to the general category that were paid or accrued by the taxpayer's foreign branches (as defined in § 1.904–4(f)(3)(vii)) bears to all foreign income taxes assigned to the general category that were paid or accrued, or deemed paid by the taxpayer with respect to such taxable year. The amount of taxes paid or accrued by a foreign branch in a taxable year beginning before January1, 2018, means all foreign income taxes properly reflected on the separate set of books and records (as defined in § 1.989(a)–1(d)(1) and (2)) of the foreign branch as an expense (which does not include any taxes deemed paid under section 902 or 960).

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

(D) *Coordination rule.* See § 1.904(f)–12(j)(5) for coordination rule with respect to the exception described in paragraph (j)(1)(iii) of this section and the exceptions described in § 1.904(f)–12(j)(2) through (4).

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

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

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

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

■ **Par. 19.** Section 1.904–3 is amended by:

■ 1. Revising the section heading.

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

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

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

■ 5. Revising paragraphs (e) and (f)(1) through (3).

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

■ 7. Removing paragraph (f)(6) and the undesignated paragraph following paragraph (f)(6)(ii).

■ 8. Removing and reserving paragraph (g).

■ 9. Adding paragraph (h).

The additions and revisions read as follows:

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

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

* * * * *

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

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

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

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

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

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

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

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

* * * * *

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

■ **Par. 20.** Section 1.904–4 is amended by:

■ 1. Revising paragraph (a).

■ 2. Removing the word ''or'' from the end of paragraph (b)(2)(i)(A).

■ 3. Removing the period from the end of paragraph (b)(2)(i)(B) and adding a semicolon in its place.

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

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

■ 6. Revising paragraph (b)(2)(iv).

■ 7. In paragraph (c)(1):

■ i. Removing the language ''shall not be'' from the first sentence and adding the language ''is not'' in its place.

■ ii. Revising the second, third, and fourth sentences and removing the last two sentences.

■ 8. Removing the language ''1.861–14T'' in the first sentence of paragraph (c)(2)(i) and adding the language ''1.861–17'' in its place.

■ 9. Adding paragraph (c)(2)(iii).

■ 10. In paragraph (c)(3) introductory text:

■ i. Removing the language ''shall be'' in the first sentence and adding the language ''are'' in its place.

■ ii. Revising the second, third, and fourth sentences, and adding a sentence after the fourth sentence.

■ 11. Revising paragraphs (c)(4) and (c)(5)(ii).

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

■ 13. Revising paragraph (c)(5)(iii)(C).

■ 14. In paragraph (c)(6)(i):

■ i. Revising the first sentence.

■ ii. Removing the language ''deemed paid or accrued'' and adding the language ''deemed paid'' in its place and removing the word ''taxable'' in the second sentence.

■ 15. In paragraph (c)(6)(iii):

■ i. Revising the first, fourth, fifth, and sixth sentences.

■ ii. Removing the word ''taxable'' in the second and third sentences.

■ iii. Removing the language ''deemed paid or accrued'' and adding the language ''deemed paid'' in its place and removing ''(A),'' ''(B),'' and ''(C)'' in the third sentence.

■ 16. Revising paragraph (c)(6)(iv).

■ 17. In paragraph (c)(7)(i):

■ i. Removing the language ''is reduced'' and adding the language ''would be reduced'' in its place in the first sentence.

■ ii. Revising the second and sixth sentences.

■ 18. In paragraph (c)(7)(iii):

■ i. Removing the language ''general category income'' and adding the language ''income in another separate category'' in its place in the third sentence.

■ ii. Removing the last sentence.

■ 19. Revising paragraph (c)(8).

■ 20. Adding paragraph (d).

■ 21. Revising paragraph (e)(1).

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

■ 23. Removing the seventh sentence of paragraph (e)(3)(i).

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

■ 25. Removing and reserving paragraphs (e)(3)(iv) and (e)(4)(i)(B).

■ 26. Removing paragraph (e)(5).

■ 27. Adding paragraphs (f) and (g).

■ 28. Revising paragraphs (h)(2), (4), and (5) and (k) through (n).

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

The revisions and additions read as follows:

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

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

(b) * * *

(2) * * *

(i) * * *

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

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

(ii) *Exceptions.* Passive income does not include any export financing interest (as defined in paragraph (h) of this section), any high-taxed income (as defined in paragraph (c) of this section), financial services income (as defined in paragraph (e)(1)(ii) of this section), or any active rents and royalties (as defined in paragraph (b)(2)(iii) of this section). In addition, passive income does not include any income that would otherwise be passive but is excluded from passive category income under § 1.904–5(b)(1) or that is assigned to a separate category other than passive category income under § 1.904–5(c)(4)(iii). See also paragraph (k) of this section for rules relating to income resourced under a tax treaty. * * *

* * * * *

(iv) *Examples.* The following examples illustrate the application of this paragraph (b)(2).

(A) *Example 1.* For Year 1, USP, a domestic corporation, has a net foreign currency gain that would not constitute foreign personal holding company income if USP were a controlled foreign corporation because the gain is directly related to the business needs of USP. See section 954(c)(1)(D). Under paragraph (b)(2)(i)(A) of this section, the foreign currency gain is, therefore, not passive category income to USP because it is not income of a kind that would be foreign personal holding company income.

(B) *Example 2.* Controlled foreign corporation, CFC, is a wholly-owned subsidiary of USP, a domestic corporation. CFC is regularly engaged in the restaurant franchise business. USP licenses trademarks, tradenames, certain know-how, related services, and certain restaurant designs for which CFC pays USP an arm's length royalty. USP is regularly engaged in the development and licensing of such property. Some of the franchisees are unrelated to CFC and USP. Other franchisees are related to CFC or USP and use the licensed property outside of CFC's country of incorporation. CFC does not satisfy, but USP does satisfy, the active trade or business requirements of section 954(c)(2)(A). The royalty income earned by CFC from both its related and unrelated franchisees is foreign personal holding company income because CFC does not satisfy the active trade or business requirements of section 954(c)(2)(A) and, in addition, the royalty income from the related franchisees does not qualify for the same country exception of section 954(c)(3) or the look-through exception in section 954(c)(6). However, all of the royalty income earned by CFC is general category income to CFC under § 1.904–4(b)(2)(iii) because USP, a member of CFC's affiliated group, satisfies the active trade or business test (which is applied without regard to whether the royalties are paid by a related person). USP's inclusion under section 951(a)(1)(A) of CFC's royalty income is general category income to USP under § 1.904–5(c)(5) and paragraph (d) of this section. The royalties received by USP are general category income to USP under § 1.904–5(b)(1) and paragraph (d) of this section.

* * * * *

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

(2) * * *

(iii) *Coordination with section 904(b), (f) and (g).* The determination of whether foreign source passive income is high-taxed is made before taking into account any adjustments under section 904(b) or any allocation or recapture of a separate limitation loss, overall foreign loss, or overall domestic loss under section 904(f) and (g).

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

* * * * *

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

and all amounts of passive income received or accrued by a United States person through a foreign QBU. The grouping rules of paragraphs (c)(3)(i) through (iv) of this section apply separately to dividends, to inclusions under section 951(a)(1) and to inclusions under section 951A(a) with respect to each controlled foreign corporation of which the taxpayer is a United States shareholder, and to dividends with respect to each noncontrolled 10-percent owned foreign corporation of which the taxpayer is a United States shareholder that is a domestic corporation. The grouping rules of paragraphs (c)(3)(i) through (iv) of this section also apply separately to income attributable to each foreign QBU of a controlled foreign corporation, noncontrolled 10-percent owned foreign corporation, any other look-through entity as defined in § 1.904–5(i), or any United States person.

(5) * * *

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

* * * * *

(iii) * * *

(C) *Example.* The following example illustrates the application of this paragraph (c)(5)(iii).

(*1*) *Facts.* USP, a domestic corporation, owns all of the stock of CFC, a controlled foreign corporation organized and operating in Country X that uses the ''u'' as its functional currency. In Year 1, when the highest rate of U.S. tax in section 11 is 21%, CFC earns 100u of passive category foreign personal holding company income subject to no foreign tax. When included in USP's income under section 951(a), the applicable exchange rate is 1u=$1x. Therefore, USP's section 951(a) inclusion is $100x and no foreign taxes are deemed paid by USP with respect to the inclusion. At the end of Year 1, CFC has previously taxed earnings and profits of 100u and USP's basis in those earnings is $100x. In Year 2, CFC has no earnings and profits and distributes 100u to USP. The value of the earnings when distributed is $150x. Assume that under section 986(c), USP must recognize $50x of passive category income attributable to the appreciation of the previously taxed earnings and profits. Country X does not recognize any gain or loss on the distribution, but imposes a 10u withholding tax on USP with respect to the distribution.

(*2*) *Analysis.* Because the section 986(c) gain is not subject to any foreign withholding tax or other foreign tax, under paragraph (c)(3)(iii) of this section the section 986(c) gain is grouped with other items of USP's income that are subject to no withholding tax or other foreign tax. Under paragraph (c)(6)(iii) of this section, the 10u withholding tax is related to passive category income. See section 960(c) and § 1.960–4 for rules relating to the increase in limitation in the year of distribution of previously taxed earnings and profits.

* * * * *

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

* * * * *

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

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

(7) * * * (i) * * * If the inclusion is considered to be high-taxed income, then the taxpayer treats the inclusion as general category income, section 951A category income, or income in a specified separate category as provided in paragraph (c)(1) of this section. * * * For purposes of this paragraph (c)(7)(i), 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. * * *

* * * * *

(8) *Examples.* The following examples illustrate the application of this paragraph (c). All of the examples assume that the highest tax rate under section 11 is 21%, unless otherwise noted.

(i) *Example 1.* CFC, a controlled foreign corporation, is a wholly-owned subsidiary of domestic corporation USP. CFC is a single qualified business unit (QBU) operating in foreign Country X. In Year 1, CFC earns $130x of gross royalty income that is passive income from Country X sources, and incurs $30x of expenses that do not include any payments to USP. CFC's $100x of pre-tax passive income from the royalty is subject to $30x of foreign tax, and is included under section 951(a)(1) in USP's gross income for the taxable year. USP allocates $50x of expenses to the $100x (consisting of the $70x section 951(a)(1) inclusion and $30x section 78 amount), resulting in net passive income of $50x. USP does not elect to exclude from subpart F under section 954(b)(4) the $70x of CFC's net passive income. After application of the high-tax kick-out rules of paragraph (c) of this section, the $50x of USP's net passive income is treated as general category income, and the $30x of taxes deemed paid are treated as taxes imposed on general category income, because the foreign taxes paid and deemed paid on the income exceed the highest U.S. tax rate multiplied by the $50x of net passive income ($30x > $10.5x (21% × $50x)).

(ii) *Example 2.* CFC, a controlled foreign corporation, is a wholly-owned subsidiary of domestic corporation USP. CFC is incorporated and operating in Country Y and has a branch in Country Z. CFC has two QBUs (QBU Y and QBU Z). In Year 1, CFC earns $65x of gross royalty income that is passive income in Country Y through QBU Y and $65x of gross royalty income that is passive income in Country Z through QBU Z. CFC allocates $15x of expenses to the gross royalty income earned by each QBU, resulting in pre-tax passive income of $50x in each QBU. Country Y imposes $5x of foreign tax on the royalty income earned in Y, and Country Z imposes $10x of tax on royalty income earned in Z. All of CFC's income constitutes foreign personal holding company income that is passive income and is included under section 951(a)(1) in USP's gross income for the taxable year. USP allocates $50x of expenses pro rata to the $100x section 951(a)(1) inclusion attributable to the QBUs (consisting of the $45x section 951(a)(1) inclusion derived through QBU Y, the $5x section 78 amount attributable to QBU Y, the $40x section 951(a)(1) inclusion derived through QBU Z, and the $10x section 78 amount attributable to QBU Z), resulting in net passive income of $50x. Pursuant to paragraph (c)(4) of this section, the high-tax kickout rules must be applied separately to the subpart F inclusion attributable to the income earned by QBU Y and the income earned by QBU Z. After application of the high-tax kickout rules, the $25x of net passive income attributable to QBU Y will be treated as passive category income because the foreign taxes paid and deemed paid on the income do not exceed the highest U.S. tax rate multiplied by the $25x of net passive income ($5x < $5.25x (21% × $25x)). The $25x of net passive income attributable to QBU Z will be treated as general category income because the foreign taxes paid and deemed paid on the income exceed the highest U.S. tax rate multiplied by the $25x of net passive income ($10x > $5.25x (21% × $25x)).

(iii) *Example 3.* Domestic corporation USP operates in branch form in foreign countries X and Y. The branches are qualified business units (QBUs), within the meaning of section 989(a). In Year 1, QBU X earns passive royalty income, interest income, and rental income. All of the QBU X passive income is from Country Z sources. The royalty income is not subject to a withholding tax, and is not taxed by Country X, and the interest and the rental income are subject to a 4% and 10% withholding tax, respectively. QBU Y earns interest income in Country Y that is not subject to foreign tax. For purposes of determining whether USP's foreign source passive income is high-taxed income, the rental income and the interest income earned in QBU X are treated as one item of income pursuant to paragraph (c)(3)(ii) of this section. The interest income earned in QBU Y and the royalty income earned in QBU X are each treated as a separate item of income under paragraphs (c)(4) and (c)(3)(iii) of this section. If, after allocation of expenses, QBU X's items of income composed of rental income and interest income are high-taxed income, the income may be treated as foreign branch category income.

(iv) *Example 4.* CFC, a controlled foreign corporation incorporated in foreign Country R, is a wholly-owned subsidiary of USP, a domestic corporation. USP and CFC have calendar year taxable years for both U.S. and Country R tax purposes. The highest tax rate under section 11 is 34% and 21% in Year 1 and Year 2, respectively. For Year 1, USP is required under section 951(a)(1) to include in gross income $80x (not including the section 78 amount) attributable to the earnings and profits of CFC for such year, all of which is foreign personal holding company income that is passive rent or royalty income. CFC does not make any distributions in Year 1. Foreign income taxes paid by CFC for Year 1 that are deemed paid by USP for such year under section 960(a) with respect to the section 951(a)(1) inclusion equal $20x. USP properly allocates $30x of expenses to the section 951(a)(1) inclusion. The foreign income tax paid with respect to the section 951(a)(1) inclusion does not exceed the highest U.S. tax rate multiplied by the amount of income after allocation of USP's expenses ($20x < $23.80x (34% × $70x)). Thus, USP's section 951(a)(1) inclusion for Year 1 is included in USP's passive category income and the $20x of taxes attributable to that inclusion are treated as taxes related to passive category income. In Year 2, CFC distributes $70x to USP, and under section 959 that distribution is treated as attributable to the earnings and profits with respect to the amount included in income by USP in Year 1 and is excluded from USP's gross income. Foreign Country R imposes a withholding tax of $14x on the distribution in Year 2. Under paragraph (c)(6)(i) of this section, the withholding tax in Year 2 does not affect the characterization of the Year 1 inclusion as passive category income, nor does it affect the characterization of the $20x of taxes paid in Year 1 as taxes paid with respect to passive category income. No further expenses of USP are allocable to the receipt of that distribution. In Year 2, the foreign taxes paid ($14x) exceed the product of the highest U.S. tax rate and the amount of the inclusion reduced by taxes deemed paid in the year of inclusion ($14x > $3.80x ((34% × $70x) − $20x)). Thus, under paragraph (c)(6)(iii) of this section, $3.80x ((34% × $70x) − $20x) of the $14x withholding tax paid in Year 2 is treated as taxes related to passive category income and the remaining $10.20x ($14x − $3.80x) of the withholding tax is treated as related to general category income.

(v) through (viii) [Reserved]

(ix) *Example 9.* USP, a domestic corporation, earns $100x of passive royalty income from sources within the United States. Under the laws of Country X, however, that royalty is considered to be from sources within Country X, and Country X imposes a 5% withholding tax on the payment of the royalty. USP also earns $100x of foreign source passive dividend income from Country Y subject to a 10% withholding tax to which $15x of expenses are allocated. In determining whether USP's passive income is high-taxed, the $5x withholding tax on USP's royalty income is allocated to passive income, and to the group of passive income described in paragraph (c)(3)(ii) of this section (passive income subject to a withholding tax of less than 15% (but greater than zero)). For purposes of determining whether the income is high-taxed, however, only the $85x of foreign source dividend income (and not the $100x of U.S. source royalty income) is taken into account. The foreign source dividend income is treated as passive category income because the foreign taxes paid on the passive income in the group ($15x) do not exceed the highest U.S. tax rate multiplied by the $85x of net foreign source income in the group ($15x < $17.85x ($100x − $15x) × 21%).

(x) *Example 10.* In Year 1, P, a U.S. citizen with a tax home in Country X, earns the following items of gross income: $400x of foreign source, passive interest income not subject to foreign withholding tax but subject to Country X income tax of $100x, $200x of foreign source, passive royalty income subject to a 5% foreign withholding tax (foreign tax paid is $10x), $1,300x of foreign source, passive rental income subject to a 25% foreign withholding tax (foreign tax paid is $325x), $500x of foreign source, general category loss, and $2,000x of U.S. source capital gain that is not subject to any foreign tax. P has a $900x deduction allocable to its passive rental income. P's only other deduction is a $700x capital loss on the sale of stock that is allocated to foreign source passive category income under § 1.865–2(a)(3)(i). The $700x capital loss is initially allocated to the group of passive income described in paragraph (c)(3)(iv) of this section (passive income subject to no withholding tax but subject to foreign tax other than withholding tax). This group comprises the $400x of interest income not subject to foreign withholding tax but subject to Country X income tax. Under paragraph (c)(2)(ii) of this section, the $300x amount by which the capital loss exceeds the income in the group must be reallocated to the net income in the other groups described in paragraph (c)(3) of this section, but the $500x general category separate limitation loss is not allocated until the high-tax kickout rules are applied to determine whether the passive income is high-taxed income. P's $200x of royalty income subject to a 5% withholding tax is described in paragraph (c)(3)(i) of this section (passive income that is subject to a withholding tax of less than 15%, but greater than zero). P's $1,300x of rental income subject to a 25% withholding tax is described in paragraph (c)(3)(ii) of this section (passive income that is subject to a withholding tax of 15% or greater). The $1,300x of rental income is reduced by the $900x deduction allocable to such income. Therefore, the total net income in the other groups under paragraph (c)(3) is $600x, the $200x of royalty income and the $400x of rental income. The ($300x) net loss in the net basis tax group thus reduces the royalty income by $100x to $100x ($200x − ($300x × (200x/600x))) and the rental income by $200x to

$200x ($400x − ($300x × (400x/600x))). The $100x of net royalty income is not high-taxed and remains passive category income because the foreign taxes of $10x do not exceed the highest U.S. rate of tax on that income, which is 37% for individuals ($10x < $37x (37% × $100x)). Under the high-tax kickout, the $200x of rental income and the $325x of associated foreign tax are assigned to the general category.

(xi) *Example 11.* The facts are the same as in paragraph (c)(8)(x) of this section (the facts in *Example 10*), except the amount of the capital loss that is allocated under § 1.865–2(a)(3)(i) and paragraph (c)(2) of this section to the group of foreign source passive income subject to no withholding tax but subject to foreign tax other than withholding tax is $1,200x. Under paragraph (c)(2)(ii) of this section, the excess deductions of $800x must be reallocated to the $200x of net royalty income subject to a 5% withholding tax and the $400x of net rental income subject to a 15% or greater withholding tax. The income in each of these groups is reduced to zero, and the foreign taxes imposed on the rental and royalty income are considered related to general category income. The remaining loss of $200x constitutes a separate limitation loss with respect to passive category income.

(xii) *Example 12.* In Year 1, USP, a domestic corporation, earns a $100x dividend that is foreign source passive income subject to a 30% withholding tax. The dividend is not paid by a specified 10-percent owned foreign corporation (as defined in section 245A(b)(1)). A foreign tax credit for the withholding tax on the dividend is disallowed under section 901(k). A deduction for the tax is allowed, however, under sections 164 and 901(k)(7). In determining whether USP's passive income is high-taxed, under paragraph (c)(3) of this section the $100x dividend and the $30x deduction are allocated to the group of income described in paragraph (c)(3)(iv) of this section (passive income subject to no withholding tax or other foreign tax).

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

(e) * * * (1) *In general*—(i) *Treatment of financial services income.* Passive income that is characterized as financial services income is not assigned to the passive category but is assigned in accordance with this paragraph (e)(1)(i). Financial services income that meets the definition of foreign branch category income (see paragraph (f)(1) of this section) is treated as income in that category. Financial services income of a controlled foreign corporation that is included in gross income of a United States shareholder under section 951A(a) is treated as section 951A category income in the hands of the United States shareholder. Financial services income that is neither treated as foreign branch category income nor treated as section 951A category income is treated as general category income. Distributions, interest, rents, or royalties received from a related person that is a financial services entity that would be assigned to the passive category under the look-through rules in § 1.904–5, but for the fact such amounts are paid by a financial services entity (and, therefore, not attributable to passive category income of the payor), are assigned to separate categories (other than the passive category) under the rules in this section.

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

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

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

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

* * * * *

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

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

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

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

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

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

(ii) *Income attributable to U.S. activities.* Except as provided in paragraph (f)(2)(vi) of this section, gross income attributable to a foreign branch does not include items arising from activities carried out in the United States, regardless of whether the items are reflected on the foreign branch's separate books and records.

(iii) *Income arising from stock*—(A) *In general.* Except as provided in paragraph (f)(2)(iii)(B) of this section, gross income attributable to a foreign branch does not include items of income arising from stock of a corporation (whether foreign or domestic), including gain from the disposition of such stock or any inclusion under sections 951(a), 951A(a), 1248, or 1293(a).

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

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

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

(*1*) Directly engages in the same, or a related, trade or business as that partnership, other pass-through entity, or disregarded entity; and

(*2*) In the case of a partnership or other pass-through entity, the foreign branch owns 10 percent or more of the capital or profits interests in the partnership or other pass-through entity.

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

(vi) *Attribution of gross income to which disregarded payments are allocable*—(A) *In general.* If a foreign branch makes a disregarded payment to its foreign branch owner and the disregarded payment is allocable to gross income that would be attributable to the foreign branch under the rules in paragraphs (f)(2)(i) through (v) of this section, the gross income attributable to the foreign branch is adjusted downward to reflect the allocable amount of the disregarded payment, and the gross income attributable to the foreign branch owner is adjusted upward by the same amount, translated (if necessary) from the foreign branch's functional currency to U.S. dollars at the spot rate (as defined in § 1.988–1(d)) on the date of the disregarded payment. For rules addressing multiple disregarded payments in a taxable year, see paragraph (f)(2)(vi)(F) of this section. Similarly, if a foreign branch owner makes a disregarded payment to its foreign branch and the disregarded payment is allocable to gross income attributable to the foreign branch owner, the gross income attributable to the foreign branch owner is adjusted downward to reflect the allocable amount of the disregarded payment, and the gross income attributable to the foreign branch is adjusted upward by the same amount, translated (if necessary) from U.S. dollars to the foreign branch's functional currency at the spot rate on the date of the disregarded payment. An adjustment to the attribution of gross income under this paragraph (f)(2)(vi) does not change the total amount, character, or source of the United States person's gross income; does not change the amount of a United States person's income in any separate category other than the foreign branch and general categories (or a specified separate category associated with the foreign branch and general categories); and has no bearing on the analysis of whether an item of gross income is eligible to be resourced under an income tax treaty. The principles of the rules in this paragraph (f)(2)(vi)(A) also apply in the case of disregarded payments between a foreign branch and another foreign branch with the same foreign branch owner if either foreign branch makes a disregarded payment to, or receives a disregarded payment from, the foreign branch owner.

(B) *Allocation of disregarded payments*—(*1*) *In general.* Except as provided in paragraph (f)(2)(vi)(B)(*2*) of this section, whether a disregarded payment is allocable to gross income attributable to a foreign branch or gross income attributable to its foreign branch owner, and the source and separate category of the gross income to which the disregarded payment is allocable, is determined under the following rules:

(*i*) Disregarded payments from a foreign branch owner to its foreign branch are allocable to gross income attributable to the foreign branch owner to the extent a deduction for that payment or any disregarded cost recovery deduction relating to that payment, if regarded, would be allocated and apportioned to gross income attributable to the foreign branch owner under the principles of §§ 1.861–8 through 1.861–14T and 1.861–17 (without regard to exclusive apportionment) by treating foreign source gross income and U.S. source gross income in each separate category (determined prior to the application of this paragraph (f)(2)(vi) to the disregarded payment at issue) each as a statutory grouping; and

(*ii*) Disregarded payments from a foreign branch to its foreign branch owner are allocable to gross income attributable to the foreign branch to the extent a deduction for that payment or any disregarded cost recovery deduction relating to that payment, if regarded, would be allocated and apportioned to gross income attributable to the foreign branch under the principles of §§ 1.861–8 through 1.861–14T and 1.861–17 (without regard to exclusive apportionment) by treating foreign source gross income and U.S. source gross income in each separate category (determined prior to the application of this paragraph (f)(2)(vi) to the disregarded payment at issue) each as a statutory grouping.

(*2*) *Special rule for certain disregarded payments.* Whether a disregarded payment made in connection with a sale or exchange of property is allocable to gross income attributable to a foreign branch or its foreign branch owner, and the source and separate category of the gross income to which the disregarded payment is allocable, is determined under the following rules:

(*i*) Except as provided in paragraph (f)(2)(vi)(D) of this section, disregarded payments from a foreign branch owner to its foreign branch in respect of non-inventory property are allocable to the gross income attributable to the foreign branch owner, if any, that is recognized with respect to a regarded sale or exchange of that property (including gross income arising in a later taxable year) to the extent of the adjusted disregarded gain with respect to the transferred property, and in the same proportions as the source and separate category of the gain recognized on the regarded sale or exchange of the transferred property;

(*ii*) Except as provided in paragraph (f)(2)(vi)(D) of this section, disregarded payments from a foreign branch to its foreign branch owner or to another foreign branch in respect of non-inventory property are allocable to the gross income attributable to the foreign branch, if any, that is recognized with respect to a regarded sale or exchange of that property (including gross income arising in a later taxable year) to the extent of the adjusted disregarded gain with respect to the transferred property, and in the same proportions as the source and separate category of the gain recognized on the regarded sale or exchange of the transferred property; and

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

(*3*) *Timing of reattribution*—(*i*) *In general.* The gross income attributable to the foreign branch is adjusted under paragraph (f)(2)(vi)(B)(*1*) of this section only in the taxable year that a disregarded payment, if regarded, would be allowed as a deduction (including by giving rise to disregarded cost recovery deductions), or otherwise would be taken into account as an increase to cost of goods sold.

(*ii*) *Disregarded sales of property.* The gross income attributable to a foreign branch is adjusted under paragraph (f)(2)(vi)(B)(*2*) of this section only in the taxable year or years in which gain is recognized by reason of the disposition of property with an adjusted disregarded basis in a transaction that is regarded for Federal income tax purposes.

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

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

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

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

(*4*) Any disregarded payment that, if made to a foreign branch and regarded for Federal income tax purposes, could not result in the attribution of gross income to a foreign branch (for example, the sale of an interest in a partnership by a foreign branch to its foreign branch owner, unless the sale or exchange occurred in the ordinary course of business within the meaning of paragraph (f)(2)(iv)(B) of this section).

(D) *Certain transfers of intangible property*—(*1*) *In general.* For purposes of applying this paragraph (f)(2)(vi), the amount of gross income attributable to a foreign branch (and the amount of gross income attributable to its foreign branch owner) must be adjusted under the principles of paragraph (f)(2)(vi)(B) of this section to reflect all transactions that are disregarded for Federal income tax purposes in which property described in section 367(d)(4) is transferred to or from a foreign branch or between foreign branches, whether or not a disregarded payment is made in connection with the transfer. In determining the amount of gross income that is attributable to a foreign branch that must be adjusted by reason of this paragraph (f)(2)(vi)(D), the principles of sections 367(d) and 482 apply. For example, if a foreign branch owner transfers property described in section 367(d)(4) to a foreign branch, the principles of section 367(d) are applied by treating the foreign branch as a separate foreign corporation to which the property is transferred in exchange for stock of the corporation in a transaction described in section 351. Similarly, if a foreign branch remits property described in section 367(d)(4) to its foreign branch owner, the foreign branch is treated as having sold the transferred property to the foreign branch owner in exchange for annual payments contingent on the productivity or use of the property, the amounts of which are determined under the principles of section 367(d).

(*2*) *Transactions occurring before December 7, 2018.* Paragraph (f)(2)(vi)(D)(*1*) of this section does not apply to a disregarded transfer of property that occurred before December 7, 2018.

(*3*) *Transitory ownership*—(*i*) *In general.* Paragraph (f)(2)(vi)(D)(*1*) of this section does not apply to disregarded transfers of property by a foreign branch or a foreign branch owner (such foreign branch or foreign branch owner, the *limited transferor*), if the conditions in paragraphs (f)(2)(vi)(D)(*3*)(*ii*) and (*iii*) of this section are met.

(*ii*) *Transitory ownership period.* The limited transferor's ownership of the property is transitory.

(*iii*) *Use of property.* The limited transferor does not develop, exploit, or otherwise employ the property in a trade or business, other than in the ordinary course of the limited transferor's business during the period of transitory ownership.

(*iv*) *Predecessors.* For purposes of paragraphs (f)(2)(vi)(D)(*3*)(*ii*) and (*iii*) of this section, a reference to a limited transferor that is a foreign branch owner includes any predecessor to the foreign branch owner. No person is a predecessor with respect to a foreign branch under this paragraph (f)(2)(vi)(D)(*3*)(*iv*).

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

(F) *Multiple disregarded payments.* In the case of multiple disregarded payments, this paragraph (f)(2)(vi) is applied with respect to each disregarded payment, and under the ordering rules specified in paragraphs (f)(2)(vi)(F)(*1*) and (*2*) of this section. For purposes of this paragraph (f)(2)(vi), paragraph (f)(2)(vi)(F)(*1*) of this section applies before paragraph (f)(2)(vi)(F)(*2*) of this section.

(*1*) *Income initially attributable to a foreign branch.* In applying this paragraph (f)(2)(vi) to gross income that would, but for this paragraph (f)(2)(vi), be attributable to a foreign branch, adjustments related to disregarded payments from a foreign branch to another foreign branch are computed first, followed by adjustments related to disregarded payments from a foreign branch to its foreign branch owner, followed by adjustments related to disregarded payments from a foreign branch owner to its foreign branch.

(*2*) *Income initially attributable to a foreign branch owner.* In applying this paragraph (f)(2)(vi) to gross income that would, but for this paragraph (f)(2)(vi), be attributable to a foreign branch owner, adjustments related to disregarded payments from a foreign branch owner to a foreign branch are computed first, followed by adjustments related to disregarded payments from a foreign branch to another foreign branch, followed by adjustments related to disregarded payments from a foreign branch to its foreign branch owner.

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

(i) *Adjusted disregarded basis.* The term *adjusted disregarded basis* means, with respect to property transferred in a transaction that is disregarded for Federal income tax purposes, the tentative disregarded basis of the property—

(A) Reduced by any disregarded cost recovery deductions with respect to the property; and

(B) Increased by any disregarded section 1016(a)(1) expenditures with respect to the property.

(ii) *Adjusted disregarded gain*—(A) *In general.* The term *adjusted disregarded gain* means, with respect to property transferred in a transaction that is disregarded for Federal income tax purposes, the lesser of—

(*1*) The adjusted disregarded basis of the property, reduced by the adjusted basis of the property at the time the property was transferred in a transaction that is disregarded for Federal income tax purposes; and

(*2*) The gain (if any) attributable to a regarded sale or exchange of the transferred property.

(B) *Limitation.* Adjusted disregarded gain may not be less than zero.

(iii) *Disregarded cost recovery deduction.* For a taxable year, the term *disregarded cost recovery deduction* means, with respect to property transferred in a transaction that is disregarded for Federal income tax purposes—

(A) The amounts that would be allowed as a deduction, and that would give rise to an adjustment described in section 1016(a)(2), with respect to the transferred property if the transfer (and the foreign branch) were regarded for Federal income tax purposes, to the extent that, under paragraph (f)(2)(vi)(B)(*1*) of this section, the deduction would be allocable to—

(*1*) Gross income attributable to a foreign branch owner, in the case of property transferred to a foreign branch owner; or

(*2*) Gross income attributable to a foreign branch, in the case of property transferred to a foreign branch; reduced by

(B) The amounts that are allowed as a deduction, and that give rise to an adjustment described in section 1016(a)(2), with respect to the transferred property to the extent that, under the principles of paragraph (f)(2)(vi)(B)(*1*) of this section, the deduction would be allocable to—

(*1*) Gross income attributable to a foreign branch owner, in the case of property transferred to a foreign branch owner; or

(*2*) Gross income attributable to a foreign branch, in the case of property transferred to a foreign branch.

(iv) *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.

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

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

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

(vi) *Disregarded section 1016(a)(1) expenditure.* The term *disregarded section 1016(a)(1) expenditure* means a disregarded payment that, if regarded for Federal income tax purposes, would be described in section 1016(a)(1) and that, under the principles of paragraph (f)(2)(vi)(B)(*1*) of this section, would be allocable to—

(A) General category gross income, in the case of property held by a foreign branch owner; or

(B) Foreign branch category income, in the case of property held by a foreign branch.

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

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

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

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

(*ii*) Comprise a foreign branch.

(*2*) *Separate set of books and records.* A foreign branch described in this paragraph (f)(3)(vii)(C) is treated as maintaining a separate set of books and records with respect to the activities described in paragraph (f)(3)(vii)(C)(*1*) of this section, and must determine, as the context requires, the items of gross income, disregarded payments, and any other items that would be reflected on those books and records in applying this paragraph (f) with respect to the foreign branch. The principles of § 1.1503(d)–5(c) apply for purposes of determining which items would be reflected on such books and records.

(viii) *Foreign branch owner.* The term *foreign branch owner* means, with respect to a foreign branch, the person (including a foreign or domestic partnership or other pass-through entity) that owns the foreign branch, either directly or indirectly through one or more disregarded entities. For purposes of this paragraph (f)(3)(viii), the foreign branch owner does not include the foreign branch or another foreign branch of the person that owns the foreign branch.

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

(x) *Tentative disregarded basis.* The term *tentative disregarded basis* means, in connection with the transfer of property in a transaction that is disregarded for Federal income tax purposes, the basis that property would have if the disregarded payment made in exchange for the transferred property were treated as the cost of such property under section 1012(a).

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

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

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

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

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

(*2*) Country B Business's activities comprise a trade or business outside the United States within the meaning of § 1.989(a)–1(b)(2)(ii)(A) and (b)(3) (in each case, as modified by paragraph (f)(3)(vii) of this section). PRS maintains a separate set of books and records with respect to the Country B Business, as described in § 1.989(a)–1(b)(2)(ii)(B). Thus, for purposes of this section, the activities of the Country B Business constitute a QBU as defined in § 1.989–1(b)(2)(ii) and (b)(3), as modified by paragraph (f)(3)(vii) of this section, that conducts a trade or business outside the United States. Accordingly, the activities of the Country B Business constitute a foreign branch within the meaning of paragraph (f)(3)(vii) of this section. Under paragraph (f)(3)(viii) of this section, PRS, the person that owns the Country B Business indirectly through FDE1 (a disregarded entity), is the foreign branch owner with respect to the Country B Business.

(*3*) The same analysis that applies to the Country B Business applies to the Country C Business. Accordingly, the activities of the Country C Business constitute a foreign branch within the meaning of paragraph (f)(3)(vii) of this section. PRS, the person that owns the Country C Business indirectly through FDE1 and FDE2 (disregarded entities), is the foreign branch owner with respect to the Country C Business.

(ii) *Example 2: Sale of foreign branch*—(A) *Facts.* The facts are the same as in paragraph (f)(4)(i)(A) of this section (the facts in *Example 1*), except that in Year 1, FDE1 sells FDE2 to an unrelated person, recording gain from the sale on its books and records. In Year 2, PRS sells FDE1 to another unrelated person, recording gain from the sale on its books and records. In each year, PRS allocates a portion of the gain to P.

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

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

(iii) *Example 3: Disregarded payment for services*—(A) *Facts.* P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch within the meaning of paragraph (f)(3)(vii) of this section. FDE's functional currency is the U.S. dollar. In Year 1, P accrues and records on its books and records (and not FDE's books and records) $1,000x of gross income from the performance of services to unrelated parties that is not passive category income, $400x of which is foreign source income in respect of services performed outside the United States by employees of FDE and $600x of which is U.S. source income in respect of services performed in the United States. Absent the application of paragraph (f)(2)(vi) of this section, the $1,000x of gross income earned by P would be general category income that would not be attributable to FDE. FDE provides services in support of P's gross income from services. P compensates FDE for its services with an arm's length payment of $400x, which is disregarded for Federal income tax purposes. The deduction for the payment of $400x from P to FDE would be allocated to P's $1,000x of general category gross services income and apportioned entirely to the $400x of foreign source services income under §§ 1.861–8 and 1.861–8T principles (treating foreign source general category gross income and U.S. source general category gross income each as a statutory grouping) if the payment were regarded for Federal income tax purposes.

(B) *Analysis.* The disregarded payment from P, a United States person, to FDE, its foreign branch, is not recorded on FDE's separate books and records (as adjusted to conform to Federal income tax principles) within the meaning of paragraph (f)(2)(i) of this section because it is disregarded for Federal income tax purposes. However, the disregarded payment is allocable to gross income attributable to P because a deduction for the payment, if it were regarded, would be allocated and apportioned to the $400x of P's foreign source services income. Accordingly, under paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*3*) of this section, the amount of gross income attributable to the FDE foreign branch (and the gross income attributable to P) is adjusted in Year 1 to take the disregarded payment into account. As such, $400x of P's foreign source gross income from the performance of services is attributable to the FDE foreign branch for purposes of this section. Therefore, $400x of the foreign source gross income that P earned with respect to its services in Year 1 constitutes gross income that is assigned to the foreign branch category.

(iv) *Example 4: Disregarded payment for non-inventory property*—(A) *Facts.* P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch within the meaning of paragraph (f)(3)(vii) of this section. FDE's functional currency is the U.S. dollar. P holds Asset A, a non-depreciable asset, with an adjusted basis of $200x. In Year 1, P sells Asset A, which will be used in FDE's manufacturing business, to FDE for $500x. FDE makes no other disregarded payments with respect to Asset A. No adjustments described in section 1016(a) apply with respect to Asset A while FDE holds Asset A. In Year 3, FDE sells Asset A to a third party for $600x and reflects $400x of gross income on its separate set of books and records (that is, $600x amount realized less Asset A's $200x adjusted basis). Under sections 865(e)(1) and 904(d)(2)(B)(i), the income arising from the sale of Asset A is foreign source income that is not treated as passive category income. Asset A is not inventory property. Absent the application of paragraph (f)(2)(vi) of this section, the entire $400x of gross income earned by P by reason of FDE's sale of Asset A would be attributable to FDE and be treated as foreign branch category income.

(B) *Analysis*—(*1*) *Disregarded basis determinations.* If regarded, the $500x payment from FDE to P would result in FDE holding Asset A with a basis of $500x under section 1012. Accordingly, the tentative disregarded basis (within the meaning of paragraph (f)(3)(x) of this section) with respect to Asset A is $500x. Because there are no adjustments described in section 1016 with respect to Asset A (including any adjustments resulting from any disregarded payments made with respect to the transferred property), the adjusted disregarded basis (within the meaning of paragraph (f)(3)(i) of this section) with respect to Asset A is $500x.

(*2*) *Adjusted disregarded gain.* Under paragraph (f)(3)(ii) of this section, the adjusted disregarded gain with respect to Asset A is $300x, which is equal to the lesser of $300x (FDE's adjusted disregarded basis in Asset A ($500x) less the adjusted basis of Asset A at the time that Asset A was transferred to FDE ($200x)) and $400x (the gain (if any) attributable to the regarded sale or exchange of Asset A).

(*3*) *Attribution of gross income.* Under paragraph (f)(2)(vi)(A) of this section, the gross income attributable to FDE ($400x) is adjusted downward to the extent that the $500x disregarded payment from FDE to P is allocable to gross income of FDE that is reflected on FDE's separate set of books and records. Under paragraph (f)(2)(vi)(B)(*2*)(*ii*) of this section, the $500x payment from FDE to P is allocable to gross income attributable to FDE to the extent of FDE's adjusted disregarded gain ($300x) with respect to Asset A. The source and separate category of the gross income of FDE to which the payment is allocable is proportionate to the source and separate category of the gain recognized by FDE with respect to Asset A. Accordingly, $300x of the payment is allocable to foreign source income that would be foreign branch category income. Thus, under paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*3*) of this section, foreign source gross income attributable to P is adjusted upward by $300x (increasing foreign source general category income by $300x) and foreign source gross income attributable to FDE is adjusted downward by $300x (decreasing foreign source foreign branch category income by $300x) in Year 3.

(v) *Example 5: Disregarded payment for depreciable non-inventory property*—(A) *Facts.* The facts are the same as in paragraph (f)(4)(iv)(A) of this section (the facts in *Example 4*), except as set forth in this paragraph (f)(4)(v)(A). Asset A is depreciable property. In Year 2, P is entitled to a $20x depreciation deduction with respect to Asset A, $18x of which is allocated and apportioned to non-passive category gross income attributable to FDE under §§ 1.861–8 through 1.861–14T and $2x of which is allocated and apportioned to passive category gross income under §§ 1.861–8 through 1.861–14T. If the transfer of Asset A were regarded for Federal income tax purposes, FDE would be entitled to a $50x depreciation deduction, 90% of which would be allocated and apportioned to non-passive category gross income attributable to FDE under §§ 1.861–8 through 1.861–14T and 10% of which would be allocated and apportioned to passive category gross income under §§ 1.861–8 through 1.861–14T. In Year 2, FDE earns $315x of gross income that it reflects on its books and records that, in the absence of paragraph (f)(2)(vi) of this section, would be foreign branch category income. FDE also earns $35x of passive category income in Year 2 from the non-active rental of a portion of Asset A. In Year 3, FDE reflects $420x of gross income on its separate set of books and records by reason of the sale of Asset A (that is, $600x amount realized less Asset A's $180x adjusted basis), $42x of which is passive category income under paragraph (b) of this section.

(B) *Analysis*—(*1*) *Attribution of gross income in Year 2.* The disregarded payment from FDE to P in Year 1 is disregarded for Federal income tax purposes, and does not generate gross income. However, under paragraph (f)(2)(vi)(B)(*1*)(*ii*) of this section, the disregarded payment is allocable to gross income attributable to FDE to the extent of any disregarded cost recovery deduction relating to that payment in Year 2. Under paragraph (f)(3)(iii) of this section, the disregarded cost recovery deduction with respect to Asset A is $30x, which is $50x (the amount that would be allowed as a deduction, and that would give rise to an adjustment described in section 1016(a)(2), with respect to Asset A if the transfer of Asset A to FDE were regarded for Federal income tax purposes, to the extent that the deduction would be allocable to income attributable to a foreign branch), reduced by $20x (the amount allowed as a deduction, and that gives rise to an adjustment described in section 1016(a)(2), with respect to Asset A, to the extent allocable to income attributable to a foreign branch). If regarded, $27x (90% of $30x) of the disregarded cost recovery deduction would be allocated and apportioned to non-passive category gross income attributable to FDE under §§ 1.861–8 through 1.861–14T and $3x (10% of $30x) would be allocated and apportioned to passive category gross income under §§ 1.861–8 through 1.861–14T. Accordingly, under paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*3*) of this section, the $315x of non-passive category gross income that would otherwise be attributed to FDE is reduced to $288x ($315x less $27x), and the non-passive category gross income attributable to P is increased by $27x in Year 2. As a result, in Year 2, P's foreign branch category gross income is $288x, and its general category gross income is increased by $27x. P's passive category gross income is $35x. *See* paragraphs (f)(1)(ii) and (f)(2)(vi)(A) of this section.

(*2*) *Attribution of gross income in Year 3*—(*i*) *Adjusted disregarded basis.* If regarded, the $500x payment from FDE to P would result in FDE holding Asset A with a basis of $500x under section 1012. Accordingly, the tentative disregarded basis (within the meaning of paragraph (f)(3)(x) of this section) with respect to Asset A is $500x. To determine FDE's adjusted disregarded basis with respect to Asset A under paragraph (f)(3)(i) of this section, FDE's tentative disregarded basis is reduced by $30x (the disregarded cost recovery deduction with respect to Asset A), resulting in an adjusted disregarded basis of $470x.

(*ii*) *Adjusted disregarded gain.* Under paragraph (f)(3)(ii) of this section, the adjusted disregarded gain with respect to Asset A is $270x, which is equal to the lesser of $270x (FDE's adjusted disregarded basis in Asset A ($470x) less the adjusted basis of Asset A at the time that Asset A was transferred to FDE ($200x)), and $420x (the gain attributable to the regarded sale or exchange of Asset A).

(*iii*) *Sale of Asset A.* Under paragraph (f)(2)(vi)(A) of this section, the gross income attributable to FDE ($420x) by reason of the sale of Asset A is adjusted downward to the extent that the $500x disregarded payment from FDE to P is allocable to gross income that would be attributable to FDE under paragraphs (f)(2)(i) through (v) of this section. Under paragraph (f)(2)(vi)(B)(*2*)(*ii*) of this section, the $500x payment from FDE to P is allocable to gross income attributable to FDE to the extent of the adjusted disregarded gain with respect to Asset A, which is $270x. The source and separate category of the gross income of FDE to which that amount is allocable is proportionate to the source and separate category of the $420x of gain recognized on the regarded sale of Asset A ($378x of foreign source non-passive category income and $42x of foreign source passive category income). Consequently, under paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*3*) of this section, in Year 3, gross income attributable to P is adjusted upward by $270x (increasing P's foreign source general category gross income by $243x, which bears the same proportion to $270x as the foreign source non-passive gain ($378x) bears to P's overall gain with respect to Asset A ($420x)), and the foreign source gross income attributable to FDE is adjusted downward by $270x (with foreign source foreign branch category gross income reduced by $243x). P also has $42x of foreign source passive category income from the sale of Asset A. *See* paragraphs (f)(1)(ii) and (f)(2)(vi)(A) of this section.

(vi) *Example 6: Disregarded payment for non-depreciable non-inventory property—regarded gain limitation*—(A) *Facts.* The facts are the same as in paragraph (f)(4)(iv)(A) of this section (the facts in *Example 4*), except that in Year 3, FDE sells Asset A to a third party for $340x and reflects $140x of gross income on its separate set of books and records (that is, $340x amount realized less Asset A's $200x adjusted basis), none of which is passive category income.

(B) *Analysis.* The analysis is the same as the analysis in paragraph (f)(4)(iv)(B) of this section (the analysis in *Example 4*), except that in Year 3, the adjusted disregarded gain with respect to Asset A is $140x, which is equal to the lesser of $300x (FDE's adjusted disregarded basis in Asset A ($500x) less the adjusted basis of Asset A at the time that Asset A was transferred to FDE ($200x)), and $140x (the gain attributable to the regarded sale or exchange of Asset A). Accordingly, under paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*3*) of this section, gross income attributable to P is adjusted upward by $140x (increasing P's foreign source general category gross income by $140x) and gross income attributable to FDE is adjusted downward by $140x (decreasing P's foreign source foreign branch category gross income by $140x) in Year 3.

(vii) *Example 7: Disregarded payment for non-depreciable non-inventory property—loss*—(A) *Facts.* The facts are the same as in paragraph (f)(4)(iv)(A) of this section (the facts in *Example 4*), except that in Year 3, FDE sells Asset A to a third party for $175x and reflects a $25x loss on its separate set of books and records (that is, $175x amount realized less Asset A's $200x adjusted basis).

(B) *Analysis.* The analysis is the same as the analysis in paragraph (f)(4)(iv)(B) of this section (the analysis in *Example 4*), except that in Year 3, the adjusted disregarded gain with respect to Asset A is $0x, which is equal to the lesser of $300x (FDE's adjusted disregarded basis in Asset A ($500x) less the adjusted basis of Asset A at the time that Asset A was transferred to FDE ($200x)), and $0x (the gain attributable to the regarded sale or exchange of Asset A). Accordingly, gross income amounts attributable to P and FDE are not adjusted under paragraph (f)(2)(vi)(A) of this section by reason of the transfer of Asset A from P to FDE.

(viii) *Example 8: Disregarded payment for non-depreciable non-inventory property—disregarded gain limitation*—(A) *Facts.* The facts are the same as in paragraph (f)(4)(iv)(A) of this section (the facts in *Example 4*), except that in Year 1, P sells Asset A to FDE for $65x.

(B) *Analysis.* The analysis is the same as the analysis in paragraph (f)(4)(iv)(B) of this section (the analysis in *Example 4*), except that in Year 3, the tentative disregarded basis and the adjusted disregarded basis with respect to Asset A are $65x. Under paragraph (f)(3)(ii)(B) of this section, the adjusted disregarded gain with respect to Asset A is $0x. Accordingly, under paragraph (f)(2)(vi)(A) of this section, gross income amounts attributable to P and FDE are not adjusted under paragraph (f)(2)(vi)(A) of this section by reason of the transfer of Asset A from P to FDE.

(ix) *Example 9: Application of the rules to the sale of inventory from a foreign branch owner to a foreign branch for distribution*—(A) *Facts.* P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch within the meaning of paragraph (f)(3)(vii) of this section. FDE's functional currency is the U.S. dollar. P manufactures portable electronic devices, which it sells to FDE for $1,500x during a taxable year in a transaction that is disregarded for Federal income tax purposes. In the same taxable year, FDE sells the portable electronic devices to its customers for $1,750x. P uses an overall accrual method of accounting and has $1,300x of cost of goods sold for the taxable year, $1,200x of which were incurred prior to the disregarded sale to FDE and recorded on P's separate set of books and records and $100x of which were incurred after the disregarded sale and recorded on the books and records of FDE. P reports $450x of gross income for the taxable year: $1,750x of gross receipts less cost of goods sold of $1,300x. The $450x of gross income from the sale of portable electronic devices is U.S. source income under section 863(b).

(B) *Analysis*—(*1*) *In general.* The gross receipts from the sale of portable electronic devices ($1,750x), which results in U.S. source gross income of $450x, is recorded on FDE's separate books and records (as adjusted to conform to Federal income tax principles). Therefore, the gross income ($450x) generally would be foreign branch category income under paragraph (f)(2)(i) of this section. However, under paragraph (f)(2)(vi)(A) of this section, the amount of gross income attributable to FDE (and the gross income attributable to P) is adjusted to take the disregarded payment for the portable electronic devices from FDE to P into account. If both FDE and the disregarded payment from FDE to P were recognized for Federal income tax purposes, the amount of the payment ($1,500x) would reduce FDE's gross income. Therefore, under paragraph (f)(2)(vi)(B)(*2*)(*iii*) of this section, the principles of paragraph (f)(2)(vi)(B)(*2*)(*ii*) of this section apply for purposes of determining whether, and to what extent, the disregarded payment is allocable to non-passive category income attributable to FDE for purposes of determining the extent of any adjustment.

(*2*) *Applying the principles of the tangible property rules to sales of inventory.* The principles of paragraph (f)(2)(vi)(B)(*2*)(*ii*) of this section are applied by treating the cost of goods sold with respect to expenses recorded on P's separate set of books and records ($1,200x) similarly to the adjusted basis at the time of the disregarded sale; the gross income ($450x) similarly to gain from the disposition of non-inventory property; and the lesser of the recognized gross income ($450x) and the disregarded payment less the cost of goods sold attributable to expenses reflected on P's separate set of books and records ($1,500x less $1,200x) similarly to disregarded gain ($300x). Accordingly, under paragraph (f)(2)(vi)(A) of this section, general category U.S. source gross income attributable to P is adjusted upward by $300x and the non-passive category U.S. source gross income attributable to FDE is adjusted downward by $300x.

(x) *Example 10: Gross income initially attributable to a foreign branch*—(A) *Facts*—(*1*) *Overview.* P, a domestic corporation, owns FDE, which is a disregarded entity that is a foreign branch within the meaning of paragraph (f)(3)(vii) of this section that has the U.S. dollar as its functional currency. P, which is a foreign branch owner with respect to FDE, also conducts a trade or business in the United States. During a single taxable year, P and FDE engage in the transactions described in paragraphs (f)(4)(x)(A)(*2*) and (*3*) of this section.

(*2*) *Unrelated party transactions.* P, through its U.S. office, accrues and records on its books and records $5,000x of gross income from the performance of accounting services for Customer A, an unrelated party (the Customer A services). The gross income from the Customer A services performed by P is non-passive category income and, under section 861(a)(3), is U.S. source income. Absent the application of paragraph (f)(2)(vi) of this section, the gross income earned by P through its U.S. office would be general category income. FDE accrues and records on its books and records $3,400x of gross income from the performance of web design services for Customer B, an unrelated party (the Customer B services). The gross income from the Customer B services performed by FDE is non-passive category income and, under section 862(a)(3), is foreign source income. Absent the application of paragraph (f)(2)(vi) of this section, the $3,400x of gross income earned by FDE would be foreign branch category income.

(*3*) *Disregarded payments.* FDE provides web design services to P. As compensation for those services, P pays $300x to FDE. The deduction for P's payment to FDE (if regarded) would be allocable to the $5,000x of general category U.S. source gross income earned from P's performance of the Customer A services. P provides accounting services to FDE from P's U.S. office. As compensation for those services, FDE pays $300x to P. The deduction for FDE's payment to P (if regarded) would be allocable to the $3,400x of non-passive category foreign source gross income earned from FDE's performance of the Customer B services.

(B) *Analysis*—(*1*) *Application of multiple disregarded payments rule.* Under paragraph (f)(2)(vi)(F) of this section, paragraph (f)(2)(vi) of this section applies to determine the effects of the disregarded payments described in paragraph (f)(4)(x)(A)(*3*) of this section on gross income initially attributable to FDE before paragraph (f)(2)(vi) of this section is applied to gross income initially attributable to P.

(*2*) *Disregarded payment from FDE to P.* The disregarded payment from FDE to P is disregarded for Federal income tax purposes, and does not generate gross income. However, the disregarded payment is allocable to non-passive category gross income attributable to FDE because a deduction for the payment, if it were regarded, would be allocated to FDE's $3,400x of non-passive category foreign source gross services income under § 1.861–8. Under paragraph (f)(2)(vi)(A) of this section, the amount of non-passive category foreign source gross income attributable to

FDE is adjusted downward, and the amount of general category foreign source gross income attributable to P (in its capacity as a foreign branch owner) is adjusted upward, to take the disregarded payment into account. Thus, $300x of FDE's foreign source gross income relating to the Customer B services is attributable to P for purposes of this section, and $3,100x of that income is attributable to FDE.

(*3*) *Disregarded payment from P to FDE.* The disregarded payment from P to FDE is not recorded on FDE's separate books and records (as adjusted to conform to Federal income tax principles) within the meaning of paragraph (f)(2)(i) of this section because it is disregarded for Federal income tax purposes. However, the disregarded payment is allocable to general category U.S. source gross income attributable to P because a deduction for the payment, if it were regarded, would be allocated to P's $5,000x of general category U.S. source gross services income under § 1.861–8. Accordingly, under paragraph (f)(2)(vi)(A) of this section, the amount of general category U.S. source gross income attributable to P is adjusted downward, and the amount of non-passive category U.S. source gross income attributable to FDE is adjusted upward, to take the disregarded payment into account. Thus, $300x of P's U.S. source gross income from the performance of Customer A services is attributable to FDE for purposes of this section, and $4,700x of that income is attributable to P.

(xi) *Example 11: Ordering rule*—(A) *Facts*—(*1*) *Overview.* P, a domestic corporation, owns FDE1 and FDE2, each of which is a disregarded entity that is a foreign branch within the meaning of paragraph (f)(3)(vii) of this section that has the U.S. dollar as its functional currency. P, which is a foreign branch owner with respect to FDE1 and FDE2, also conducts a trade or business in the United States. During a single taxable year, P, FDE1, and FDE2 engage in the transactions described in paragraphs (f)(4)(xi)(A)(*2*) and (*3*) of this section.

(*2*) *Unrelated party transactions.* FDE1 accrues and records on its books and records $1,000x of gross income from the performance of services for Customer A, an unrelated party (the Customer A services). The gross income from the Customer A services performed by FDE is non-passive category income and, under section 862(a)(3), is foreign source income. Absent the application of paragraph (f)(2)(vi) of this section, the $1,000x of non-passive foreign source gross income earned by FDE1 would be foreign branch category income. FDE2 accrues and records on its books and records $1,100x of gross income from royalties received from Customer B, an unrelated party (the Customer B royalties) on licensed intangible property developed by FDE2 and used by Customer B in the United States. The gross income from the Customer B royalties is non-passive category income and under section 861(a)(4) is U.S. source income. Absent the application of paragraph (f)(2)(vi) of this section, the $1,100x of non-passive category U.S. source gross income earned by FDE2 would be foreign branch category income.

(*3*) *Disregarded payments.* FDE2 provides services to FDE1. As compensation for those services, FDE1 pays $200x to FDE2. The deduction for FDE1's payment to FDE2 (if regarded) would be allocable to the $1,000x of non-passive category foreign source gross income earned from the Customer A services. P provides services to FDE2 from P's U.S. office. As compensation for those services, FDE2 pays $50x to P. The deduction for FDE2's payment to P (if regarded) would be allocable to the non-passive category foreign source gross income attributable to FDE2 (see paragraph (f)(4)(xi)(B)(*1*) of this section) relating to gross income from the Customer A services.

(B) *Analysis*—(*1*) *Disregarded payment from FDE1 to FDE2.* The $1,000x of gross income earned by FDE1 from the Customer A services would, but for paragraph (f)(2)(vi) of this section, be attributable to FDE1 (a foreign branch). Accordingly, under paragraph (f)(2)(vi)(F)(*1*) of this section, adjustments related to disregarded payments from FDE1 to FDE2 are computed before adjustments related to disregarded payments from FDE2 to P (in its capacity as a foreign branch owner). The disregarded payment from FDE1 to FDE2 is not recorded on FDE2's separate books and records (as adjusted to conform to Federal income tax principles) within the meaning of paragraph (f)(2)(i) of this section because it is disregarded for Federal income tax purposes. However, the disregarded payment is allocable to gross income attributable to FDE1 because a deduction for the payment, if it were regarded, would be allocated to FDE1's $1,000x of non-passive category foreign source gross services income under § 1.861–8. Accordingly, under paragraph (f)(2)(vi)(A) of this section, the amount of non-passive category foreign source gross income attributable to FDE1 is adjusted downward, and the amount of non-passive category foreign source gross income attributable to FDE2 is adjusted upward, to take the disregarded payment into account. Thus, $200x of FDE1's non-passive category foreign source gross income from the performance of Customer A services is attributable to FDE2 for purposes of this section, and $800x of that income is attributable to FDE1.

(*2*) *Disregarded payment from FDE2 to P.* The disregarded payment from FDE2 to P is disregarded for Federal income tax purposes, and does not generate gross income. However, the disregarded payment is allocable to gross income attributable to FDE2 because a deduction for the payment, if it were regarded, would be allocated to FDE2's $200x of non-passive category foreign source gross services income under § 1.861–8. Under paragraph (f)(2)(vi)(A) of this section, the amount of non-passive category foreign source gross income attributable to FDE2 is adjusted downward, and the amount of general category foreign source gross income attributable to P is adjusted upward, to take the $50x disregarded payment into account. Thus, $50x of non-passive category foreign source gross income relating to the Customer A services is attributable to P for purposes of this section, $150x of that income is attributable to FDE2, and $800x of that income remains attributable to FDE1. FDE2's $1,100x of U.S. source royalty income is not adjusted under paragraph (f)(2)(vi) of this section and remains foreign branch category income.

(xii) *Example 12: Application of intangible property rules*—(A) *Facts.* P, a domestic corporation that has a calendar taxable year, owns FDE, a disregarded entity that is a foreign branch within the meaning of paragraph (f)(3)(vii) of this section. FDE's functional currency is the U.S. dollar. Asset A, a patent with a useful life ending on December 31, Year 2, was obtained with respect to a discovery that was made by FDE in the course of its trade or business and was used in that trade or business until December 31, Year 1. On December 31, Year 1, FDE remits Asset A to P and receives no consideration. Asset A has an adjusted basis of $0. In Year 2, P uses Asset A to generate general category gross income. P earns $1,000x of general category U.S. source gross income in Year 2, including the income generated by its use of Asset A. If FDE were a domestic corporation, P were a foreign corporation, and Asset A had been transferred in exchange for stock in a transaction described in section 351, such that section 367(d) applied by its terms (but all other facts remained the same), the payment determined under section 367(d) for Year 2 would be $300x. A disregarded payment for the use of Asset A, if it were regarded, would be allocated to FDE's $1,000x of general category U.S. source gross income under § 1.861–8.

(B) *Analysis.* The remittance of Asset A by FDE to P is a transfer of intangible property described in section 367(d)(4) from a foreign branch to its foreign branch owner. The facts in paragraph (f)(4)(xii)(A) of this section do not implicate an exception in paragraph (f)(2)(vi)(D)(*2*) or (*3*) of this section. Therefore, this is a transaction to which paragraph (f)(2)(vi)(D)(*1*) of this section applies. The foreign branch is treated as having sold the transferred property to the foreign branch owner in exchange for annual payments contingent on the productivity or use of the property, the amount of which for Year 2 is determined under the principles of section 367(d) to be $300x. Thus, in Year 2, P is treated as making a $300x disregarded payment to FDE. The payment would be allocable to general category U.S. source income under paragraph (f)(2)(vi)(B)(*1*)(*i*) of this section. Therefore, $300x of P's non-passive category U.S. source gross income is attributable to FDE under paragraphs (f)(2)(vi)(A) and (f)(2)(vi)(B)(*3*) of this section. P has $700x of general category U.S. source gross income and $300x of foreign branch category U.S. source gross income in Year 2.

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

(2) *Exceptions for passive category income.* Section 951A category income does not include any amounts included under section 951A(a) that are allocable

to passive category income under § 1.904–5(c)(6).

(h) * * *

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

* * * * *

(4) *Examples.* The following examples illustrate the application of paragraph (h)(3) of this section.

(i) *Example 1.* Controlled foreign corporation CFC is a wholly-owned subsidiary of domestic corporation USP. CFC is not a financial services entity and has accumulated cash reserves. USP has uncollected trade and service receivables of foreign obligors. USP sells the receivables at a discount (''factors'') to CFC. The income derived by CFC on the receivables is related person factoring income. The income is also export financing interest. Because the income is related person factoring income, the income is passive category income to CFC.

(ii) *Example 2.* Domestic corporation USS is a wholly-owned subsidiary of domestic corporation USP. USS is not a financial services entity, does not have any foreign qualified business entities, and has accumulated cash reserves. USP has uncollected trade and service receivables of foreign obligors. USP factors the receivables to USS. The income derived by USS on the receivables is related person factoring income. The income is also export financing interest. The income will be passive category income to USS.

(iii) *Example 3.* The facts are the same as in paragraph (h)(4)(ii) of this section (the facts in *Example 2*), except that instead of factoring USP's receivables, USS finances the sales of USP's goods by making loans to the purchasers of USP's goods. The interest derived by USS on these loans is export financing interest and is not related person factoring income. The income will be general category income to USS.

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

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

(iii) *Examples.* The following examples illustrate the application of this paragraph (h)(5):

(A) *Example 1.* CFC1, a controlled foreign corporation, is a wholly-owned subsidiary of domestic corporation USP. CFC2, a controlled foreign corporation, is a wholly-owned subsidiary of CFC1. CFC1 and CFC2 are incorporated in Country M. In Year 1, USP sells tractors to CFC2, which CFC2 sells to X, an unrelated foreign corporation organized in Country M. The tractors are to be used in Country M. CFC2 uses a substantial part of its assets in its trade or business located in Country M. CFC2 has uncollected trade receivables from X that it factors to CFC1. The income is not related person factoring income because it is described in section 864(d)(7) (income eligible for the same country exception) and is tested income. If section 864(d)(1) applied, the income CFC1 derived from the receivables would meet the definition of export financing interest. The income, therefore, is considered to be export financing interest and is general category income to CFC1 and may be section 951A category income to USP.

(B) *Example 2.* CFC1, a controlled foreign corporation, is a wholly-owned subsidiary of domestic corporation, USP. CFC2, a controlled foreign corporation, is a wholly-owned subsidiary of CFC1. CFC1 and CFC2 are incorporated in Country M. In Year 1, USP sells tractors to CFC2, which CFC2 sells to X, a foreign partnership that is organized in Country M and is related to CFC1 and CFC2. CFC1 makes a loan to X to finance the tractor sales. The interest earned by CFC1 from financing the sales is described in section 864(d)(7) and is export financing interest and is tested income. Therefore, the income is general category income to CFC1 and may be section 951A category income to USP.

* * * * *

(k) *Separate category under section 904(d)(6) or 865(h) for items resourced under treaties*—(1) *Section 904(d)(6)*—(i) *In general.* Except as provided in paragraph (k)(1)(iv)(A) of this section, sections 904(a), (b), (c), (d), (f), and (g) and sections 907 and 960 are applied separately to any item of income that, without regard to a treaty obligation of the United States, would be treated as derived from sources within the United States, but under a treaty obligation of the United States such item of income would be treated as arising from sources outside the United States, and the taxpayer chooses the benefits of such treaty obligation.

(ii) *Aggregation of items of income in each other separate category.* For purposes of applying the general rule of paragraph (k)(1) of this section, items of income in each other separate category of income that are resourced under each applicable treaty are aggregated in a single separate category for income in that separate category that is resourced under that treaty. For example, all items of passive category income that would otherwise be treated as derived from sources within the United States but which the taxpayer chooses to treat as arising from sources outside the United States pursuant to a provision of a bilateral U.S. income tax treaty are treated as income in a separate category for passive category income resourced under the particular treaty, and the high-tax kickout grouping rules of paragraph (c) of this section are applied separately to the groups of passive income included in that separate category. Any items of resourced high-taxed passive income are assigned to a separate category for general (or other) category income resourced under a tax treaty. Items of income described in paragraph (k)(1) of this section are not combined with other income that is foreign source income under the Code, even if the other income arises from sources within the jurisdiction with which the United States has a bilateral income tax treaty (''treaty jurisdiction'') and is included in the same separate category to which the resourced income would be assigned without regard to section 904(d)(6). Items of income described in paragraph (k)(1) of this section are also not combined with other items of resourced income that are subject to a separate limitation by reason of a Code provision other than section 904(d)(6).

(iii) *Related taxes.* Foreign taxes, including foreign taxes paid to a foreign jurisdiction other than the treaty jurisdiction on an item of resourced income, are allocated to each separate category described in paragraph (k)(1)(ii) of this section in accordance with § 1.904–6.

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

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

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

(2) *Section 865(h).* If any gain, as defined in section 865(h)(2)(A)(i), would be treated as derived from sources within the United States under section 865, but pursuant to a treaty obligation of the United States such gain would be treated as arising from sources outside the United States, and the taxpayer chooses the benefits of such treaty obligation, then that gain will be treated as foreign source income. However, sections 904(a), (b), (c), (d), (f), and (g) and sections 907 and 960 are applied separately to amounts described in the preceding sentence with respect to each treaty under which the taxpayer has claimed benefits and, within each treaty, to each separate category of income. The principles of the rules in paragraphs (k)(1)(ii) through (iv) of this section apply to gains, and foreign taxes on gains, that are subject to a separate limitation under section 865(h).

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

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

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

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

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

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

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

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

(4) *Example.* The following example illustrates the application of this paragraph (n).

(i) *Facts.* PRS is a domestic partnership. PRS has two general partners, A and B. A and B each have a greater than 10% interest in PRS. PRS also has two limited partners, C and D. C has a 50% interest in the partnership and D has a 9% interest. D's partnership interest is not held in the ordinary course of business. A, B, C and D are all United States persons. In Year 1, PRS has $100x of general category non-subpart F income on which it pays no foreign tax.

(ii) *Analysis.* Under paragraph (n)(1)(i) of this section, A's, B's, and C's distributive shares of PRS's income are not passive category income. Under paragraph (n)(1)(ii)(A) of this section, because D is a limited partner with a less than 10% interest in PRS, D's distributive share of PRS's income is passive category income.

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

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

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

■ **Par. 21.** Section 1.904–5 is amended by:

■ 1. Revising paragraphs (a), (b), and (c)(1).

■ 2. Revising the third and fourth sentences and adding a sentence to the end of paragraph (c)(2)(i).

■ 3. Removing the language ''noncontrolled section 902 corporation'' and adding the language ''noncontrolled 10-percent owned foreign corporation'' in its place in the heading and text of paragraph (c)(2)(iii).

■ 4. Revising paragraphs (c)(2)(v) and (c)(3).

■ 5. In paragraph (c)(4)(i):

■ i. Revising the first sentence.

■ ii. Removing the language ''paragraph'' and adding the language ''paragraph (c)(4)'' in its place in the second sentence.

■ 6. Revising paragraph (c)(4)(iii).

■ 7. Removing paragraph (c)(4)(iv).

■ 8. Adding paragraphs (c)(5), (6), and (7).

■ 9. Revising paragraphs (d)(1), (2), and (3) and (e)(2).

■ 10. Removing and reserving paragraph (f)(1).

■ 11. Removing paragraph (f)(3).

■ 12. In paragraph (g):

■ i. Removing the language ''section 904(d)(3) and this section'' and adding the language ''paragraph (c) of this section'' in its place in the first sentence.

■ ii. Removing the language ''United States corporation'' and adding the language ''domestic corporation'' wherever it appears.

■ iii. Removing the last sentence.

■ 13. Revising paragraph (h).

■ 14. In paragraph (i)(1):

■ i. Removing the language ''paragraphs (i)(2), (3), and (4)'' and adding the language ''paragraphs (i)(2) and (3)'' in its place in the first sentence.

■ ii. In the second sentence:

■ A. Removing the language ''noncontrolled section 902 corporation'' and adding the language ''noncontrolled 10-percent owned foreign corporation''.

■ B. Removing the language ''paragraph (i)(4)'' and adding the language ''paragraph (i)(3)'' in its place.

■ iii. Revising the sixth and seventh sentences.

■ 15. Revising paragraph (i)(2) and (3).

■ 16. Removing and reserving paragraph (i)(4).

■ 17. Revising paragraph (i)(5).

■ 18. Removing the last sentence of paragraph (j).

■ 19. Adding the language ''under § 1.904–4'' after the language ''characterized'' in the first sentence of paragraph (k)(1).

■ 20. Revising paragraphs (k)(2)(iii) and (l).

■ 21. In paragraph (m)(1):

■ i. Removing the language ''noncontrolled section 902 corporations'' and adding the language ''noncontrolled 10-percent owned foreign corporations'' in its place and removing the language ''noncontrolled section 902 corporation'' and adding the language ''noncontrolled 10-percent owned foreign corporation'' in its place.

■ ii. Removing the language ''or amount treated as a dividend, including'' and adding the language ''which, for purposes of this paragraph (m), includes'' in its place in the third sentence.

■ iii. Removing the language ''951(a)(1)(A),'' and adding the language ''951(a)(1)(A), 951A(a),'' in its place in the fourth sentence.

■ 22. Revising paragraphs (m)(2)(ii), (m)(3), and (m)(4)(i).

■ 23. Removing paragraph (m)(4)(iii).

■ 24. Revising the heading of paragraph (m)(5), the first sentence of paragraph (m)(5)(i), and paragraph (m)(5)(ii).

■ 25. Removing the language ''section 902(a) and section 960(a)(1)'' and adding the language ''section 960'' in its place in paragraph (m)(6).

■ 26. In paragraph (m)(7)(i):

■ i. Removing the language ''904(g)(6)'' and ''904(g)'' from the first sentence and adding the language ''904(h)(6)'' and ''904(h)'' in its place, respectively.

■ ii. Removing the language ''(d) and (f)'' from the second sentence and adding the language ''(d), (f), and (g)'' in its place and removing the language ''902,''.

■ 27. Revising paragraph (m)(7)(ii).

■ 28. In paragraph (n):

■ i. Removing the language ''noncontrolled section 902 corporation'' and adding the language ''noncontrolled 10-percent owned foreign corporation'' in its place, and by removing the language ''section 904(d)(1)'' and adding ''§ 1.904–4'' in its place in the first sentence.

■ ii. Revising the last sentence.

■ 29. Revising paragraph (o).

The additions and revisions read as follows:

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

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

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

(3) *Other rules provided in this section.* Paragraph (b) of this section provides operative rules for this section. Paragraph (d) of this section provides rules addressing exceptions to passive category income for certain purposes in the case of controlled foreign corporations that meet the requirements of section 954(b)(3)(A) (de minimis rule) or section 954(b)(4) (high-tax exception). Paragraph (e) of this section provides rules for characterizing a controlled foreign corporation's foreign base company income and gross insurance income when section 954(b)(3)(B) (full inclusion rule) applies. Paragraph (f) of

this section modifies the look-through rules for certain types of income. Paragraph (k) of this section provides ordering rules for applying the look-through rules. Paragraph (l) of this section provides examples illustrating the application of certain rules in this section. Paragraphs (m) and (n) of this section provide rules related to the resourcing rules described in section 904(h).

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

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

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

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

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

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

(vi) The term *United States shareholder* has the meaning given such term by section 951(b) (taking into account the special rule for certain captive insurance companies contained in section 953(c)), except that for purposes of this section, a United States shareholder includes any member of the controlled group of the United States shareholder. For purposes of this paragraph (a)(4)(vi), the controlled group is any member of the affiliated group within the meaning of section 1504(a)(1) except that ''more than 50 percent'' is substituted for ''at least 80 percent'' wherever it appears in section 1504(a)(2). When used in reference to a noncontrolled 10-percent owned foreign corporation described in section 904(d)(2)(E)(i)(II), the term *United States shareholder* also means a taxpayer that meets the stock ownership requirements described in section 904(d)(2)(E)(i)(II).

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

(2) *Priority and ordering of look-through rules.* Except as provided in this paragraph (b)(2), to the extent the look-through rules assign income to a separate category, the income is assigned to that separate category rather than the separate category to which the income would have been assigned under § 1.904–4 (not taking into account § 1.904–4(l)). See paragraph (k) of this section for ordering rules for applying the look-through rules. However, passive income that is financial services income is assigned to a separate category under the rules in § 1.904–4(e)(1), (f)(1), and (l), regardless of whether the look-through rules otherwise would have assigned such income to the passive category.

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

(2) * * * (i) * * * Related person interest is treated as passive category income to the extent it is allocable to passive category income of the controlled foreign corporation. If related person interest is received or accrued from a controlled foreign corporation by two or more persons, the amount of interest received or accrued by each person that is allocable to passive category income is determined by multiplying the amount of related person interest allocable to passive category income by a fraction. * * * Solely for purposes of assigning interest income to a separate category under section 904(d)(3) and the look-through rule in this paragraph (c)(2), the rules in paragraph (c)(2)(ii) of this section for allocating and apportioning interest expense of a controlled foreign corporation apply for purposes of characterizing interest income in the hands of the recipient, even if a deduction for the interest expense is deferred or disallowed to the controlled foreign corporation.

* * * * *

(v) *Examples.* The following examples illustrate the application of this paragraph (c)(2).

(A) *Example 1*—(*1*) CFC, a controlled foreign corporation, is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns $200x of foreign personal holding company income that is passive category income. CFC also earns $100x of foreign base company sales income that is general category income. CFC has $2,000x of passive category assets and $2,000x of general category assets. In Year 1, CFC makes a $150x interest payment to USP with respect to a $1,500x loan from USP. CFC also pays $100x of interest to an unrelated person on a $1,000x loan from that person. CFC has no other expenses. CFC uses the asset method to apportion interest expense.

(*2*) Under paragraph (c)(2)(ii)(C) of this section, the $150x related person interest payment is allocable to CFC's passive category foreign personal holding company income. Therefore, the $150x interest payment is passive category income to USP. Because the entire related person interest payment is allocated to passive category income under paragraph (c)(2)(ii)(C) of this section, none of the related person interest payment is apportioned to general category income under paragraph (c)(2)(ii)(D) of this section. Under paragraph (c)(2)(iv)(B) of this section, the entire amount of the related person debt is allocable to passive category assets ($1,500x = $1,500x × $150x/$150x). Under paragraph (c)(2)(ii)(E) of this section, $20x of the interest expense paid to an unrelated person is apportioned to passive category income ($20x = $100x × ($2,000x − $1,500x)/($4,000x − $1,500x)), and $80x of the interest expense paid to an unrelated person is apportioned to general category income ($80x = $100x × $2,000x/($4,000x − $1,500x)).

(B) *Example 2.* The facts are the same as in paragraph (c)(2)(v)(A) of this section (the facts in *Example 1*), except that CFC uses the modified gross income method to apportion interest expense. Under paragraph (c)(2)(ii)(E) of this section, the unrelated person interest expense is apportioned based on gross income. Therefore, $33x of interest expense paid to an unrelated person is apportioned to CFC's passive category income ($33x = $100x × ($200x − $150x)/($300x − $150x)) and $67x of interest expense paid to an unrelated person is apportioned to CFC's general category income ($67x = $100x × $100x/($300x − $150x)).

(C) *Example 3*—(*1*) The facts are the same as in paragraph (c)(2)(v)(A) of this section (the facts in *Example 1*), except that CFC has an additional $50x of third person interest expense that is directly allocated to income from a specific property that produces only passive category income. The principal amount of indebtedness to which the interest relates is $500x. CFC also has $50x of additional non-interest expenses that are not definitely related expenses and that are apportioned on an asset basis.

(*2*) Under paragraph (c)(2)(ii)(B) of this section, the $50x of directly allocated third person interest is first allocated to reduce the passive category income of CFC. Under paragraph (c)(2)(ii)(C) of this section, the $150x of related person interest is allocated to the remaining $150x of passive category income. Under paragraph (c)(2)(iv)(B) of this section, all of the related person debt is allocated to passive category assets ($1,500x = $1,500x × $150x/$150x).

(*3*) Under paragraph (c)(2)(ii)(E) of this section, the non-interest expenses that are not definitely related are apportioned on the basis of the asset values reduced by the allocated related person debt. Therefore, $10x of these expenses are apportioned to the passive category ($50x × ($2,000x − $1,500x)/($4,000x − $1,500x)) and $40x are apportioned to the general category ($50x × $2,000x/($4,000x − $1,500x)).

(*4*) In order to apportion third person interest (that was not directly allocated third person interest) between the categories of assets, the value of assets in a separate category must also be reduced under the principles of § 1.861–8 by the indebtedness relating to the specifically allocated interest. Therefore, under paragraph (c)(2)(iv)(B) of this section, the value of assets in the passive category for purposes of apportioning the additional third person interest = 0 ($2,000x minus $500x (the principal amount of the debt, the interest payment on which is directly allocated to specific interest-producing properties) minus $1,500x (the related person debt allocated to passive category assets)). Under paragraph (c)(2)(ii)(E) of this section, all $100x of the non-definitely related third person interest expense is apportioned to the general category ($100x = $100x × $2,000x/($4,000x − $500x − $1,500x)).

(D) *Example 4*—(*1*) CFC, a controlled foreign corporation, is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns $100x of foreign personal holding company income that is passive category income. CFC also earns $100x of foreign base company sales income that is general category income. CFC has $1,000x of general category assets and $1,000x of passive category assets. In Year 1, CFC makes a $150x interest payment to USP on a $1,500x loan from USP and has $20x of general and administrative expenses (G & A) that under the principles of §§ 1.861–8 through 1.861–14T is treated as directly allocable to all of CFC's gross income. CFC also makes a $25x interest payment to an unrelated person on a $250x loan from the unrelated person. CFC has no other expenses. CFC uses the asset method to apportion interest expense. CFC uses the modified gross income method to apportion G & A.

(*2*) Under paragraph (c)(2)(iv)(B) of this section, related person debt allocated to passive category assets equals $1,000x ($1,000x = $1,500x × $100x/$150x).Under paragraph (c)(2)(ii)(C) of this section, $100x of the interest payment to USP is allocable to CFC's passive category foreign personal holding company income. Under paragraph (c)(2)(ii)(D) of this section, the additional $50x of related person interest expense is apportioned to CFC's general category income ($50x = $50x × $1,000x/$1,000x).

(*3*) Under paragraph (c)(2)(ii)(E) of this section, none of the $25x of interest expense paid to an unrelated person is apportioned to passive category income ($0 = $25x × ($1,000x − $1,000x)/($2,000x − $1,000x)). All $25x of the interest expense paid to an unrelated person is apportioned to general category income ($25x = $25x × $1,000x/($2,000x − $1,000x)). Under paragraph (c)(2)(ii)(E) of this section, none of the G & A is allocable to CFC's passive category foreign personal holding company income ($0 = $20x × ($100x − $100x)/($200x − $100x)). All $20x of the G & A is apportioned to CFC's general category income ($20x = $20x × $100x/($200x − $100x)).

(E) *Example 5.* The facts are the same as in paragraph (c)(2)(v)(D) of this section (the facts in *Example 4*), except that CFC uses the modified gross income method to apportion interest expense. As in paragraph (c)(2)(v)(D) of this section (*Example 4*), $100x of the interest payment to USP is allocated to passive category income under paragraph (c)(2)(ii)(C) of this section. Under paragraph (c)(2)(ii)(D) of this section, the additional $50x of related person interest expense is apportioned to general category income ($150x—100x × $100x/$100x). Under paragraph (c)(2)(ii)(E) of this section, none of the unrelated person interest expense and none of the G & A is apportioned to passive category income, because after the application of paragraph (c)(2)(ii)(C) of this section, no income remains in the passive category.

(F) *Example 6.* CFC2, a controlled foreign corporation, is a wholly-owned subsidiary of CFC1, a controlled foreign corporation. CFC1 is a wholly-owned subsidiary of USP, a domestic corporation. CFC1 and CFC2 are incorporated in the same country. In Year 1, USP sells tractors to CFC2, which CFC2 sells to X, a foreign corporation that is related to both CFC1 and CFC2 and is organized in the same country as CFC1 and CFC2. CFC1 makes a loan to × to finance the tractor sales. Assume that the interest earned by CFC1 from financing the sales is export financing interest that is neither related person factoring income nor foreign personal holding company income. Under § 1.904–4(h), the export financing interest earned by CFC1 is, therefore, general category income. CFC1 earns no other income. CFC1 makes a $100x interest payment to USP. The $100x of interest paid is not allocable under the look-through rules and paragraph (c)(2)(ii) of this section to passive category income of CFC1. The income is general category income to USP.

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

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

* * * * *

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

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

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

951(a)(1)(B), see paragraph (c)(4)(i) of this section.

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

(7) *Examples.* The following examples illustrate the application of paragraph (c) of this section.

(i) *Example 1*—(A) *Facts.* CFC, a controlled foreign corporation, is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns $100x of net income, $85x of which is general category foreign base company sales income and $15x of which is passive category foreign personal holding company income. No foreign tax is imposed on the income. CFC's income of $100x is subpart F income taxed currently to USP under section 951(a)(1)(A).

(B) *Analysis.* Because $15x of the subpart F inclusion is attributable to passive category income of CFC, under section 904(d)(3)(B) and paragraph (c)(5) of this section $15x of the subpart F inclusion is passive category income to USP. The remaining $85x subpart F inclusion is general category income to USP.

(ii) *Example 2*—(A) *Facts.* CFC1, a controlled foreign corporation, is a wholly-owned subsidiary of USP, a domestic corporation. CFC2 is a controlled foreign corporation wholly owned by CFC1 and is incorporated and operates all of its business in the same country as CFC1. All of CFC2's earnings and profits are attributable to passive category foreign personal holding company income. USP elects to exclude CFC2's income from subpart F income under section 954(b)(4). In Year 1, CFC2 makes a distribution to CFC1 and CFC1 makes a distribution to USP, all of which is attributable to Year 1 earnings and profits. CFC1 has no earnings and profits in Year 1 other than those received from CFC2.

(B) *Analysis*—(*1*) With respect to the dividend from CFC2 to CFC1, such amount is not subpart F income. *See* section 954(c)(3). Under section 904(d)(3)(D) and (E) and paragraphs (c)(4) and (d)(2) of this section the dividend income is not passive category income and therefore under § 1.904–4 it is general category income to CFC1. Under section 951A(c)(2)(A)(i)(IV), such dividend income is not tested income.

(*2*) With respect to the dividend from CFC1 to USP, under section 904(d)(3)(D) and (E) and paragraphs (c)(4) and (d)(2) of this section, such dividend income is not passive category income and therefore under § 1.904–4 is general category income to USP.

(iii) *Example 3*—(A) *Facts.* The facts are the same as in paragraph (c)(7)(ii)(A) of this section (the facts in *Example 2*), except that CFC1 receives interest income from CFC2 instead of dividend income.

(B) *Analysis.* Under section 904(d)(3)(C) and paragraph (c)(2)(i) of this section, the interest income is passive category income to CFC1 because such interest is properly allocable to the passive category income of CFC2. The interest income from CFC2 is subpart F income of CFC1 taxable to USP because such income reduces the subpart F income of CFC2 or such interest is properly allocable to the subpart F income of CFC2. *See* section 954(c)(3) and (6). Under section 904(d)(3)(B) and paragraph (c)(5) of this section, the subpart F inclusion is passive category income to USP. Under section 959(a), the distribution from CFC1 to USP is excluded from USP's gross income.

(iv) *Example 4*—(A) *Facts.* The facts are the same as in paragraph (c)(7)(iii)(A) of this section (the facts in *Example 3*), except that USP elects to exclude CFC1's interest income from subpart F income under section 954(b)(4).

(B) *Analysis.* Under section 904(d)(3)(D) and (E) and paragraphs (c)(4) and (d)(2) of this section, the distribution from CFC1 to USP is not a passive category dividend and therefore under § 1.904–4 is general category income to USP.

(v) *Example 5*—(A) *Facts.* The facts are the same as in paragraph (c)(7)(iv)(A) of this section (the facts in *Example 4*), except that USP receives interest income from CFC1 instead of dividend income.

(B) *Analysis.* Under section 904(d)(3)(C) and paragraph (c)(2)(i) of this section, the interest income is passive category income to USP because such interest is properly allocable to passive category income of CFC1.

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

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

(3) *Example.* The following example illustrates the application of this paragraph (d).

(i) *Facts.* CFC, a controlled foreign corporation, is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns $100x of gross income, $4x of which is interest that is foreign personal holding company income and $96x of which is gross manufacturing income that is not subpart F income. CFC has no other earnings for Year 1. CFC has no expenses and pays no foreign taxes.

(ii) *Analysis.* Under the de minimis rule of section 954(b)(3)(A) and § 1.954–1(b)(1)(i), none of CFC's income is treated as foreign base company income. All of CFC's income, therefore, is treated as general category income and tested income. In Year 1, USP has a GILTI inclusion amount with respect to CFC. Such amount is section 951A category income to USP.

(e) * * *

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

(i) *Facts.* Controlled foreign corporation CFC is a wholly-owned subsidiary of USP, a domestic corporation. CFC earns $100x, $75x of which is foreign personal holding company income and $25x of which is non-subpart F services income. CFC's gross and net income are equal.

(ii) *Analysis.* Under the 70 percent full inclusion rule of section 954(b)(3)(B), the entire $100x is foreign base company income currently taxable to USP under section 951. Because $75x of the $100x section 951 inclusion is attributable to CFC's passive category income, $75x of the inclusion is passive category income to USP. The remaining $25x of the inclusion is treated as general category income to USP.

* * * * *

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

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

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

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

* * * * *

(5) *Examples.* The following examples illustrate the application of this paragraph (i):

(i) *Example 1.* USP, a domestic corporation, owns all of the stock of CFC1, a controlled foreign corporation. CFC1 owns 40% of the stock of CFC2, a Country X corporation that is a controlled foreign corporation. The remaining 60% of the stock of CFC2 is owned by V, a domestic corporation, unrelated to USP. The percentages of value and voting power of CFC2 owned by CFC1 and V correspond to their percentages of stock ownership. CFC2 owns 40% (by vote and value) of the stock of CFC3, a Country Z corporation that is a controlled foreign corporation. The remaining 60% of CFC3 is owned by unrelated United States persons. CFC3 earns exclusively general category income that is neither subpart F income nor tested income. In Year 1, CFC3 makes an interest payment of $100x to CFC2. Look-through principles do not apply because CFC2 and CFC3 are not related look-through entities under paragraph (i)(1) of this section (because CFC2 does not own more than 50% of the voting power or value of CFC3). The interest is passive category income to CFC2 and is subpart F income of CFC2 that is taxable to USP and V. Under paragraph (c)(5) of this section, USP and V's subpart F inclusion with respect to CFC2 is passive category income.

(ii) *Example 2.* The facts are the same as in paragraph (i)(5)(i) of this section (the facts in *Example 1*), except that instead of a $100x interest payment, CFC3 pays a $50x dividend to CFC2 in Year 1. USP and V each own, directly or indirectly, more than 10% of the voting power of all classes of stock of both CFC2 and CFC3, and, therefore, CFC2 and CFC3 have the same United States shareholders. Pursuant to paragraph (i)(3) of this section, because CFC2 and CFC3 have a common United States shareholder, for purposes of applying this section to the dividend from CFC2 to CFC3, CFC2 and CFC3 are treated as related look-through entities. Therefore, look-through principles apply. Because CFC3 has no passive category income or earnings and profits, the dividend income is characterized as general category income to CFC2. The dividend is subpart F income of CFC2 that is taxable to USP and V. Under paragraph (c)(5) of this section, the subpart F inclusions of USP and V are not passive category income to USP and V and therefore under § 1.904–4 the subpart F inclusions are general category income to USP and V.

(iii) *Example 3.* The facts are the same as in paragraph (i)(5)(i) of this section (the facts in *Example 1*), except that CFC3 pays both a $100x interest payment and a $50x dividend to CFC2, and CFC2 owns 80% (by vote and value) of CFC3. Under paragraph (i)(1) of this section, CFC2 and CFC3 are related look-through entities, because CFC2 owns more than 50% (by vote and value) of CFC3. Therefore, look-through principles apply to both the interest and dividend income paid or accrued by CFC3 to CFC2, and CFC2 treats both types of income as general category income because CFC3 does not have any passive category earnings. Under paragraph (c)(5) of this section and § 1.904–4, the resulting subpart F inclusions are general category income to USP and V.

(iv) *Example 4.* USP, a domestic corporation, owns 50% of the voting stock of CFC1, a controlled foreign corporation. CFC1 owns 10% of the voting stock of CFC2, a controlled foreign corporation. The remaining 50% of the stock of CFC1 is owned by X. The remaining 90% of the stock of CFC2 is owned by Y. X and Y are each United States shareholders of CFC2 but are not related to USP, CFC1, or each other. In Year 1, CFC2 pays a $100x dividend to CFC1. Under paragraph (i)(3) of this section because no person is a United States shareholder of both CFC1 and CFC2 (USP and X each own only 5% of CFC2), CFC1 and CFC2 are not related look-through entities. Because CFC2 is not a related person to CFC1 within the meaning of section 954(d)(3), section 954(c)(3) and (c)(6) are inapplicable, and the dividend is subpart F income of CFC1 that is taxable to USP and X. Therefore, under section 904(d)(2)(B)(i) and § 1.904–4(b)(2)(i)(A), because the dividend income is foreign personal holding company income, it is passive category income to CFC1.

(v) *Example 5.* The facts are the same as in paragraph (i)(5)(iv) of this section (the facts in *Example 4*), except that X owns 10% of the voting stock of CFC2 and Y owns only 80% of the voting stock of CFC2. Because CFC2 is not a related person to CFC1 within the meaning of section 954(d)(3), the dividend is subpart F income of CFC1 that is taxable to USP and X. In addition, because X is a United States shareholder of both CFC1 and CFC2, CFC2 and CFC1 are related look-through entities under paragraph (i)(3) of this section, the dividend income is general category income to CFC1 and the subpart F inclusion is general category income to USP and X.

* * * * *

(k) * * *

(2) * * *

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

* * * * *

(l) *Examples.* The following examples illustrate the application of this section.

(1) *Example 1*—(i) *Facts.* CFC1 and CFC2, controlled foreign corporations, are wholly-owned subsidiaries of USP, a domestic corporation. CFC1 and CFC2 are incorporated in two different foreign countries and CFC2 is a financial services entity. In Year 1, CFC1 earns $100x of gross income that is passive category foreign personal holding company

income. CFC1's only expense is a $50x interest payment to CFC2. CFC1's $50x of pre-tax income is subject to $20x of foreign income tax, and USP elects to exclude CFC1's $30x of net income from subpart F income under section 954(b)(4).

(ii) *Analysis.* The $50x of interest is foreign personal holding company income in CFC2's hands because section 954(c)(3)(A)(i) (same country exception for interest payments) and section 954(c)(6) do not apply, because the interest payment is allocable to and reduces CFC1's subpart F income. The $50x of interest income is also passive category income to CFC2 because CFC1 and CFC2 are related look-through entities within the meaning of paragraph (i)(1) of this section and, therefore the look-through rules of paragraph (c)(2)(i) of this section apply to characterize the interest payment. However, because CFC2 is a financial services entity, under § 1.904–4(e)(1) and paragraph (b)(2) of this section, the income is treated as financial services income and therefore as general category income in CFC2's hands. Thus, with respect to CFC2, under § 1.904–4(d) and paragraph (c)(5) of this section, USP includes in its gross income a $50x general category inclusion under section 951(a)(1)(A) attributable to the general category foreign personal holding company income.

(2) *Example 2*—(i) *Facts.* USP, a domestic corporation, owns 75% of USS, a domestic corporation. USP and USS are not financial services entities. In Year 1, USS's earnings consist of $100x of foreign source passive income. USS makes a $100x foreign source royalty payment to USP.

(ii) *Analysis.* Under paragraph (g) of this section, the royalty payment to USP is subject to the look-through rules of paragraph (c)(3) of this section and is characterized as passive category income the extent that it is allocable to such income in USS's hands.

(3) *Example 3*—(i) *Facts.* USP, a domestic corporation, owns 100% of the stock of CFC1, a controlled foreign corporation, and CFC1 owns 100% of the stock of CFC2, a controlled foreign corporation. CFC1 has $100x of passive foreign personal holding company income from unrelated persons and $100x of general category income. CFC1 also has $50x of interest income from CFC2. CFC1 pays CFC2 $100x of interest.

(ii) *Analysis.* Under paragraph (k)(2) of this section, the $100x interest payment from CFC1 to CFC2 is reduced for limitation purposes to the extent of the $50x interest payment from CFC2 to CFC1 before application of the rules in paragraph (c)(2)(ii) of this section. Therefore, the interest payment from CFC2 to CFC1 is disregarded. CFC1 is treated as if it paid $50x of interest to CFC2, all of which is allocable to CFC1's passive category foreign personal holding company income under paragraph (c)(2)(ii)(C) of this section. Therefore, under paragraph (c)(2)(i) of this section, the $50x interest payment from CFC1 to CFC2 is passive category income.

(4) *Example 4*—(i) *Facts.* USP, a domestic corporation, owns 100% of the stock of CFC1, a controlled foreign corporation. CFC1 owns 100% of the stock of CFC2, a controlled foreign corporation, and 100% of the stock of CFC3, a controlled foreign corporation. In Year 1, CFC2 pays CFC1 $5x of interest, CFC1 pays CFC3 $10x of interest, and CFC3 pays CFC2 $20x of interest.

(ii) *Analysis.* Under paragraph (k)(2) of this section, the interest payments from CFC1 to CFC3 must be offset by the amount of interest that CFC1 is considered as receiving indirectly from CFC3 and the interest payment from CFC3 to CFC2 is offset by the amount of the interest payment that CFC3 is considered as receiving indirectly from CFC2. The $10x payment by CFC1 to CFC3 is reduced by $5x, the amount of the interest payment from CFC2 to CFC1 that is treated as being paid indirectly by CFC3 to CFC1. Similarly, the $20x interest payment from CFC3 to CFC2 is reduced by $5x, the amount of the interest payment from CFC1 to CFC3 that is treated as being paid indirectly by CFC2 to CFC3. Therefore, under paragraph (k)(2) of this section, CFC2 is treated as having made no interest payment to CFC1, CFC1 is treated as having paid $5x of interest to CFC3, and CFC3 is treated as having paid $15x to CFC2.

(5) *Example 5*—(i) *Facts.* USP, a domestic corporation, owns 100% of the stock of CFC1, a controlled foreign corporation, and CFC1 owns 100% of the stock of CFC2, a controlled foreign corporation. In Year 1, CFC1 earns $100x of passive category foreign personal holding company income and $100x of general category non-subpart F sales income from unrelated persons and $100x of general category non-subpart F interest income from a related person. CFC1 pays $150x of interest to CFC2. CFC2 earns $200x of general category sales income from unrelated persons and the $150x interest payment from CFC1. CFC2 pays CFC1 $100x of interest. USP does not have an inclusion under section 951A.

(ii) *Analysis*—(A) Under paragraph (k)(2) of this section, the $100x interest payment from CFC2 to CFC1 reduces the $150x interest payment from CFC1 to CFC2. CFC1 is treated as though it paid $50x of interest to CFC2. CFC2 is treated as though it made no interest payment to CFC1.

(B) Under paragraph (k)(2)(ii) of this section, the remaining $50x interest payment from CFC1 to CFC2 is then characterized. The interest payment is first allocable under the rules of paragraph (c)(2)(ii)(C) of this section to CFC1's passive category income. Therefore, under paragraph (c)(2)(i) of this section, the $50x interest payment to CFC2 is passive category income. The interest income is foreign personal holding company income in CFC2's hands. CFC2, therefore, has $50x of passive category subpart F income and $200x of general category non-subpart F income.

(C) Under paragraph (k)(2)(iii) of this section, inclusions under section 951(a)(1)(A) are characterized next. USP has an inclusion under section 951(a)(1)(A) with respect to CFC1 of $50x that is attributable to passive category income of CFC1 and is treated as passive category income to USP. USP has an inclusion under section 951(a)(1)(A) with respect to CFC2 of $50x that is attributable to passive category income of CFC2 and is treated as passive category income to USP.

(6) *Example 6*—(i) *Facts.* USP, a domestic corporation, owns 100% of the stock of CFC1, a controlled foreign corporation, and CFC1 owns 100% of the stock of CFC2, a controlled foreign corporation. USP also owns 100% of the stock of CFC3, a controlled foreign corporation. CFC1, CFC2, and CFC3 are all incorporated in different foreign countries. In Year 1, CFC1 earns $100x of passive category foreign personal holding company income and $200x of general category non-subpart F income from unrelated persons. CFC1 also receives a $150x distribution from CFC2. CFC1 pays $100x of interest to CFC2 and $100x of interest to CFC3. CFC3 earns $300x of general category non-subpart F income and the $100x of interest received from CFC1. CFC3 pays a $100x royalty to CFC2. The royalty is directly allocable to CFC3's general category income and the royalty is not subpart F income to CFC2. CFC2 earns the $100x interest payment received from CFC1 and the $100x royalty received from CFC3. USP does not have an inclusion under section 951A.

(ii) *Analysis*—(A) Under paragraph (k)(2)(i) of this section, the royalty paid by CFC3 to CFC2 is characterized first. With respect to CFC2, the royalty is general category non-subpart F income.

(B) Under paragraph (k)(2)(ii) of this section, the interest payments from CFC1 to CFC2 and CFC3 are characterized next. Under paragraph (c)(2)(ii)(C) of this section, the interest payments are first allocable to CFC1's passive category income. Therefore, under paragraph (c)(2)(i) of this section, $50x of the interest payment to CFC2 is passive category income and $50x of the interest payment to CFC3 is passive category income. The remaining $50x paid to CFC2 is general category income and the remaining $50x paid to CFC3 is general category income. Because $100x of the interest income received or accrued from CFC1 is properly allocable to income of CFC1 which is not subpart F income, under section 954(c)(6) the general category interest income is not treated as foreign personal holding company income to CFC2 and CFC3. The remaining $100x of interest income received or accrued from CFC1 is passive category subpart F foreign personal holding company income to both recipients. Therefore, CFC3 and CFC2 each have $50x of passive category subpart F foreign personal holding company income related to the interest received from CFC1.

(C) Under paragraph (k)(2)(iii) of this section, USP's $50x inclusion under section 951(a)(1)(A) with respect to CFC2 is characterized next. Under paragraph (c)(5) of this section, USP's inclusion under section 951(a)(1)(A) is attributable to the passive category portion of the interest income received by CFC2 from CFC1 and is passive category income to USP. Under paragraph (k)(2)(iii) of this section, USP's $50x inclusion under section 951(a)(1)(A) with respect to CFC3 is also characterized next. Under paragraph (c)(5) of this section, USP's inclusion under section 951(a)(1)(A) is attributable to the passive category portion of the interest income received by CFC3 from CFC2 and is passive category income to USP.

(D) Under paragraph (k)(2)(iv) of this section, the $150x distribution from CFC2 to CFC1 is characterized next. The first $50x of the distribution is out of passive category earnings and profits described in section 959(c)(2). The remaining $100x of the distribution is a dividend that is not attributable to CFC2's passive category income, so under paragraph (c)(4)(i) of this section it is general category income to CFC1 in its entirety. Because $100x of the dividend received or accrued from CFC2 is attributable to income of CFC2 which is not subpart F income, under section 954(c)(6) such dividend income is not treated as foreign personal holding company income of CFC1.

(7) *Example 7*—(i) *Facts.* USP, a domestic corporation, owns 100% of the stock of CFC1, a controlled foreign corporation, and CFC1 owns 100% of the stock of CFC2, a controlled foreign corporation. USP also owns 100% of the stock of CFC3, a controlled foreign corporation. CFC1, CFC2, and CFC3 are all incorporated in different foreign countries. In Year 1, CFC2 earns $100x of general category income that is not subpart F income and distributes the entire amount to CFC1 as a dividend. CFC1 earns $100x of passive category foreign personal holding company income and the $100x dividend from CFC2. CFC1 pays $100x of interest to CFC3. CFC3 earns $200x of general category income that is foreign base company income and the $100x of interest income from CFC1. USP does not have an inclusion under section 951A.

(ii) *Analysis.* This transaction does not involve circular payments and, therefore, the ordering rules of paragraph (k)(2) of this section do not apply. Instead, pursuant to paragraph (k)(1) of this section, income received is characterized first. CFC2's earnings and, thus, the dividend from CFC2 to CFC1 are characterized first. Under paragraph (c)(4)(i) of this section, CFC1 includes the $100x dividend from CFC2 in gross income as general category income because none of CFC2's earnings are passive category income. CFC1 thus has $100x of passive category foreign personal holding company income and $100x of general category income that is excluded from subpart F income under section 954(c)(6)(A). The interest payment from CFC1 to CFC3 is then characterized as $100x passive category income under paragraph (c)(2)(ii)(C) of this section because it is allocable to passive foreign personal holding company income of CFC1. For Year 1, CFC3 thus has $200x of general category income that is subpart F income, and $100x of passive category foreign personal holding company income. For Year 1, under § 1.904–4(d) and paragraph (c)(5) of this section, USP includes in its gross income an inclusion under section 951(a)(1)(A) with respect to CFC3, $200x of which is general category income and $100x of which is passive category income.

(m) * * *

(2) * * *

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

(3) *Examples.* The following examples illustrate the application of this paragraph (m).

(i) *Example 1*—(A) *Facts.* Controlled foreign corporation CFC is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC pays USP $300x of interest. CFC has no other expenses. In Year 1, CFC has $3,000x of assets that generate $650x of foreign source general category income and a $1,000x loan to an unrelated foreign person that generates $20x of foreign source passive category interest income. CFC also has a $4,000x loan to an unrelated United States person that generates $70x of U.S. source passive category interest income and $4,000x of assets that generate $100x of U.S. source general category income. CFC uses the asset method to allocate interest expense. The following chart summarizes CFC's assets and income:

TABLE 1 TO PARAGRAPH (m)(3)(i)(A)

	Foreign	U.S.	Totals
Assets:			
Passive	1,000x	4,000x	5,000x
General	3,000x	4,000x	7,000x
Total	4,000x	8,000x	12,000x
Income:			
Passive	20x	70x	90x
General	650x	100x	750x
Total	670x	170x	840x

(B) *Analysis.* Under paragraph (c)(2)(ii)(C) of this section, $90x of the related person interest payment is allocable to CFC's passive category income. Under paragraph (m)(2) of this section, $70x of USP's $90x of passive category interest income is from sources within the United States and $20x is from foreign sources. Under paragraph (c)(2)(ii)(D) of this section, the remaining $210x of the related person interest payment is allocated to general category income. Under paragraph (m)(2) of this section, $120x of the remaining $210x of USP's interest income is treated as general category income from sources within the United States ($120x = $210x × $4,000x/$7,000x) and $90x is treated as general category income from foreign sources ($90x = $210x × $3,000x/$7,000x).

(ii) *Example 2.* The facts are the same as in paragraph (m)(3)(i) of this section (the facts in *Example 1*), except that CFC uses the modified gross income method to allocate interest expense. The first $90x of related person interest expense is allocated to passive category income in the same manner as in paragraph (m)(3)(i) of this section (*Example 1*), $70x to U.S. sources and $20x to foreign sources. Under paragraph (c)(2)(ii)(D) of this section, the remaining $210x of the related person interest expense is allocated to CFC's general category income. Under paragraph (m)(2) of this section, $28x of the remaining $210x of USP's interest income is treated as general category income from U.S. sources ($28x = $210x × $100x/$750x) and $182x is treated as general category income from foreign sources ($182x = $210x × $650x/$750x).

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

* * * * *

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

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

(A) *Facts.* Controlled foreign corporation CFC is a wholly-owned subsidiary of domestic corporation, USP. In Year 1, CFC earns $100x of subpart F foreign personal holding company income that is passive category income. Of this amount, $40x is derived from sources within the United States. CFC also earns $50x of subpart F general category income. None of this income is from sources within the United States. Assume that CFC pays no foreign taxes and has no expenses.

(B) *Analysis.* USP must include $150x in gross income under section 951(a). Of this amount, $60x is foreign source passive category income to USP, $40x is U.S. source passive category income to USP, and $50x is foreign source general category income to USP.

* * * * *

(7) * * *

(ii) *Example.* The following example illustrates the application of this paragraph (m)(7).

(A) *Facts.* Controlled foreign corporation CFC is incorporated in Country A and is a wholly-owned subsidiary of USP, a domestic corporation. In Year 1, CFC earns $80x of general category foreign base company sales income in Country A and $40x of passive category U.S. source interest income. CFC incurs $20x of expenses attributable to its sales business. CFC pays USP $40x of interest that is allocated to CFC's U.S. source passive category income under paragraph (c)(2)(ii)(C) of this section and so is U.S. source passive category income to USP under paragraphs (c)(2)(i) and (m)(2) of this section. Assume that earnings and profits equal net income. All of CFC's net income of $60x is subpart F income includible in USP's gross income under section 951(a)(1). For Year 1, USP also has $100x of foreign source passive category income derived from investments in Country B. Pursuant to section 904(h)(3) and paragraph (m)(2) of this section, the $40x interest payment from CFC is U.S. source income to USP because it is attributable to U.S. source interest income of CFC. The United States–Country A income tax treaty, however, treats all interest payments by residents of Country A as Country A sourced and USP elects to apply the treaty.

(B) *Analysis.* Pursuant to section 904(h)(10) and this paragraph (m)(7), the entire interest payment will be treated as foreign source income to USP. USP thus has $60x of foreign source general category income, $40x of foreign source Country A treaty category passive income from CFC, and $100x of foreign source passive category income.

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

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

■ **Par. 22.** Section 1.904–6 is amended by:

■ 1. In paragraph (a)(1)(i):

■ i. Revising the first sentence and adding two sentences after the fourth sentence.

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

■ 3. Revising paragraph (a)(1)(iv).

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

■ 5. Revising paragraph (b).

■ 6. Removing and reserving paragraph (c).

■ 7. Adding paragraph (d).

The revisions and additions read as follows:

§ 1.904–6 Allocation and apportionment of taxes.

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

* * * * *

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

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

(ii) *Disregarded reattribution transactions*—(A) *Foreign branch to foreign branch owner.* In the case of a disregarded payment from a foreign branch to a foreign branch owner that is treated as a disregarded reattribution transaction that results in gross income being attributed to the foreign branch owner under § 1.904–4(f)(2)(vi), any foreign tax imposed solely by reason of that transaction, such as a withholding tax imposed on a disregarded payment, is allocated and apportioned to the reattributed gross income.

(B) *Foreign branch owner to foreign branch.* In the case of a disregarded payment from a foreign branch owner to a foreign branch that is treated as a disregarded reattribution transaction that results in gross income being attributed to the foreign branch under § 1.904–4(f)(2)(vi), any foreign tax imposed solely by reason of that transaction is allocated and apportioned to the reattributed gross income. In the case of a foreign branch owner that is a partnership, a foreign tax imposed solely by reason of a disregarded reattribution transaction that results in general category income being attributed to a foreign branch is allocated and apportioned to the partnership's general category income that is attributable to the foreign branch (as described in paragraph (b)(4)(ii) of this section).

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

(B) *Foreign branch owner to foreign branch.* In the case of a disregarded payment from a foreign branch owner that is a United States person to a foreign branch that is neither a disregarded reattribution transaction nor described in § 1.904–4(f)(2)(vi)(C)(*4*), any foreign tax imposed solely by reason of the receipt of that disregarded payment is allocated and apportioned to the foreign branch category. In the case of a foreign branch owner that is a partnership, a foreign tax imposed solely by reason of the receipt of a disregarded payment by a foreign branch is allocated and apportioned to the partnership's general category income that is attributable to the foreign branch (as described in paragraph (b)(4)(ii) of this section).

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

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

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

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

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

(2) *Taxes deemed paid under section 960(b)(1).* If a domestic corporation that is a United States shareholder receives a distribution of previously taxed earnings and profits from a first-tier corporation that is excluded from the domestic corporation's income under section 959(a) and § 1.959–1, any foreign tax deemed paid under section 960(b)(1) with respect to such distribution is allocated to the same separate category as the annual PTEP account and PTEP group (as defined in § 1.960–3(c)) from which the distribution is made.

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

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

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

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

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

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

* * * * *

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

■ **Par. 23.** Section 1.904(b)–3 is added to read as follows:

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

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

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

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

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

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

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

245A subgroups. The deduction allowed under section 245A(a) for dividends is allocated and apportioned solely among the section 245A subgroups on the basis of the relative amounts of gross income from such dividends in each section 245A subgroup.

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

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

(d) *Coordination with OFL and ODL rules*—(1) *In general.* Section 904(b)(4) and this section apply before the operation of the overall foreign loss rules in section 904(f) and the overall domestic loss rules in section 904(g). *See* § 1.904(g)–3(c).

(2) [Reserved]

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

(1) *Facts*—(i) *Income and assets of USP.* USP is a domestic corporation. USP owns a factory in the United States with a tax book value of $27,000x. USP also directly owns all of the stock of each of the following three controlled foreign corporations: CFC1, CFC2, and CFC3. USP's tax book value in each of CFC1, CFC2, and CFC3 is $10,000x. USP incurs $1,500x of interest expense and earns $1,600x of U.S. source gross income. Under section 951A and the section 951A regulations (as defined in § 1.951A–1(a)(1)), USP's GILTI inclusion amount is $2,200x. USP's deduction under section 250 is $1,100x (''section 250 deduction''), all of which is by reason of section 250(a)(1)(B)(i). No portion of USP's section 250 deduction is reduced by reason of section 250(a)(2)(B). None of the CFCs makes any distributions.

(ii) *Characterization of CFC stock.* After application of § 1.861–13(a), USP determined that $8,000x of the stock of each of CFC1, CFC2, and CFC3 is assigned to the section 951A category (''section 951A category stock'') in the non-section 245A subgroup and the remaining $2,000x of the stock of each of CFC1, CFC2, and CFC3 is assigned to the general category (''general category stock'') in the section 245A subgroup. Additionally, under § 1.861–8(d)(2)(ii)(C)(*2*), $4,000x of the stock of each of CFC1, CFC2, and CFC3 that is section 951A category stock is an exempt asset. Accordingly, with respect to the stock of its controlled foreign corporations in the aggregate, USP has $12,000x of section 951A category stock in a non-section 245A subgroup; $6,000x of general category stock in a section 245A subgroup; and $12,000x of stock that is an exempt asset.

(iii) *Apportioning of expenses.* Taking into account USP's factory and its stock in CFC1, CFC2, and CFC3, the tax book value of USP's assets for purposes of apportioning expenses is $45,000x (excluding the $12,000x of exempt assets). Under § 1.861–9T(g), USP's $1,500 of interest expense is apportioned as follows: $400x ($1,500x × $12,000x/$45,000x) to section 951A category income, $200x ($1,500x × $6,000x/$45,000x) to general category income, and the remaining $900x ($1,500 × $27,000x/$45,000x) to the residual U.S. source grouping. Under § 1.861–8(e)(14), all of USP's section 250 deduction is allocated and apportioned to section 951A category income.

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

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

(A) *General category income.* Before application of section 904(b)(4) and the rules in this section, USP's foreign source taxable income in the general category is a loss of $200x, which equals $0 (USP's foreign source general category income) less $200x (interest expense apportioned to general category income), and USP's worldwide taxable income is $1,200. Under paragraph (d) of this section, the rules in section 904(f) and (g) apply after section 904(b)(4) and the rules in this section. Under paragraphs (b) and (c)(1) of this section, USP has no deductions properly allocable or apportioned to gross income in the section 245A subgroup because USP has no dividend income in the general category for which a deduction is allowed under section 245A. Under paragraphs (b) and (c) of this section, USP has $200x of deductions for interest expense that are properly allocable or apportioned to stock of specified 10-percent owned foreign corporations in the section 245A subgroup because USP's only general category assets are the general category stock of CFC1, CFC2, and CFC3, all of which are in the section 245A subgroup. Therefore, under paragraph (a) of this section, USP's foreign source taxable income in the general category and its worldwide taxable income are determined without regard to the $200x of deductions for interest expense. Accordingly, USP's foreign source taxable income in the general category is $0 and its worldwide taxable income is $1,400x, and therefore, there is no separate limitation loss for purposes of section 904(f). Under section 904(a) and (d)(1) USP's foreign tax credit limitation for the general category is $0.

(B) *Section 951A category income.* Before application of section 904(b)(4) and the rules in this section, USP's foreign source taxable income in the section 951A category is $700x, which equals $2,200x (USP's GILTI inclusion amount) less $1,100x (USP's section 250 deduction) less $400x (interest apportioned to section 951A category income). Under paragraphs (b) and (c)(1) of this section, USP has no deductions properly allocable and apportioned to gross income in a section 245A subgroup of the section 951A category. Under paragraphs (b) and (c) of this section, USP has no deductions properly allocable and apportioned to stock of specified 10-percent owned foreign corporations in a section 245A subgroup of section 951A category stock because no portion of section 951A category stock is assigned to a section 245A subgroup. *See* § 1.861–13(a)(5)(v). Therefore, under paragraph (a) of this section no adjustment is made to USP's foreign source taxable income in the section 951A category. However, the adjustments to USP's worldwide taxable income described in paragraph (e)(2)(ii)(A) of this section apply for purposes of calculating USP's foreign tax credit limitation for the section 951A category. Accordingly, USP's foreign source taxable income in the section 951A category is $700x and its worldwide taxable income is $1,400x. Under section 904(a) and (d)(1), USP's foreign tax credit limitation for the section 951A category is $126x ($252x × $700x/$1,400x).

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

■ **Par. 24.** § 1.904(f)–12 is amended by adding reserved paragraph (i) and paragraph (j) to read as follows:

§ 1.904(f)–12 Transition rules.

* * * * *

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

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

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

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

(ii) *Exception for general category separate limitation loss or overall foreign loss account*—(A) *In general.* To the extent a taxpayer has a balance in any separate limitation loss or overall foreign loss account in the pre-2018 separate category for general category income at the end of the taxpayer's last taxable year beginning before January 1, 2018, a taxpayer may choose to allocate any such balance to the taxpayer's post-2017 separate category for foreign branch category income to the extent the balance in the loss account would have been allocated to the taxpayer's post-2017 separate category for foreign branch category income if that separate category applied in the year or years the losses giving rise to the account were incurred. Any remaining portion of the balance in the separate limitation loss or overall foreign loss account is allocated to the taxpayer's post-2017 separate category for general category income.

(B) *Safe harbor.* In lieu of applying paragraph (j)(2)(ii)(A) of this section, the taxpayer may choose to recapture the balance in any loss account described in paragraph (j)(2)(ii)(A) of this section from the first available income in the taxpayer's post-2017 separate category for general category income or foreign branch category income. If the sum of taxpayer's general category income and foreign branch category income for a taxable year subject to recharacterization exceeds the amount of the loss account described in paragraph (j)(2)(ii)(A) of this section that is to be recaptured, then the amount of general category income and foreign branch category income that will be recharacterized under the relevant recapture provisions is determined on a proportionate basis. The recapture under this paragraph (j)(2)(ii)(B) of any loss account described in paragraph (j)(2)(ii)(A) of this section is made before the recapture of any amount by which the balance of the loss account is increased after the end of the taxpayer's last taxable year beginning before January 1, 2018.

(C) *Rules regarding the exception.* A taxpayer applying the exception described in paragraph (j)(2)(ii)(A) or (B) of this section must apply the exception to all balances in any separate limitation loss or overall foreign loss account in a pre-2018 separate category for general category income at the end of the taxpayer's last taxable year beginning before January 1, 2018. A taxpayer may apply the exception on a timely filed original return (including extensions) or an amended return. A taxpayer that applies the exception on an amended return must make appropriate adjustments to eliminate any double benefit arising from application of the exception to years that are not open for assessment.

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

(ii) *Exception for separate limitation loss or overall domestic loss that reduced general category income*—(A) *In general.* To the extent that a taxpayer's separate limitation loss or overall domestic loss account offset pre-2018 separate category income that was general category income, a taxpayer may choose to recapture the balance in the loss account at the end of the taxpayer's last taxable year beginning before January 1, 2018, in subsequent taxable years as income in the post-2017 separate category for foreign branch category income to the extent the balance in the loss account would have offset foreign branch category income had that separate category applied in the year or years the losses were incurred. Any remaining portion of the balance in the loss account is recaptured as income in the taxpayer's post-2017 separate category for general category income.

(B) *Safe harbor.* In lieu of applying paragraph (j)(3)(ii)(A) of this section, a taxpayer that had unused foreign income taxes in a pre-2018 taxable year that were allocated to the foreign branch category under § 1.904–2(j)(1)(iii)(A) or (B) may choose to recapture the balance in any loss account described in paragraph (j)(3)(ii)(A) of this section in subsequent taxable years ratably as income in the taxpayer's post-2017 separate categories for general category and foreign branch category income, based on the proportion in which any unused foreign taxes in the pre-2018 separate category for general category income are allocated under § 1.904–2(j)(1)(iii)(A) or (B).

(C) *Rules regarding the exception.* A taxpayer applying the exception described in paragraph (j)(2)(ii)(A) or (B) of this section must apply the exception to the recapture of all balances at the end of the taxpayer's last taxable year beginning before January 1, 2018 in any separate limitation loss or overall domestic loss account which offset pre-2018 separate category income that was general category income. A taxpayer may apply the exception on a timely filed original return (including extensions) or an amended return. A taxpayer that applies the exception on an amended return must make appropriate adjustments to eliminate any double benefit arising from application of the exception to years that are not open for assessment.

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

(ii) *Exception for general category foreign losses that are part of net operating losses*—(A) *In general.* A taxpayer may choose to treat the portion of a net operating loss carryforward that is attributable to a foreign loss from the pre-2018 separate category for general category income as attributable to the post-2017 separate category for foreign branch category income to the extent the net operating loss would have been attributable to the taxpayer's post-2017 separate category for foreign branch category income had that separate category applied in the year or years the net operating loss arose. Any remaining portion of the net operating loss carryforward is treated as attributable to the taxpayer's post-2017 separate category for general category income.

(B) *Safe harbor.* In lieu of applying paragraph (j)(4)(ii)(A) of this section, for the post-2017 taxable year in which a net operating loss carryforward described in paragraph (j)(4)(ii)(A) of this section is used, the taxpayer may choose to treat the net operating loss carryforward as attributable to the taxpayer's post-2017 separate categories for general category income and foreign branch category income to the extent of any general category income and foreign branch category income, respectively, that is available in the carryforward year to be offset by the net operating loss carryforward. To the extent the net operating loss carryforward offsets any other income in the carryforward year, it is treated as attributable to the taxpayer's post-2017 separate category for general category income. If the sum of taxpayer's general category income and foreign branch income in the carryforward year exceeds the amount of the net operating loss carryforward, then the amount of each type of separate income that is offset by the net operating loss carryforward, and therefore the separate category treatment of the net operating loss carryforward, is be determined on a proportionate basis. A general category net operating loss to which the exception is applied is absorbed before any general category net operating loss that is incurred after the end of the taxpayer's last taxable year beginning before January 1, 2018.

(C) *Rules regarding the exception.* A taxpayer applying the exception described in paragraph (j)(4)(ii)(A) or (B) of this section must apply the exception to all of its net operating losses that are attributable to a foreign loss from the pre-2018 separate category for general category income. A taxpayer may apply the exception on a timely filed original return (including extensions) or an amended return. A taxpayer that applies the exception on an amended return must make appropriate adjustments to eliminate any double benefit arising from application of the exception to years that are not open for assessment.

(5) *Coordination rule with respect to exceptions.* A taxpayer that applies any exception described in § 1.904–2(j)(1)(iii) or paragraph (j)(2)(ii), (j)(3)(ii), or (j)(4)(ii) of this section must apply all such exceptions and cannot apply any of the general rules described in § 1.904–2(j)(1)(ii) or paragraph (j)(2)(i), (j)(3)(i), or (j)(4)(i) of this section. However, in applying each such exception, the taxpayer may choose to apply the safe harbor provision regardless of whether the safe harbor is applied for purposes of any other exception.

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

■ **Par. 25.** Section 1.904(g)–0 is amended by:

■ 1. Adding an entry for § 1.904(g)–3(i) and removing and reserving the entry for § 1.904(g)–3(j).

■ 2. Revising the entry for § 1.904(g)–3(k) and adding an entry for § 1.904(g)–3(l).

The revisions and additions read as follows:

§ 1.904(g)–0 Outline of regulation provisions.

* * * * *

§ 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.*

* * * * *

(i) Step Eight: Dispositions under section 904(f)(3) in which gain would not otherwise be recognized.

(j) [Reserved]

(k) Examples.

(l) Applicability date.

■ **Par. 26.** Section 1.904(g)–3 is amended by:

■ 1. Removing the language ''paragraphs (b) through (i)'' and adding the language ''paragraphs (b) through (j)'' in its place in paragraph (a).

■ 2. Adding a sentence at the end of paragraph (c).

■ 3. Revising paragraph (f).

■ 4. Adding paragraph (i).

■ 5. Removing and reserving paragraph (j) and revising paragraph (k).

■ 6. Adding paragraph (l).

The revisions and additions 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.

* * * * *

(c) * * * The taxpayer also takes into account any adjustments required under section 904(b)(4) and § 1.904(b)–3.

* * * * *

(f) *Step Five: Recapture of overall foreign loss accounts.* If the taxpayer's separate limitation income for the taxable year (reduced by any losses carried over under paragraph (b) of this section) exceeds the sum of the taxpayer's U.S. source loss and separate limitation losses for the year, so that the taxpayer has separate limitation income remaining after the application of paragraphs (d)(1) and (e) of this section, then the taxpayer recaptures prior year overall foreign losses, if any, in accordance with § 1.904(f)–2, and reduces overall foreign loss accounts in accordance with § 1.904(f)–2. The recapture in this paragraph (f) includes amounts determined under § 1.904(f)–2(c) and (d)(3) but not § 1.904(f)–2(d)(4), which is covered in paragraph (i) of this section.

* * * * *

(i) *Step Eight: Dispositions under section 904(f)(3) in which gain would not otherwise be recognized.* The taxpayer determines the amount of gain that would otherwise not be recognized but that must be recognized in accordance with § 1.904(f)–2(d)(4) (not exceeding the taxpayer's applicable overall foreign loss account) and then applies § 1.904(f)–2(a) and (b) to recapture and reduce its overall foreign loss accounts in an amount equal to the gain recognized. To the extent this recognition of gain in a taxable year reduces the amount of a current year net operating loss or increases the amount of a net operating loss carryover to that taxable year, paragraphs (b) through (e) 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, but only after the applicable overall foreign loss account has been recaptured as provided in this paragraph (i).

* * * * *

(k) *Examples.* The following examples illustrate the rules of this section. Unless otherwise noted, all corporations use the calendar year as the U.S. taxable year.

(1) *Example 1*—(i) *Facts*—(A) USC is a domestic corporation with foreign branch operations in Country X. For Year 1, USC had the following taxable income and losses after application of section 904(f) and (g) to income and loss in Year 1:

TABLE 1 TO PARAGRAPH (k)(1)(i)(A)

Foreign branch	Passive	US
$400x	$200x	$110x

(B) For Year 2, USC has a net operating loss of ($500x), determined as follows:

TABLE 2 TO PARAGRAPH (k)(1)(i)(B)

Foreign branch	Passive	US
($300x)	$0	($200x)

(ii) *Analysis*—(A) *Net operating loss allocation.* Because USC's taxable income for Year 1 exceeds its total net operating loss for Year 2, the full net operating loss is carried back. Under paragraph (b) of this section (Step 1), each component of the net operating loss is carried back and combined with its same category in Year 1. See paragraph (b)(2) of this section. After allocation of the net operating loss, USC has the following taxable income and losses for Year 1:

TABLE 3 TO PARAGRAPH (k)(1)(ii)(A)

Foreign branch	Passive	US
$100x	$200x	($90x)

(B) *Loss allocation.* Under paragraph (e) of this section (Step 4), the ($90x) of U.S. loss is allocated proportionately to reduce the foreign branch category and passive category income. Accordingly, $30x ($90x × $100x/$300x) of the U.S. loss is allocated to foreign branch category income and $60x ($90x × $200x/$300x) of the U.S. loss is allocated to passive category income, with a corresponding creation or increase to USC's overall domestic loss accounts.

(2) *Example 2*—(i) *Facts*—(A) USC is a domestic corporation with foreign branch operations in Country X. As of January 1, Year 1, USC has no loss accounts subject to recapture. For Year 1, USC has a net operating loss of ($1,400x), determined as follows:

TABLE 4 TO PARAGRAPH (k)(2)(i)(A)

Foreign branch	Passive	US
($400x)	($200x)	($800x)

(B) For Year 2, USC has the following taxable income and losses:

TABLE 5 TO PARAGRAPH (k)(2)(i)(B)

Foreign branch	Passive	US
$500x	($100x)	$1200x

(ii) *Analysis*—(A) *Net operating loss allocation.* Under paragraph (b) of this section (Step 1), because USC's total taxable income for Year 2 of $1600x ($1,200x + $500x − $100x) exceeds the total Year 1 net operating loss, the full $1,400x net operating loss is carried forward. Under paragraph (b)(2) of this section, each component of the net operating loss is carried forward and combined with its same category in Year 2. After allocation of the net operating loss, USC has the following taxable income and losses:

TABLE 6 TO PARAGRAPH (k)(2)(ii)(A)

Foreign branch	Passive	US
$100x	($300x)	$400x

(B) *Loss allocation.* Under paragraph (d) of this section (Step 3), $100x of the passive category loss offsets the $100x of foreign branch category income, resulting in a passive category separate limitation loss account with respect to foreign branch category income, and the other $200x of passive category loss offsets $200x of the U.S. source taxable income, resulting in the creation of an overall foreign loss account in the passive category.

(3) *Example 3*—(i) *Facts.* Assume the same facts as in paragraph (k)(2)(i) of this section (the facts in *Example 2*), except that in Year 2, USC had the following taxable income and losses:

TABLE 7 TO PARAGRAPH (k)(3)(i)

Foreign branch	Passive	US
$200x	($100x)	$1200x

(ii) *Analysis*—(A) *Net operating loss allocation.* Under paragraph (b) of this section (Step 1), because the total net operating loss for Year 1 of ($1,400x) exceeds total taxable income for Year 2 of $1,300x ($1,200x + $200x − $100x), USC has a partial net operating loss carryover to Year 2 of $1,300x. Under paragraph (b)(3)(i) of this section, first, the $800x U.S. source component of the net operating loss is allocated to U.S. income for Year 2. The tentative foreign branch category carryover under paragraph (b)(3)(ii) of this section ($200x) does not exceed the remaining net operating loss carryover amount ($500x). Therefore, $200x of the foreign branch category component of the net operating loss is next allocated to the foreign branch category income for Year 2. Under paragraph (b)(3)(iii) of this section, the remaining $300x of net operating loss carryover ($1300x − $800x − $200x) is carried over proportionally from the remaining net operating loss components in the foreign branch category ($200x, or $400x total foreign branch category loss − $200x foreign branch category loss already allocated) and passive category ($200x). Therefore, $150x ($300x × $200x/$400x) of the remaining net operating loss carryover is carried over from the foreign branch category for Year 1 and combined with the foreign branch category income for Year 2, and $150x ($300x × $200x/$400x) of the remaining net operating loss carryover is carried over from the passive category for Year 1 and combined with the passive category loss for Year 2. After allocation of the net operating loss carryover from Year 1 to the appropriate categories for Year 2, USC has the following taxable income and losses:

TABLE 8 TO PARAGRAPH (k)(3)(ii)(A)

Foreign branch	Passive	US
($150x)	($250x)	$400x

(B) *Loss allocation.* Under paragraph (d) of this section (Step 3), the losses in the foreign branch and passive categories fully offset the U.S. source income, resulting in the creation of foreign branch category and passive category overall foreign loss accounts.

(4) *Example 4*—(i) *Facts.* Assume the same facts as in paragraph (k)(2)(i) of this section (the facts in *Example 2*), except that in Year 2, USC has the following taxable income and losses:

TABLE 9 TO PARAGRAPH (k)(4)(i)

Foreign branch	Passive	US
$200x	$200x	($200x)

(ii) *Analysis*—(A) *Net operating loss allocation.* Under paragraph (b) of this section (Step 1), because the total net operating loss of ($1400x) exceeds total taxable income for Year 2 of $200x ($200x + $200x − $200x), USC has a partial net operating loss carryover to Year 2 of $200x. Because USC has no U.S. source income in Year 2, under paragraph (b)(3)(i) of this section no portion of the U.S. source component of the net operating loss is initially carried into Year 2. Because the total tentative carryover under paragraph (b)(3)(ii) of this section of $400x ($200x in each of the foreign branch and passive categories) exceeds the net operating loss carryover amount, the tentative carryover from each separate category is reduced proportionately by $100x ($200x × $200x/$400x). Accordingly, $100x ($200x − $100x) of the foreign branch category component of the net operating loss is carried forward and $100x ($200x − $100x) of the passive category component of the net operating loss is carried forward and combined with income in the same respective categories for Year 2. After allocation of the net operating loss carryover from Year 1, USC has the following taxable income and losses:

TABLE 10 TO PARAGRAPH (k)(4)(ii)(A)

Foreign branch	Passive	US
$100x	$100x	($200x)

(B) *Loss allocation.* Under paragraph (e) of this section (Step 4), the $200x U.S. source loss offsets the remaining $100x of foreign branch category income and $100x of passive category income, resulting in the creation of overall domestic loss accounts with respect to the foreign branch and passive categories.

(5) *Example 5*—(i) *Facts.* Assume the same facts as in paragraph (k)(2)(i) of this section (the facts in *Example 2*), except that in Year 2, USC has the following taxable income and losses:

TABLE 11 TO PARAGRAPH (k)(5)(i)

Foreign branch	Passive	US
$800x	($100x)	$100x

(ii) *Analysis*—(A) *Net operating loss allocation.* Under paragraph (b) of this section (Step 1), because USC's total net operating loss in Year 1 of ($1,400x) exceeds its total taxable income for Year 2 of $800x ($100x + $800x − $100x), USC has a partial net operating loss carryover to Year 2 of $800x. Under paragraph (b)(3)(i) of this section, $100x of the U.S. source component of the net operating loss is allocated to U.S. income for Year 2. The tentative foreign branch category carryover under paragraph (b)(3)(ii) of this section does not exceed the remaining net operating loss carryover amount. Therefore, $400x of the foreign branch category component of the net operating loss is allocated to reduce foreign branch category income in Year 2. Under paragraph (b)(3)(iii) of this section, of the remaining $300x of net operating loss carryover ($800x − $100x − $400x), $200x is carried forward from the passive category component of the net operating loss and combined with the passive category loss for Year 2. Under paragraph (b)(3)(iv) of this section, the remaining $100x ($300x − $200x) of net operating loss carryover is carried forward from the U.S. source component of the net operating loss and combined with the U.S. source income (and the previously allocated U.S. source component of the net operating loss) for Year 2. After allocation of the net operating loss carryover from Year 1, USC has the following taxable income and losses:

TABLE 12 TO PARAGRAPH (k)(5)(ii)(A)

Foreign branch	Passive	US
$400x	($300x)	($100x)

(B) *Loss allocation*—(*1*) Under paragraph (d) of this section (Step 3), the $300x passive category loss offsets the $300x of income in the foreign branch category, resulting in the creation of a passive category separate limitation loss account with respect to the foreign branch category.

(*2*) Under paragraph (e) of this section (Step 4), the $100x U.S. source loss offsets the remaining $100x of the foreign branch category income, resulting in the creation of an overall domestic loss account with respect to the foreign branch category.

(6) *Example 6*—(i) *Facts*—(A) USC is a domestic corporation with foreign branch operations in Country X. USC has no net operating losses and does not make an election to recapture more than the required amount of overall foreign losses. As of January 1, Year 1, USC has a ($200x) foreign branch category overall foreign loss (OFL) account and a ($200x) foreign branch category separate limitation loss (SLL) account with respect to the passive category. For Year 1, USC has $400x of passive category income that is fully offset by a ($400x) domestic loss in that taxable year, giving rise to the creation of an overall domestic loss (ODL) account with respect to the passive category. As of January 1, Year 2, USC has the following balances in its OFL, SLL, and ODL accounts:

TABLE 13 TO PARAGRAPH (k)(6)(i)(A)

Foreign branch		US
OFL	SLL (passive)	ODL (passive)
$200x	$200x	$400x

(B) In Year 2, USC has the following taxable income and losses:

TABLE 14 TO PARAGRAPH (k)(6)(i)(B)

Foreign branch	Passive	US
$400x	($100x)	$600x

(ii) *Analysis*—(A) *Loss allocation.* Under paragraph (d) of this section (Step 3), the $100x of passive category loss offsets $100x of the foreign branch category income, creating a passive category SLL account of $100x with respect to the foreign branch category. Because there is an offsetting foreign branch category SLL account of $200x with respect to the passive category from a prior taxable year, the two accounts are netted against each other so that all that remains is a $100x foreign branch category SLL account with respect to the passive category.

(B) *OFL account recapture.* Under paragraph (f) of this section (Step 5), 50% of the remaining $300x, or $150x, of income in the foreign branch category is subject to recharacterization as U.S. source income as a recapture of part of the OFL account in the foreign branch category.

(C) *SLL account recapture.* Under paragraph (g) of this section (Step 6), $100x of the remaining $150x of income in the foreign branch category is recharacterized as passive category income as a recapture of the foreign branch category SLL account with respect to the passive category.

(D) *ODL account recapture.* Under paragraph (h) of this section (Step 7), 50% of the $600, or $300, of U.S. source income is subject to recharacterization as foreign source passive category income as a recapture of a part of the ODL account with respect to the passive category. None of the $150x of foreign branch category income that was recharacterized as U.S. source income under paragraph (f) of this section (Step 5) is included here as income subject to recharacterization in connection with recapture of the ODL account.

(E) *Results*—(*1*) After the allocation of loss and recapture of loss accounts, USC has the following taxable income and losses for Year 2:

TABLE 15 TO PARAGRAPH (k)(6)(ii)(E)(*1*)

Foreign branch	Passive	US
$50x	$400x	$450x

(*2*) As of January 1, Year 3, USC has the following balances in its OFL, SLL and ODL accounts:

TABLE 16 TO PARAGRAPH (k)(6)(ii)(E)(*2*)

Foreign branch		Passive	US
OFL	SLL (passive)	SLL (foreign branch)	ODL (passive)
$50x	$0	$0	$100x

(l) *Applicability date.* This section applies to taxable years ending on or after December 16, 2019.

§ 1.904(i)–1 [Amended]

■ **Par. 27.** Section 1.904(i)–1 is amended by removing the language "§ 1.904–5(a)(1)" and adding in its place the language "§ 1.904–5(a)(4)(v)" in the first sentence of paragraph (a)(1)(i).

■ **Par. 28.** Section 1.905–2 is amended by adding a sentence after the fourth sentence of paragraph (a)(2) to read as follows:

§ 1.905–2 Conditions of allowance of credit.

(a) * * *

(2) * * * If the receipt or the return is in a foreign language, a certified translation thereof must be furnished by the taxpayer. * * *

* * * * *

■ **Par. 29.** Section 1.905–3 is added to read as follows:

§ 1.905–3 Adjustments to U.S. tax liability as a result of a foreign tax redetermination.

(a) *Foreign tax redetermination.* The term *foreign tax redetermination* means a change in the liability for a 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 foreign tax credit. In the case of a taxpayer that claims the credit in the year the taxes are paid, a foreign tax redetermination occurs if any portion of the tax paid is subsequently refunded. In the case of a taxpayer that claims the credit in the year the taxes accrue, a foreign tax redetermination occurs if taxes that when paid or later adjusted differ from amounts accrued by the taxpayer and claimed as a credit or added to PTEP group taxes (as defined in § 1.960–3(d)(1)). A foreign tax redetermination includes corrections and other adjustments to accrued amounts to reflect the final foreign tax liability, including additional payments of tax that accrue after the close of the taxable year to which the tax relates and, for foreign income taxes taken into account when accrued but translated into dollars on the date of payment, a payment of accrued tax if the value of the foreign currency relative to the dollar has changed between the date or taxable year of accrual and the date of payment. A foreign tax redetermination occurs if any tax claimed as a credit or added to PTEP group taxes is refunded in whole or in part, regardless of whether such tax was paid within the meaning of § 1.901–2(e) at the time the tax was claimed as a credit or added to PTEP group taxes. A foreign tax redetermination also includes accrued foreign income taxes that are not paid on or before the date that is 24 months after the close of the taxable year of the section 901 taxpayer (as defined in § 1.986(a)–1(a)(1)) to which such taxes relate, as well as a subsequent payment of any such accrued but unpaid taxes. If accrued foreign income taxes are not paid on or before the date that is 24 months after the close of the taxable year to which they relate, the resulting foreign tax redetermination is accounted for as if the unpaid portion of the foreign income taxes were refunded on such date. Foreign income taxes that first accrue after the date 24 months after the close of the taxable year to which such taxes relate may not be claimed as a credit or added to PTEP group taxes until paid. See section 905(b) and § 1.461–4(g)(6)(iii)(B), which require the taxpayer to establish the amount of tax that was properly accrued.

(b) *Redetermination of U.S. tax liability*—(1) *Foreign income taxes other than taxes deemed paid under section 960*—(i) *In general.* This paragraph (b)(1) applies to foreign income taxes claimed as a credit under section 901 other than foreign income taxes deemed paid under section 960. If a foreign tax redetermination occurs with respect to foreign income tax claimed as a credit under section 901 (other than a tax deemed paid under section 960), then a redetermination of U.S. tax liability is required for the taxable year in which the tax was claimed as a credit and any year to which unused foreign taxes from such year were carried under section 904(c). In the case of a taxpayer that claims the credit in the year the taxes are paid, the redetermination of U.S. tax liability is made by reducing the tax paid in such year by the amount refunded. In the case of a taxpayer that claims the credit in the year the taxes accrue, the redetermination of U.S. tax liability is made by treating the redetermined amount of foreign tax as the amount of tax that accrued in the year to which the redetermined tax relates. However, a redetermination of U.S. tax liability is not required (and a taxpayer need not notify the IRS) if the foreign income taxes are taken into account when accrued but translated into dollars on the date of payment, the difference between the dollar value of the accrued foreign income tax and the dollar value of the foreign income tax paid is solely attributable to fluctuations in the value of the foreign currency relative to the dollar between the date or taxable year of accrual and the date of payment, and the net dollar amount of the currency fluctuations attributable to the foreign tax redeterminations with respect to each and every foreign country is less than the lesser of $10,000 or two percent of the total dollar amount of the foreign income tax initially accrued with respect to that foreign country for the taxable year. In such case, if no redetermination of U.S. tax liability is made, an appropriate adjustment is made to the taxpayer's U.S. tax liability in the taxable year during which the foreign tax redeterminations occur.

(ii) *Examples.* The following examples illustrate the application of this paragraph (b)(1) and § 1.986(a)–1. In all examples, assume that USC is a domestic corporation that uses the calendar year as its taxable year both for Federal income tax purposes and for foreign tax purposes and that it is doing business through a foreign branch operating in Country X, which is a qualified business unit (within the meaning of section 989 and § 1.989(a)–1) (QBU) the functional currency of which is the ''u.'' Except as otherwise provided, the ''u'' is not an inflationary currency within the meaning of § 1.986(a)–1(a)(2)(iii). USC is an accrual basis taxpayer.

(A) *Example 1: Contested tax*—(*1*) *Facts.* In Year 1, USC earned 500u of foreign source foreign branch category income through its foreign branch in Country X and accrued and paid 50u of Country X foreign income tax on its earnings. The average exchange rate for Year 1 used to translate the foreign income taxes into dollars was $1x:1u. *See* § 1.986(a)–1(a)(1). On its Year 1 income tax return, USC claimed a foreign tax credit under section 901 of $50x (50u translated at the average exchange rate for Year 1, that is, $1x:1u). In Year 4, Country X assessed an additional 20u of tax with respect to USC's Year 1 earnings. USC did not pay or accrue the additional 20u of tax and contested the assessment. After exhausting all effective and practical remedies to reduce, over time, its liability for foreign tax, USC settled the contest with Country X in Year 6, paying 10u of additional tax on September 1, Year 6, when the spot rate was $1.10x:1u.

(*2*) *Analysis.* USC's payment in Year 6 of the 10u of additional tax accrued with respect to Year 1 is a foreign tax redetermination under paragraph (a) of this section. Under paragraph (b)(1)(i) of this section, the additional tax is taken into account in Year 1, the year to which the redetermined tax relates, irrespective of when the tax is paid. Under § 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 redetermined tax relates, the 10u of tax is translated into dollars at the spot rate on the date of payment in Year 6 (10u at $1.10x:1u = $11x). If USC timely notifies the IRS, it may claim an increased foreign tax credit for Year 1. USC must also make corresponding adjustments in determining its taxable income and net unrecognized section 987 gain or loss in Year 1. See §§ 1.987–3(c)(2)(v) and 1.987–4(d)(7).

(B) *Example 2: Refund of tax improperly claimed as a credit*—(*1*) *Facts.* USC holds a note issued by FC, an unrelated foreign corporation in Country Y. In Year 1, FC owed USC 500u of interest on the loan. The statutory rate of withholding on interest paid to a nonresident of Country Y is 20%. On December 1, Year 1, when the spot rate was $1x:1u, FC withheld and remitted to Country Y 100u of tax and paid 400u to USC Effective for Year 1, USC elected under § 1.986(a)–1(a)(2)(iv) to translate its taxes denominated in nonfunctional currency into dollars at the spot rate on the date the taxes are paid. Under the United States—Country Y Income Tax Treaty (Treaty), USC was entitled to a reduced 15% rate of withholding that would result in a withholding tax of 75u. However, USC improperly claimed a foreign tax credit under section 901 for 100u = $100x on its Year 1 Federal income tax return. (See § 1.901–2(e)(2)(i) and (e)(5), providing that an amount is not tax paid to the extent it exceeds the taxpayer's liability for tax or is reasonably certain to be refunded.) In Year 4, USC filed a refund claim with Country Y for 25u, the difference between the amount actually withheld at the 20% statutory rate of tax and the amount owed by USC at the 15% Treaty rate. On March 15, Year 6, when the spot rate was $1.10x:1u, USC received a refund from Country Y of 25u. USC converted the 25u into dollars on the same day.

(*2*) *Analysis.* Notwithstanding that the 25u of refundable tax did not constitute an amount of tax paid within the meaning of § 1.901–2(e) at the time USC improperly claimed it as a credit, the 25u refund in Year 6 is a foreign tax redetermination under paragraph (a) of this section. Under paragraph (b)(1)(i) of this section, USC must redetermine its U.S. tax liability for Year 1, the taxable year to which the redetermined tax relates. Under § 1.986(a)–1(c), the refund is translated at the exchange rate that was used to translate such amount when originally claimed as a credit. Accordingly, if not previously adjusted by USC or the Internal Revenue Service, USC must file an amended return for Year 1, reducing the amount of foreign tax credit claimed for Year 1 by $25x (25u translated at the spot rate on December 1, Year 1; that is, $1x:1u). Under § 1.986(a)–1(e)(1), USC's basis in the 25u is the same dollar value of the refund as determined under § 1.986(a)–1(c), or $25x. When USC converted the 25u to $27.50x (translated at the spot rate on March 15, Year 6, that is, $1.10x:1u), it realized an exchange gain (within the meaning of § 1.988–1(e)) equal to $2.50x ($27.50x − $25x basis).

(C) *Example 3: Change in functional currency*—(*1*) *Facts.* In Year 1, USC earned 500u of foreign source foreign branch category income through its foreign branch in Country X and accrued 100u of Country X foreign income tax on its earnings. The average exchange rate for Year 1 used to translate the foreign income taxes into dollars was $1x:1u. *See* § 1.986(a)–1(a)(1). On its Federal income tax return for Year 1, USC claimed a foreign tax credit under section 901 of $100x (100u translated at the average exchange rate for Year 1, that is, $1x:1u). As of Year 2, the foreign branch changed its functional currency from the ''u'' to the dollar, and pursuant to § 1.985–5(d)(2), USC's foreign branch terminated and USC recognized section 987 gain or loss on December 31, Year 1 (the date of change). The rate of exchange, as determined under § 1.985–5(c), used to calculate the U.S. dollar basis in the foreign branch's property on the date of the change was $1.10x:1u, the spot rate on December 31, Year 1. On June 15, Year 3, when the spot rate was $1.30x:1u, USC's foreign branch received a refund from Country X of 10u. The foreign branch converted the 10u into $13x on the same day.

(*2*) *Analysis.* The 10u refund in Year 3 is a foreign tax redetermination under paragraph (a) of this section. Under paragraph (b)(1)(i) of this section, USC must redetermine its U.S. tax liability for Year 1, the taxable year to which the redetermined tax relates. Under § 1.986(a)–1(c), the refund is translated at the exchange rate that was used to translate such amount when originally claimed as a credit. Accordingly, USC must file an amended return, reducing the amount of foreign tax credit claimed for Year 1 by $10x (10u translated at the average exchange rate for Year 1, that is $1x:1u). USC must also make corresponding adjustments in determining its taxable income and net unrecognized section 987 gain or loss in Year 1. See §§ 1.987–3(c)(2)(v) and 1.987–4(d)(8). Because the foreign branch changed its functional currency to the dollar in Year 2, the 10u it receives is a refund of nonfunctional currency tax that is denominated in a currency that was the functional currency of the foreign branch at the time USC originally claimed a credit for that foreign income tax. Under §§ 1.985–5(d)(2) and 1.987–4(d), in Year 1 USC must recognize an additional $1x of section 987 gain (or $1x less of section 987 loss) by reason of the 10u being treated as an asset of the foreign branch at the time of the foreign branch's termination. Under § 1.986(a)–1(e)(2), USC's basis in the 10u refund is $11x, which is determined by using the exchange rate used under § 1.985–5(c) when the foreign branch changed its functional currency in Year 2 ($1.10x:1u). When the foreign branch converted the 10u to $13x (translated at the spot rate on June 15, Year 3, which is $1.30x:1u), it realized an exchange gain (within the meaning of § 1.988–1(e)) equal to $2x ($13x − $11x (10u translated at $1.10x:1u)).

(D) *Example 4: Inflationary currency*—(*1*) *Facts.* In Year 1, USC earned 500u of foreign source foreign branch category income through its foreign branch in Country X and accrued 100u of Country X foreign income tax on its earnings. The average exchange rate for Year 1 used to translate the foreign income taxes into dollars was $1x:1u. *See* § 1.986(a)–1(a)(1). On its Federal income tax return for Year 1, USC claimed a foreign tax credit under section 901 of $100x (100u translated at the average exchange rate for Year 1, that is, $1x:1u). USC paid the 100u of tax on April 15, Year 3, when the spot rate was $1x:2u. In Year 3, but not in Year 1, the u was an inflationary currency within the meaning of § 1.986(a)–1(a)(2)(iii).

(*2*) *Analysis.* Under § 1.986(a)–1(a)(2)(iii), because the u was an inflationary currency in the year the taxes were paid, USC must translate the 100u of Year 1 tax into dollars using the spot rate on the date of payment of the foreign taxes. Under paragraph (a) of this section, because the translated value of USC's Year 1 taxes when paid, that is, $50x (100u translated at the spot rate on April 15, Year 3, that is, $1x:2u), differs from the amount claimed as credits, that is, $100x (100u translated at the average exchange rate for Year 1, that is, $1x:1u), a foreign tax redetermination has occurred. Under paragraph (b)(1)(i) of this section, because the $50x foreign tax redetermination resulting from the currency fluctuation exceeds 2% of the $100x initially accrued, USC must redetermine its U.S. tax liability for Year 1, the taxable year to which the redetermined tax relates. Accordingly, USC must notify the IRS, reducing the amount of foreign tax credit claimed for Year 1 by $50x (the excess of the translated value of the Year 1 taxes when accrued, that is, $100x, over the translated value of the Year 1 taxes when paid, that is, $50x).

(E) *Example 5: Two-year rule*—(*1*) *Facts.* In Year 1, USC earned 500u of foreign source foreign branch category income through its foreign branch in Country X and accrued 100u of Country X foreign income tax on its earnings. The average exchange rate used to translate the foreign income taxes into dollars for Year 1 was $1x:1u. See § 1.986(a)–1(a)(1). On its Federal income tax return for Year 1, USC claimed a foreign tax credit under section 901 of $100x (100u translated at the average exchange rate for Year 1, that is, $1x:1u). USC did not pay the Year 1 foreign income taxes until March 15, Year 6, when the spot rate was $0.8x:1u.

(*2*) *Analysis*—(*i*) *Result in Year 3.* USC'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 were not paid on or before the date 24 months after the close of the taxable year to which the tax relates, USC must account for the redetermination as if the unpaid 100u of accrued taxes were refunded on the last day of Year 3. Under paragraph (b)(1)(i) of this section, USC must redetermine its U.S. tax liability for Year 1, the taxable year to which the redetermined tax relates. Under § 1.986(a)–1(c), the deemed refund is translated at the exchange rate that was used to translate such amount when originally claimed as a credit. Accordingly, USC must notify the IRS, reducing the amount of foreign tax credit claimed for Year 1 by $100x (100u translated at the average exchange rate for Year 1, that is, $1x:1u). USC must also make corresponding adjustments in determining its taxable income and net unrecognized section 987 gain or loss in Year 1. See §§ 1.987–3(c)(2)(v) and 1.987–4(d)(8).

(*ii*) *Result in Year 6.* USC's payment of the Year 1 tax liability of 100u on March 15, Year 6, results in a second foreign tax redetermination under paragraph (a) of this section. Under paragraph (b)(1)(i) of this section, the additional tax is taken into account in Year 1, the year to which the redetermined tax relates, irrespective of when the tax is paid. Under § 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, USC must translate the 100u of tax at the spot rate on the date of payment of the foreign taxes in Year 6. If USC timely notifies the IRS, it may claim an increased foreign tax credit for Year 1. USC must also make corresponding adjustments in determining its taxable income and net unrecognized section 987 gain or loss in Year 1. See §§ 1.987–3(c)(2)(v) and 1.987–4(d)(7).

(F) *Example 6: Cash basis taxpayer that pays additional foreign tax*—(*1*) *Facts.* Individual A, a U.S. citizen resident in Country X, is a cash basis taxpayer who has not made an election under section 905(a) to claim the foreign tax credit in the year the taxes accrue. A uses the calendar year as the taxable year for both U.S. and Country X tax purposes. In Year 2, A pays 100u of foreign income taxes to Country X with respect to Year 1. The exchange rate used to translate the foreign income taxes into dollars was $1x:1u, the spot rate on the date A paid the taxes in Year 2. *See* section 986(a)(2)(A) and § 1.986(a)–1(b). On A's Year 2 Federal income tax return, A claims a foreign tax credit under section 901 of $100x. In Year 4, Country X assesses an additional 20u of tax with respect to A's Year 1 income. A does not pay the additional 20u of tax and contests the assessment. After exhausting all effective and practical remedies to reduce, over time, A's liability for foreign tax, A settles the contest with Country X in Year 6, paying 10u of additional tax on September 1, Year 6, when the spot rate is $1.10x:1u.

(*2*) *Analysis.* Because A is a cash basis taxpayer that claims the foreign tax credit in the year the taxes are paid, A's payment in Year 6 of 10u of additional tax owed with respect to Year 1 is not a foreign tax redetermination requiring a redetermination of U.S. tax liability under paragraph (b)(1) of this section. Rather, A is eligible to claim the additional tax as a credit in Year 6, the year in which the tax is paid. Under § 1.986(a)–1(b), the 10u of tax is translated into dollars at the spot rate on the date of payment in Year 6 (10u at $1.10x:1u = $11x).

(G) *Example 7: Cash basis taxpayer that receives a refund of foreign tax*—(*1*) *Facts.*

The facts are the same as paragraph (b)(1)(ii)(F) of this section (the facts in *Example 6*) except that instead of being assessed additional tax in Year 4, A receives a refund in Year 4 of 10u with respect to A's Year 1 tax that was claimed as a credit in Year 2.

(*2*) *Analysis.* Under paragraphs (a) and (b)(1) of this section, A must redetermine its U.S. tax liability for Year 2 and any year to which unused foreign taxes were carried from Year 2. Under § 1.986(a)–1(c), the amount of A's foreign tax credit for Year 2 is reduced by $10x, the 10u refund translated at the exchange rate used to translate the tax when claimed as a credit. Under § 1.986(a)–1(e)(1), A's basis in the 10u is $10x.

(2) and (3) [Reserved]

(c) *Foreign income tax imposed on foreign refund.* If a redetermination of foreign income tax for a taxable year or years results from a refund to the section 901 taxpayer of foreign income taxes paid to a foreign country or possession of the United States and the foreign country or possession imposed foreign income tax on such refund, then, in accordance with section 905(c)(5), the amount of the refund is considered to be reduced by the amount of any foreign income tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund. In such case, no other credit under section 901, and no deduction under section 164, is allowed for any taxable year with respect to such tax imposed on such refund.

(d) *Applicability dates.* This section applies to foreign tax redeterminations occurring in taxable years ending on or after December 16, 2019.

§ 1.905–3T [Removed]

■ **Par. 30.** Section 1.905–3T is removed.

§ 1.951A–2 [Amended]

■ **Par. 31.** Section 1.951A–2 is amended by removing the language "§ 1.904–5(a)" and adding in its place the language "§ 1.904–5(a)(4)(v)" in the first sentence of paragraph (c)(3).

§ 1.952–1 [Amended]

■ **Par. 32.** Section 1.952–1 is amended by removing the language "§ 1.904–5(a)(1)" and adding in its place the language "§ 1.904–5(a)(4)(v)" in paragraph (e)(1)(i), the first sentence of paragraph (e)(5), and the first sentence of paragraph (f)(2)(ii).

■ **Par. 33.** Section 1.954–1 is amended by:

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

■ 2. In paragraph (d)(3)(i):

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

■ ii. Removing the language "section 960" and adding in its place the language "section 960(a)" in the second sentence.

■ iii. Removing the last sentence.

■ 3. Removing the language "section 960" and adding in its place the language "section 960(a) and § 1.960–2(b)(1)" in paragraph (d)(3)(ii).

■ 4. Adding paragraph (d)(3)(iii).

■ 5. Removing paragraph (g)(4).

■ 6. Adding paragraph (h).

The additions read as follows:

§ 1.954–1 Foreign base company income.

* * * * *

(d) * * *

(3) * * *

(iii) *Effect of potential and actual changes in taxes paid or accrued.* Except as otherwise provided in this paragraph (d)(3)(iii), the amount of foreign income taxes paid or accrued with respect to a net item of income, determined in the manner provided in this paragraph (d), does not take into account any potential reduction in foreign income taxes that may occur by reason of a future distribution to shareholders of all or part of such income. However, to the extent the foreign income taxes paid or accrued by the controlled foreign corporation are reasonably certain to be returned by the foreign jurisdiction imposing such taxes to a shareholder, directly or indirectly, through any means (including, but not limited to, a refund, credit, payment, discharge of an obligation, or any other method) on a subsequent distribution to such shareholder, the foreign income taxes are not treated as paid or accrued for purposes of this paragraph (d)(3).

* * * * *

(h) *Applicability dates*—(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 4, 2018.

(2) *Paragraph (g) of this section.* Paragraph (g) of this section applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

■ **Par. 34.** Section 1.960–1 is revised to read as follows:

§ 1.960–1 Overview, definitions, and computational rules for determining foreign income taxes deemed paid under section 960(a), (b), and (d).

(a) *Overview*—(1) *Scope of §§ 1.960–1 through 1.960–3.* This section and §§ 1.960–2 and 1.960–3 provide rules to associate foreign income taxes of a controlled foreign corporation with the income that a domestic corporation that is a United States shareholder of the controlled foreign corporation takes into account in determining a subpart F inclusion or GILTI inclusion amount of the domestic corporation, as well as to associate foreign income taxes of a controlled foreign corporation with distributions of previously taxed earnings and profits. This section and §§ 1.960–2 and 1.960–3 provide the exclusive rules for determining the foreign income taxes deemed paid by a domestic corporation under section 960. Therefore, only foreign income taxes of a controlled foreign corporation that are associated under these rules with a subpart F inclusion or GILTI inclusion amount of a domestic corporation that is a United States shareholder of the controlled foreign corporation, or with previously taxed earnings and profits, are eligible to be deemed paid. This section provides definitions and computational rules for determining foreign income taxes deemed paid under section 960(a), (b), and (d). Section 1.960–2 provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation under section 960(a) and (d). Section 1.960–3 provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation, or by a controlled foreign corporation, under section 960(b). This section and §§ 1.960–2 and 1.960–3 also apply for purposes of any provision that treats a taxpayer as a domestic corporation that is deemed to pay foreign income taxes or treats a foreign corporation as a controlled foreign corporation for purposes of section 960. See, for example, sections 962(a)(2) and 1293(f).

(2) *Scope of this section.* Paragraph (b) of this section provides definitions for purposes of this section and §§ 1.960–2 and 1.960–3. Paragraph (c) of this section provides computational rules to coordinate the various calculations under this section and §§ 1.960–2 and 1.960–3. Paragraph (d) of this section provides rules for computing the income in an income group within a section 904 category, and for associating foreign income taxes with an income group. Paragraph (e) of this section provides a rule for the treatment of taxes associated with the residual income group. Paragraph (f) of this section provides an example illustrating the application of this section.

(b) *Definitions.* The following definitions apply for purposes of this section and §§ 1.960–2 and 1.960–3.

(1) *Annual PTEP account.* The term *annual PTEP account* has the meaning set forth in § 1.960–3(c)(1).

(2) *Controlled foreign corporation.* The term *controlled foreign corporation* means a foreign corporation described in section 957(a).

(3) *Current taxable year.* The term *current taxable year* means the U.S. taxable year of a controlled foreign corporation that is an inclusion year, or during which the controlled foreign corporation receives a section 959(b) distribution or makes a section 959(a) distribution or a section 959(b) distribution.

(4) *Current year tax.* The term *current year tax* means a foreign income tax paid or accrued by a controlled foreign corporation in a current taxable year (taking into account any adjustments resulting from a foreign tax redetermination (as defined in § 1.905–3(a)). A foreign income tax accrues when all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. *See* §§ 1.446–1(c)(1)(ii)(A) and 1.461–4(g)(6)(iii)(B) (economic performance exception for certain foreign taxes). Withholding taxes described in section 901(k)(1)(B) that are withheld from a payment accrue when the payment is made. A foreign income tax calculated on the basis of net income (or a base in lieu of net income) for a foreign taxable year accrues on the last day of the foreign taxable year. Accordingly, current year taxes include foreign withholding taxes that are withheld from payments made to the controlled foreign corporation during the current taxable year, and foreign income taxes that accrue in the controlled foreign corporation's current taxable year in which or with which its foreign taxable year ends. Additional payments of foreign income taxes resulting from a redetermination of foreign tax liability, including contested taxes that accrue when the contest is resolved, ''relate back'' and are considered to accrue as of the end of the foreign taxable year to which the taxes relate.

(5) *Foreign income tax.* The term *foreign income tax* means each separate levy (as defined in § 1.901–2(d)) that is an income, war profits, and excess profits tax as defined in § 1.901–2(a), and tax included in the term income, war profits, and excess profits tax by reason of section 903 and § 1.903–1(a), that is imposed by a foreign country or a possession of the United States, including any such tax that is deemed paid by a controlled foreign corporation under section 960(b)(2). Income, war profits, and excess profits taxes do not include amounts excluded from the definition of those taxes under section 901. See, for example, section 901(f), (g), and (i). Foreign income tax also does not include taxes paid by a controlled foreign corporation for which a credit is disallowed at the level of the controlled foreign corporation. See, for example, sections 245A(e)(3), 901(k)(1), (l), and (m), 909, and 6038(c)(1)(B). Foreign income tax, however, includes tax that may be deemed paid but for which a credit is reduced or disallowed at the level of the United States shareholder. See, for example, sections 901(e), 901(j), 901(k)(2), 908, 965(g), and 6038(c)(1)(A).

(6) *Foreign taxable year.* The term *foreign taxable year* has the meaning set forth in section 7701(a)(23), applied by substituting ''under foreign law'' for the phrase ''under subtitle A.''

(7) *Foreign taxable income.* The term *foreign taxable income* means the base upon which a current year tax is imposed that comprises the items included in gross income under foreign law and the deductions allowed under foreign law. In the case of a current year tax that is imposed with respect to a taxable period, foreign taxable income includes all of the items taken into account under foreign law with respect to that period. See paragraph (d)(3)(ii)(A) of this section for rules for apportioning current year tax to section 904 categories or income groups on the basis of foreign taxable income.

(8) *GILTI inclusion amount.* The term *GILTI inclusion amount* has the meaning set forth in § 1.951A–1(c)(1) (or, in the case of a member of a consolidated group, § 1.1502–51(b)).

(9) *Gross tested income.* The term *gross tested income* has the meaning set forth in § 1.951A–2(c)(1).

(10) *Inclusion percentage.* The term *inclusion percentage* has the meaning set forth in § 1.960–2(c)(2).

(11) *Inclusion year.* The term *inclusion year* means the U.S. taxable year of a controlled foreign corporation which ends during or with the taxable year of a United States shareholder of the controlled foreign corporation in which the United States shareholder includes an amount in income under section 951(a)(1) or 951A(a) with respect to the controlled foreign corporation.

(12) *Income group.* The term *income group* means a group of income described in paragraph (d)(2)(ii) of this section.

(13) *Partnership CFC.* The term *partnership CFC* means, with respect to a U.S. shareholder partnership, a controlled foreign corporation stock of which is owned (within the meaning of section 958(a)) by the U.S. shareholder partnership.

(14) *Passive category.* The term *passive category* means the separate category of income described in section 904(d)(1)(C) and § 1.904–4(b).

(15) *Previously taxed earnings and profits.* The term *previously taxed earnings and profits* means earnings and profits described in section 959(c)(1) or (2), including earnings and profits described in section 959(c)(2) by reason of section 951A(f)(1) and § 1.951A–5(b)(1).

(16) *PTEP group.* The term *PTEP group* has the meaning set forth in § 1.960–3(c)(2).

(17) *PTEP group taxes.* The term *PTEP group taxes* has the meaning set forth in § 1.960–3(d)(1).

(18) *Recipient controlled foreign corporation.* The term *recipient controlled foreign corporation* has the meaning set forth in § 1.960–3(b)(2).

(19) *Reclassified previously taxed earnings and profits.* The term *reclassified previously taxed earnings and profits* has the meaning set forth in § 1.960–3(c)(4).

(20) *Reclassified PTEP group.* The term *reclassified PTEP group* has the meaning set forth in § 1.960–3(c)(4).

(21) *Residual income group.* The term *residual income group* has the meaning set forth in paragraph (d)(2)(ii)(D) of this section.

(22) *Section 904 category.* The term *section 904 category* means a separate category of income described in § 1.904–5(a)(4)(v).

(23) *Section 951A category.* The term *section 951A category* means the separate category of income described in section 904(d)(1)(A) and § 1.904–4(g).

(24) *Section 959 distribution.* The term *section 959 distribution* means a section 959(a) distribution or a section 959(b) distribution.

(25) *Section 959(a) distribution.* The term *section 959(a) distribution* means a distribution excluded from the gross income of a United States shareholder under section 959(a).

(26) *Section 959(b) distribution.* The term *section 959(b) distribution* means a distribution excluded from the gross income of a controlled foreign corporation for purposes of section 951(a) under section 959(b).

(27) *Section 959(c)(2) PTEP group.* The term *section 959(c)(2) PTEP group* has the meaning set forth in § 1.960–3(c)(4).

(28) *Subpart F inclusion.* The term *subpart F inclusion* has the meaning set forth in § 1.960–2(b)(1).

(29) *Subpart F income.* The term *subpart F income* has the meaning set forth in section 952 and § 1.952–1(a).

(30) *Subpart F income group.* The term *subpart F income group* has the meaning set forth in paragraph (d)(2)(ii)(B)(*1*) of this section.

(31) *Tested foreign income taxes.* The term *tested foreign income taxes* has the meaning set forth in § 1.960–2(c)(3).

(32) *Tested income.* The term *tested income* means the amount with respect to a controlled foreign corporation that is described in section 951A(c)(2)(A) and § 1.951A–2(b)(1).

(33) *Tested income group.* The term *tested income group* has the meaning set forth in paragraph (d)(2)(ii)(C) of this section.

(34) *United States shareholder.* The term *United States shareholder* has the meaning set forth in section 951(b).

(35) *U.S. shareholder partner.* The term *U.S. shareholder partner* means, with respect to a U.S. shareholder partnership and a partnership CFC of the U.S. shareholder partnership, a United States person that is a partner in the U.S. shareholder partnership and that is also a United States shareholder (as defined in section 951(b)) of the partnership CFC.

(36) *U.S. shareholder partnership.* The term *U.S. shareholder partnership* means a domestic partnership (within the meaning of section 7701(a)(4)) that is a United States shareholder of one or more controlled foreign corporations.

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

(c) *Computational rules*—(1) *In general.* For purposes of computing foreign income taxes deemed paid by either a domestic corporation that is a United States shareholder with respect to a controlled foreign corporation under § 1.960–2 or § 1.960–3 or by a controlled foreign corporation under § 1.960–3 for the current taxable year, the following rules apply in the following order, beginning with the lowest-tier controlled foreign corporation in a chain with respect to which the domestic corporation is a United States shareholder:

(i) First, items of gross income of the controlled foreign corporation for the current taxable year other than a section 959(b) distribution are assigned to section 904 categories and included in income groups within those section 904 categories under the rules in paragraph (d)(2) of this section. The receipt of a section 959(b) distribution by the controlled foreign corporation is accounted for under § 1.960–3(c)(3).

(ii) Second, deductions (other than for current year taxes) of the controlled foreign corporation for the current taxable year are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category. See paragraph (d)(3)(i) of this section. Additionally, the functional currency amounts of current year taxes of the controlled foreign corporation for the current taxable year are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category, and to reduce earnings and profits in any PTEP groups that were increased as provided in paragraph (c)(1)(i) of this section. See paragraph (d)(3)(ii) of this section. For purposes of computing foreign taxes deemed paid, current year taxes allocated and apportioned to income groups and PTEP groups in the section 904 categories are translated into U.S. dollars in accordance with section 986(a). See paragraph (c)(3) of this section.

(iii) Third, current year taxes deemed paid under section 960(a) and (d) by the domestic corporation with respect to income of the controlled foreign corporation are computed under the rules of § 1.960–2. In addition, foreign income taxes deemed paid under section 960(b)(2) with respect to the receipt of a section 959(b) distribution by the controlled foreign corporation are computed under the rules of § 1.960–3(b).

(iv) Fourth, any previously taxed earnings and profits of the controlled foreign corporation resulting from subpart F inclusions and GILTI inclusion amounts with respect to the controlled foreign corporation's current taxable year are separated from other earnings and profits of the controlled foreign corporation and added to an annual PTEP account, and a PTEP group within the PTEP account, under the rules of § 1.960–3(c).

(v) Fifth, paragraphs (c)(1)(i) through (iv) of this section are repeated for each next higher-tier controlled foreign corporation in the chain.

(vi) Sixth, with respect to the highest-tier controlled foreign corporation in a chain that is owned directly (or indirectly through a partnership) by the domestic corporation, foreign income taxes that are deemed paid under section 960(b)(1) in connection with the receipt of a section 959(a) distribution by the domestic corporation are computed under the rules of § 1.960–3(b).

(2) *Inclusion of current year items.* For a current taxable year, the items of income and deductions (including for taxes), and the U.S. dollar amounts of current year taxes, that are included in the computations described in this section and assigned to income groups and PTEP groups for the taxable year are the items that the controlled foreign corporation accrues and takes into account during the current taxable year.

(3) *Functional currency and translation.* The computations described in this paragraph (c) that relate to income and earnings and profits are made in the functional currency of the controlled foreign corporation (as determined under section 985), and references to taxes deemed paid are to U.S. dollar amounts (translated in accordance with section 986(a)).

(d) *Computing income in a section 904 category and an income group within a section 904 category*—(1) *Scope.* This paragraph (d) provides rules for assigning gross income (including gains) of a controlled foreign corporation for the current taxable year to a section 904 category and income group within a section 904 category, and for allocating and apportioning deductions (including losses and current year taxes) and the U.S. dollar amount of current year taxes of the controlled foreign corporation for the current taxable year among the section 904 categories, income groups within a section 904 category, and PTEP groups. For rules regarding maintenance of previously taxed earnings and profits in an annual PTEP account, and assignment of those previously taxed earnings and profits to PTEP groups, see § 1.960–3.

(2) *Assignment of gross income to section 904 categories and income groups within a category*—(i) *Assigning items of gross income to section 904 categories.* Items of gross income of the controlled foreign corporation for the current taxable year are first assigned to a section 904 category of the controlled foreign corporation under §§ 1.904–4 and 1.904–5, and under § 1.960–3(c)(1) in the case of gross income relating to a section 959(b) distribution received by the controlled foreign corporation. Income of a controlled foreign corporation, other than gross income relating to a section 959(b) distribution, cannot be assigned to the section 951A category. *See* § 1.904–4(g).

(ii) *Grouping gross income within a section 904 category*—(A) *In general.* Gross income within a section 904 category is assigned to an income group under the rules of this paragraph (d)(2)(ii), or to a PTEP group under the rules of § 1.960–3(c)(3). Gross income other than a section 959(b) distribution is assigned to a subpart F income group, tested income group, or residual income group.

(B) *Subpart F income groups*—(*1*) *In general.* The term *subpart F income group* means an income group within a section 904 category that consists of income that is described in paragraph (d)(2)(ii)(B)(*2*) of this section. Gross income that is treated as a single item of income under § 1.954–1(c)(1)(iii) is in a separate subpart F income group under paragraph (d)(2)(ii)(B)(*2*)(*i*) of this section. Items of gross income that give rise to income described in paragraph (d)(2)(ii)(B)(*2*)(*ii*) of this section are aggregated and treated as gross income in a separate subpart F income group. Similarly, items of gross income that give rise to income described in each one of paragraphs (d)(2)(ii)(B)(*2*)(*iii*) through (*v*) of this section are aggregated and treated as gross income in a separate subpart F income group.

(*2*) *Income in subpart F income groups.* The income included in subpart F income groups is:

(*i*) Items of foreign base company income treated as a single item of income under § 1.954–1(c)(1)(iii);

(*ii*) Insurance income described in section 952(a)(1);

(*iii*) Income subject to the international boycott factor described in section 952(a)(3);

(*iv*) Income from certain bribes, kickbacks and other payments described in section 952(a)(4); and

(*v*) Income subject to section 901(j) described in section 952(a)(5).

(C) *Tested income groups.* The term *tested income group* means an income group that consists of tested income within a section 904 category. Items of gross tested income in each section 904 category are aggregated and treated as gross income in a separate tested income group.

(D) *Residual income group.* The term *residual income group* means the income group within a section 904 category that consists of income that is not in a subpart F income group, tested income group, or PTEP group.

(E) *Examples.* The following examples illustrate the application of this paragraph (d)(2)(ii).

(*1*) *Example 1: Subpart F income groups*—(*i*) *Facts.* CFC, a controlled foreign corporation, is incorporated in Country X. CFC uses the ''u'' as its functional currency. At all relevant times, 1u = $1x. CFC earns from sources outside of Country X portfolio dividend income of 100,000u, portfolio interest income of 1,500,000u, and 70,000u of royalty income that is not derived from the active conduct of a trade or business. CFC also earns 50,000u from the sale of personal property to a related person for use outside of Country X that gives rise to foreign base company sales income under section 954(d). Finally, CFC earns 45,000u for performing consulting services outside of Country X for related persons that gives rise to foreign base company services income under section 954(e). None of the income is taxed by Country X. The dividend income is subject to a 15 percent third-country withholding tax after application of the applicable income tax treaty. The interest income and the royalty income are subject to no third-country withholding tax. CFC incurs no expenses.

(*ii*) *Analysis.* Under paragraph (d)(2)(i) of this section and § 1.904–4, the interest income, dividend income, and royalty income are passive category income and the sales and consulting income are general category income. Under paragraph (d)(2)(ii)(B) of this section, CFC has a separate subpart F income group within the passive category with respect to the 100,000u of dividend income, which is foreign personal holding company income described in § 1.954–1(c)(1)(iii)(A)(*1*)(*i*) (dividends, interest, rents, royalties and annuities) that falls within a single group of income under § 1.904–4(c)(3)(i) for passive income that is subject to withholding tax of fifteen percent or greater. CFC also has a separate subpart F income group within the passive category with respect to the 1,500,000u of interest income and the 70,000u of royalty income (in total 1,570,000u) which together are foreign personal holding company income described in § 1.954–1(c)(1)(iii)(A)(*1*)(*i*) (dividends, interest, rents, royalties and annuities) that falls within a single group of income under § 1.904–4(c)(3)(iii) for passive income that is subject to no withholding tax or other foreign tax. With respect to its 50,000u of sales income, CFC has a separate subpart F income group with respect to foreign base company sales income described in § 1.954–1(c)(1)(iii)(A)(*2*)(*i*) within the general category. With respect to its 45,000u of services income, CFC has a separate subpart F income group with respect to foreign base company services income described in § 1.954–1(c)(1)(iii)(A)(*2*)(*ii*) within the general category.

(*2*) *Example 2: Tested income groups*—(*i*) *Facts.* CFC, a controlled foreign corporation, is incorporated in Country X. CFC uses the ''u'' as its functional currency. At all relevant times, 1u = $1x. CFC earns 500u from the sale of goods to unrelated parties. CFC also earns 75u for performing consulting services for unrelated parties. All of its income is gross tested income. CFC incurs no deductions.

(*ii*) *Analysis.* Under paragraph (d)(2)(i) of this section and section 904 and § 1.904–4, the sales income and services income are both general category income. Under paragraph (d)(2)(ii)(C) of this section, with respect to the 500u of sales income and 75u services income (in total 575u), CFC has one tested income group within the general category.

(3) *Allocation and apportionment of deductions among section 904 categories, income groups within a section 904 category, and certain PTEP groups*—(i) *In general.* Gross income of the controlled foreign corporation in each income group within each section 904 category is reduced by deductions (including losses) of the controlled foreign corporation for the current taxable year under the rules in this paragraph (d)(3)(i). No deductions of the controlled foreign corporation for the current taxable year other than a deduction for current year taxes imposed solely by reason of the receipt of a section 959(b) distribution are allocated or apportioned to reduce earnings and profits in a PTEP group.

(A) First, the rules of sections 861 through 865 and 904(d) (taking into account the rules of section 954(b)(5) and § 1.954–1(c), and section 951A(c)(2)(A)(ii) and § 1.951A–2(c)(3), as appropriate) apply to allocate and apportion to reduce gross income (or create a loss) in each section 904 category and income group within a section 904 category any deductions of the controlled foreign corporation that are definitely related to less than all of the controlled foreign corporation's gross income as a class. See paragraph (d)(3)(ii) of this section for special rules for allocating and apportioning current year taxes to section 904 categories, income groups, and PTEP groups.

(B) Second, related person interest expense is allocated to and apportioned among the subpart F income groups within the passive category under the principles of §§ 1.904–5(c)(2) and 1.954–1(c)(1)(i).

(C) Third, any remaining deductions are allocated and apportioned to reduce gross income (or create a loss) in the section 904 categories and income groups within each section 904 category under the rules referenced in paragraph (d)(3)(i)(A) of this section.

(ii) *Allocation and apportionment of a current year tax*—(A) *In general.* A current year tax is allocated and apportioned among the section 904 categories under the rules of § 1.904–6(a)(1) based on the portion of the foreign taxable income (as characterized under Federal income tax principles) that is assigned to a particular section 904 category. 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 the principles of § 1.904–6(a)(1) based on the portion of the foreign taxable income (as characterized under Federal income tax principles) that is assigned to a particular income group. Therefore, the portion of a current year tax that is attributable to a timing difference described in § 1.904–6(a)(1)(iv) is treated as related to the section 904 category and income group within a section 904 category to which the tax would be assigned if the foreign taxable income on which the tax is imposed was recognized under Federal income tax principles in the year in which the tax is paid or accrued. 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)(C) of this section) to which the current year tax is allocated and apportioned.

(B) *Foreign taxable income that includes a base difference.* For purposes of allocating and apportioning a current year tax among the income groups within a section 904 category under the rules of this paragraph (d)(3)(ii), the portion of the foreign taxable income that constitutes a base difference described in § 1.904–6(a)(1)(iv) is assigned to a residual income group. An amount of current year tax that is imposed on such portion of the foreign taxable income is therefore allocated and apportioned to the residual income group within a section 904 category.

(C) *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 the principles of § 1.904–6(a)(1), the portion of the foreign taxable income 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)(C), and the principles of § 1.904–6(a)(1) would otherwise apply to assign foreign taxable income to a PTEP group, that foreign taxable income is instead assigned to the 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 tax imposed on a controlled foreign corporation's receipt of a section 959(b) distribution by the corporation's country of residence is allocated or apportioned to a PTEP group. Similarly, a withholding tax imposed with respect to a controlled foreign corporation's receipt of a section 959(b) distribution is allocated and apportioned to a PTEP group. In contrast, a withholding tax imposed on a disregarded payment from a disregarded entity to its controlled foreign corporation owner is 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 taxable income from which the tax was withheld does not constitute a section 959(b) distribution in the current taxable year. That foreign taxable income, however, may be assigned to a subpart F income group or tested income group under paragraph (d)(3)(ii)(A) of this section (applying the principles of § 1.904–6(a)(1)(iv)).

(e) *No deemed paid credit for current year taxes related to residual income group.* Current year taxes paid or accrued by a controlled foreign corporation that are allocated and apportioned under paragraph (d)(3)(ii) of this section to a residual income group cannot be deemed paid under section 960 for any taxable year.

(f) *Example.* The following example illustrates the application of this section and § 1.960–3.

(1) *Facts*—(i) *Income of CFC1 and CFC2.* CFC1, a controlled foreign corporation, conducts business in Country X. CFC1 uses the "u" as its functional currency. At all relevant times, 1u=$1x. CFC1 owns all of the stock of CFC2, a controlled foreign corporation. CFC1 and CFC2 both use the calendar year as their U.S. and foreign taxable years. In 2019, CFC1 earns 2,000,000u of gross income that is foreign oil and gas extraction income, within the meaning of section 907(c)(1), and 2,000,000u of interest income from unrelated persons, for both U.S. and Country X tax law purposes. Country X exempts interest income from tax. In 2019, CFC1 also receives a section 959(b) distribution from CFC2 of 4,000,000u of previously taxed earnings and profits attributable to an inclusion under section 965(a) for CFC2's 2017 U.S. taxable year. The inclusion under section 965(a) was income in the general category. There are no PTEP group taxes associated with the previously taxed earnings and profits distributed by CFC2 at the level of CFC2. The section 959(b) distribution is treated as a dividend taxable to CFC1 under Country X law. In 2019, CFC2 earns no gross income and receives no distributions.

(ii) *Pre-tax deductions of CFC1 and CFC2.* For both U.S. and Country X tax purposes, in 2019, CFC1 incurs 1,500,000u of deductible expenses other than current year taxes that are allocable to all gross income. For U.S. tax purposes, under §§ 1.861–8 through 1.861–14T, 750,000u of such deductions are apportioned to each of CFC1's foreign oil and gas extraction income and interest income. Under Country X law, 1,000,000u of deductions are allocated and apportioned to the 4,000,000u treated as a dividend, and 500,000u of deductions are allocated and apportioned to the 2,000,000u of foreign oil and gas extraction income. Under Country X law, no deductions are allocable to the interest income. Country X imposes tax of 900,000u on a base of 4,500,000u (6,000,000u gross income − 1,500,000u deductions) consisting of 3,000,000u (4,000,000u − 1,000,000u) attributable to CFC1's section 959(b) distribution and 1,500,000u (2,000,000u − 500,000u) attributable to CFC1's foreign oil and gas extraction income. In 2019, CFC2 has no expenses (including current year taxes).

(iii) *United States shareholders of CFC1.* All of the stock of CFC1 is owned (within the meaning of section 958(a)) by corporate United States shareholders that use the calendar year as their U.S. taxable year. In 2019, the United States shareholders of CFC1 include in gross income subpart F inclusions in the passive category totaling $1,250,000x with respect to 1,250,000u of subpart F income of CFC1.

(2) *Analysis*—(i) *CFC2.* Under paragraph (c)(1) of this section, the computational rules of paragraph (c)(1) of this section are applied beginning with CFC2. However, CFC2 has no gross income or expenses in 2019 (the "current taxable year"). Accordingly, the computational rules described in paragraphs (c)(1)(i) through (iv) of this section are not relevant with respect to CFC2. Under paragraph (c)(1)(v) of this section, the rules in paragraph (c)(1)(i) through (iv) of this section are then applied to CFC1.

(ii) *CFC1*—(A) *Step 1.* Under paragraph (c)(1)(i) of this section, CFC1's items of gross income for the current taxable year are assigned to section 904 categories and included in income groups within those section 904 categories. In addition, CFC1's receipt of a section 959(b) distribution is assigned to a PTEP group. Under paragraph (d)(2)(i) of this section and § 1.904–4, the interest income is passive category income and the foreign oil and gas extraction income is general category income. Under paragraph (d)(2)(ii) of this section, the 2,000,000u of interest income is assigned to a subpart F income group (the "subpart F income group") within the passive category because it is foreign personal holding company income described in § 1.954–1(c)(1)(iii)(A)(*1*)(*i*) that falls within a single group of income under § 1.904–4(c)(3)(iii) for passive income that is subject to no withholding tax or other foreign tax. The 2,000,000u of foreign oil and gas extraction income is assigned to the residual income group within the general category. Under § 1.960–3(c), the 4,000,000u section 959(b) distribution is assigned to the PTEP group described in § 1.960–3(c)(2)(vii) within the 2017 annual PTEP account (the "PTEP group") within the general category.

(B) *Step 2*—(*1*) *Allocation and apportionment of deductions for expenses other than taxes.* Under paragraph (c)(1)(ii) of this section, CFC1's deductions for the current taxable year are allocated and apportioned among the section 904 categories, income groups within a section 904 category, and any PTEP groups that were increased as provided in paragraph (c)(1)(i) of this section. Under paragraph (d)(3)(i) of this section and §§ 1.861–8 through 1.861–14T, 750,000u of deductions are allocated and apportioned to the residual income group within the general category, and 750,000u of deductions are allocated and apportioned to the subpart F income group within the passive category. Therefore, CFC1 has 1,250,000u (2,000,000u − 750,000u) of pre-tax income attributable to the residual income group within the general category and 1,250,000u (2,000,000u − 750,000u) of pre-tax income attributable to the subpart F income group within the passive category. For U.S. tax purposes, no deductions other than current year taxes are allocated and apportioned to the 4,000,000u in CFC1's PTEP group.

(*2*) *Allocation and apportionment of current year taxes.* Under paragraph (c)(1)(ii) of this section, CFC1's current year taxes are allocated and apportioned among the section 904 categories, income groups within a section 904 category, and any PTEP groups that were increased as provided in paragraph (c)(1)(i) of this section. Under paragraphs (d)(3)(i) and (ii) of this section, for purposes of allocating and apportioning taxes to reduce the income in a section 904 category, an income group, or PTEP group, § 1.904–6(a)(1) and (ii) are applied to determine the amount of foreign taxable income, computed under Country X law but characterized under Federal income tax law, in each section 904 category, income group, and PTEP group that is included in the Country X tax base. For Country X purposes, 1,000,000u of deductions are apportioned to CFC1's PTEP group within the general category, 500,000u of deductions are apportioned to the residual income group within the general category, and no deductions are apportioned to the subpart F income group in the passive category. Therefore, for Country X purposes, CFC1 has 3,000,000u of foreign taxable income attributable to the PTEP group within the general category, 1,500,000u of foreign taxable income attributable to the residual income group within the general category, and no income attributable to the subpart F income group within the passive category. Under paragraph (d)(3)(ii) of this section, 600,000u (3,000,000u/4,500,000u × 900,000u) of the 900,000u current year taxes paid by CFC1 are related to the PTEP group within the general category, and 300,000u (1,500,000u/4,500,000u × 900,000u) are related to the residual income group within the general category. No current year taxes are allocated or apportioned to the subpart F income group within the passive category because the interest expense is exempt from Country X tax. Thus, for U.S. tax purposes, CFC1 has 3,400,000u of previously taxed earnings and profits (4,000,000u − 600,000u) in the PTEP group within the general category, 1,250,000u of income in the subpart F income group within the passive category, and 950,000u of income (1,250,000u − 300,000u) in the residual income group within the general category. For purposes of determining foreign taxes deemed paid under section 960, CFC1 has $600,000x of foreign income taxes in the PTEP group within the general category and $300,000x of current year taxes in the residual income group within the general category. Under paragraph (e) of this section, the United States shareholders of CFC1 cannot claim a credit with respect to the $300,000x of taxes on CFC1's income in the residual income group.

(C) *Step 3.* Under paragraph (c)(1)(iii) of this section, the United States shareholders of CFC1 compute current year taxes deemed paid under section 960(a) and (d) and the rules of § 1.960–2. None of the Country X tax is allocated to CFC1's subpart F income group. Therefore, there are no current year taxes deemed paid by CFC1's United States shareholders with respect to their passive category subpart F inclusions. See § 1.960–2(b)(5) and (c)(7) for examples of the application of section 960(a) and (d) and the rules in § 1.960–2. Additionally, under paragraph (c)(1)(iii) of this section, foreign income taxes deemed paid under section 960(b)(2) by CFC1 are determined with respect to the section 959(b) distribution from CFC2 under the rules of § 1.960–3. There are no PTEP group taxes associated with the previously taxed earnings and profits distributed by CFC2 in the hands of CFC2. Therefore, there are no foreign income taxes deemed paid by CFC1 under section 960(b)(2) with respect to the section 959(b) distribution from CFC2. See § 1.960–3(e) for examples of the application of section 960(b) and the rules in § 1.960–3.

(D) *Step 4.* Under paragraph (c)(1)(iv) of this section, previously taxed earnings and profits resulting from subpart F inclusions and GILTI inclusion amounts with respect to CFC1's current taxable year are separated from CFC1's other earnings and profits and added to an annual PTEP account and PTEP group within the PTEP account, under the rules of § 1.960–3(c). The United States shareholders of CFC1 include in gross income subpart F inclusions totaling $1,250,000x with respect to 1,250,000u of subpart F income of CFC1, and the subpart F inclusions are passive category income. Therefore, under § 1.960–3(c)(2), 1,250,000u of previously taxed earnings and profits resulting from the subpart F inclusions is added to CFC1's section 951(a)(1)(A) PTEP within the 2019 annual PTEP account within the passive category.

(E) *Step 5.* Paragraph (c)(1)(v) of this section does not apply because CFC1 is the highest-tier controlled foreign corporation in the chain.

(F) *Step 6.* Paragraph (c)(1)(vi) of this section does not apply because CFC1 did not make a section 959(a) distribution.

■ **Par. 35.** Section 1.960–2 is revised to read as follows:

§ 1.960–2 Foreign income taxes deemed paid under sections 960(a) and (d).

(a) *Scope.* Paragraph (b) of this section provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation under section 960(a). Paragraph (c) of this section provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation under section 960(d).

(b) *Foreign income taxes deemed paid under section 960(a)*—(1) *In general.* If a domestic corporation that is a United States shareholder of a controlled foreign corporation includes in gross income under section 951(a)(1)(A) its pro rata share of the subpart F income of the controlled foreign corporation (a *subpart F inclusion*), the domestic corporation is deemed to have paid the amount of the controlled foreign corporation's foreign income taxes that are properly attributable to the items of income in a subpart F income group of the controlled foreign corporation that give rise to the subpart F inclusion of the domestic corporation that is attributable to the subpart F income group. For each section 904 category, the domestic corporation is deemed to have paid foreign income taxes equal to the sum of the controlled foreign corporation's foreign income taxes that are properly attributable to the items of income in the subpart F income groups to which the subpart F inclusion is attributable. See § 1.904–6(b)(1) for rules on assigning the foreign income tax to a section 904 category. No foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B).

(2) *Properly attributable.* The amount of the controlled foreign corporation's foreign income taxes that are properly attributable to the items of income in the subpart F income group of the controlled foreign corporation to which a subpart F inclusion is attributable equals the domestic corporation's proportionate share of the current year taxes of the controlled foreign corporation that are allocated and apportioned under § 1.960–1(d)(3)(ii) to the subpart F income group. No other foreign income taxes are considered properly attributable to an item of income of the controlled foreign corporation.

(3) *Proportionate share*—(i) *In general.* A domestic corporation's proportionate share of the current year taxes of a controlled foreign corporation that are allocated and apportioned under § 1.960–1(d)(3)(ii) to a subpart F income group within a section 904 category of the controlled foreign corporation is equal to the total U.S. dollar amount of current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to the subpart F income group multiplied by a fraction (not to exceed one), the numerator of which is the portion of the domestic corporation's subpart F inclusion that is attributable to the subpart F income group and the denominator of which is the total net income in the subpart F income group, both determined in the

functional currency of the controlled foreign corporation. If the numerator or denominator of the fraction is zero or less than zero, then the proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to the subpart F income group is zero.

(ii) *Effect of qualified deficits.* Neither an accumulated deficit nor any prior year deficit in the earnings and profits of a controlled foreign corporation reduces its net income in a subpart F income group. Accordingly, any such deficit does not affect the denominator of the fraction described in paragraph (b)(3)(i) of this section. However, the first sentence of this paragraph (b)(3)(ii) does not affect the application of section 952(c)(1)(B) for purposes of determining the domestic corporation's subpart F inclusion. Any reduction to the domestic corporation's subpart F inclusion under section 952(c)(1)(B) is reflected in the numerator of the fraction described in paragraph (b)(3)(i) of this section.

(iii) *Effect of current year E&P limitation or chain deficit.* To the extent that an amount of income in a subpart F income group is excluded from the subpart F income of the controlled foreign corporation under section 952(c)(1)(A) or (C), the net income in the subpart F income group that is the denominator of the fraction described in paragraph (b)(3)(i) of this section is reduced (but not below zero) by the amount excluded. The domestic corporation's subpart F inclusion that is the numerator of the fraction described in paragraph (b)(3)(i) of this section is based on the controlled foreign corporation's subpart F income computed with the application of section 952(c)(1)(A) and (C).

(4) *Domestic partnerships.* For purposes of applying this paragraph (b), in the case of a domestic partnership that is a U.S. shareholder partnership with respect to a partnership CFC, the distributive share of a U.S. shareholder partner of the U.S. shareholder partnership's subpart F inclusion with respect to the partnership CFC is treated as a subpart F inclusion of the U.S. shareholder partner with respect to the partnership CFC.

(5) *Example.* The following example illustrates the application of this paragraph (b).

(i) *Facts.* USP, a domestic corporation, owns 80% of the stock of CFC, a controlled foreign corporation. The remaining portion of the stock of CFC is owned by an unrelated person. USP and CFC both use the calendar year as their U.S. taxable year, and CFC also uses the calendar year as its foreign taxable year. CFC uses the ''u'' as its functional currency. At all relevant times, 1u=$1x. For its U.S. taxable year ending December 31, 2018, after the application of the rules in § 1.960–1(d) the income of CFC after foreign taxes is assigned to the following income groups: 1,000,000u of dividend income in a subpart F income group within the passive category (''subpart F income group 1''); 2,400,000u of gain from commodities transactions in a subpart F income group within the passive category (''subpart F income group 2''); and 1,800,000u of foreign base company services income in a subpart F income group within the general category (''subpart F income group 3''). CFC has current year taxes, translated into U.S. dollars, of $740,000x that are allocated and apportioned as follows: $50,000x to subpart F income group 1; $240,000x to subpart F income group 2; and $450,000x to subpart F income group 3. USP has a subpart F inclusion with respect to CFC of 4,160,000u = $4,160,000x, of which 800,000u is attributable to subpart F income group 1, 1,920,000u to subpart F income group 2, and 1,440,000u to subpart F income group 3.

(ii) *Analysis*—(A) *Passive category.* Under paragraphs (b)(2) and (3) of this section, the amount of CFC's current year taxes that are properly attributable to items of income in subpart F income group 1 to which a subpart F inclusion is attributable equals USP's proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to subpart F income group 1, which is $40,000x ($50,000x × 800,000u/1,000,000u). Under paragraphs (b)(2) and (3) of this section, the amount of CFC's current year taxes that are properly attributable to items of income in subpart F income group 2 to which a subpart F inclusion is attributable equals USP's proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to subpart F income group 2, which is $192,000x ($240,000x × 1,920,000u/2,400,000u). Accordingly, under paragraph (b)(1) of this section, USP is deemed to have paid $232,000x ($40,000x + $192,000x) of passive category foreign income taxes of CFC with respect to its $2,720,000x subpart F inclusion in the passive category.

(B) *General category.* Under paragraphs (b)(2) and (3) of this section, the amount of CFC's current year taxes that are properly attributable items of income in subpart F income group 3 to which a subpart F inclusion is attributable equals USP's proportionate share of the foreign income taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to subpart F income group 3, which is $360,000x ($450,000x × 1,440,000u/1,800,000u). CFC has no other subpart F income groups within the general category. Accordingly, under paragraph (b)(1) of this section, USP is deemed to have paid $360,000x of general category foreign income taxes of CFC with respect to its $1,440,000x subpart F inclusion in the general category.

(c) *Foreign income taxes deemed paid under section 960(d)*—(1) *In general.* If a domestic corporation that is a United States shareholder of one or more controlled foreign corporations includes an amount in gross income under section 951A(a) and § 1.951A–1(b), the domestic corporation is deemed to have paid an amount of foreign income taxes equal to 80 percent of the product of its inclusion percentage multiplied by the sum of all tested foreign income taxes in the tested income group within each section 904 category of the controlled foreign corporation or corporations.

(2) *Inclusion percentage.* The term *inclusion percentage* means, with respect to a domestic corporation that is a United States shareholder of one or more controlled foreign corporations, the domestic corporation's GILTI inclusion amount divided by the aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i) with respect to the United States shareholder.

(3) *Tested foreign income taxes.* The term *tested foreign income taxes* means, with respect to a domestic corporation that is a United States shareholder of a controlled foreign corporation, the amount of the controlled foreign corporation's foreign income taxes that are properly attributable to tested income taken into account by the domestic corporation under section 951A and § 1.951A–1.

(4) *Properly attributable.* The amount of the controlled foreign corporation's foreign income taxes that are properly attributable to tested income taken into account by the domestic corporation under section 951A(a) and § 1.951A–1(b) equals the domestic corporation's proportionate share of the current year taxes of the controlled foreign corporation that are allocated and apportioned under § 1.960–1(d)(3)(ii) to the tested income group within each section 904 category of the controlled foreign corporation. No other foreign income taxes are considered properly attributable to tested income.

(5) *Proportionate share.* A domestic corporation's proportionate share of current year taxes of a controlled foreign corporation that are allocated and apportioned under § 1.960–1(d)(3)(ii) to a tested income group within a section 904 category of the controlled foreign corporation is the U.S. dollar amount of current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to a tested income group within a section 904 category of the controlled foreign corporation multiplied by a fraction (not to exceed one), the numerator of which is the portion of the tested income of the controlled foreign corporation in the tested income group within the section 904 category that is included in computing the domestic corporation's aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i), and the denominator of which is the

income in the tested income group within the section 904 category, both determined in the functional currency of the controlled foreign corporation. If the numerator or denominator of the fraction is zero or less than zero, the domestic corporation's proportionate share of the current year taxes allocated and apportioned under § 1.960–1(d)(3)(ii) to the tested income group is zero.

(6) *Domestic partnerships.* See § 1.951A–1(e) for rules regarding the determination of the GILTI inclusion amount of a U.S. shareholder partner.

(7) *Examples.* The following examples illustrate the application of this paragraph (c).

(i) *Example 1: Directly owned controlled foreign corporation*—(A) *Facts.* USP, a domestic corporation, owns 100% of the stock of a number of controlled foreign corporations, including CFC1. USP and CFC1 each use the calendar year as their U.S. taxable year. CFC1 uses the ''u'' as its functional currency. At all relevant times, 1u=$1x. For its U.S. taxable year ending December 31, 2018, after application of the rules in § 1.960–1(d), the income of CFC1 is assigned to a single income group: 2,000u of income from the sale of goods in a tested income group within the general category (''tested income group''). CFC1 has current year taxes, translated into U.S. dollars, of $400x that are all allocated and apportioned to the tested income group. For its U.S. taxable year ending December 31, 2018, USP has a GILTI inclusion amount determined by reference to all of its controlled foreign corporations, including CFC1, of $6,000x, and an aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i) of $10,000x. All of the income in CFC1's tested income group is included in computing USP's aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i).

(B) *Analysis.* Under paragraph (c)(5) of this section, USP's proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to CFC1's tested income group is $400x ($400x × 2,000u/2,000u). Therefore, under paragraph (c)(4) of this section, the amount of current year taxes properly attributable to tested income taken into account by USP under section 951A(a) and § 1.951A–1(b) is $400x. Under paragraph (c)(3) of this section, USP's tested foreign income taxes with respect to CFC1 are $400x. Under paragraph (c)(2) of this section, USP's inclusion percentage is 60% ($6,000x/$10,000x). Accordingly, under paragraph (c)(1) of this section, USP is deemed to have paid $192 of the foreign income taxes of CFC1 (80% × 60% × $400x).

(ii) *Example 2: Controlled foreign corporation owned through domestic partnership*—(A) *Facts*—(*1*) US1, a domestic corporation, owns 95% of PRS, a domestic partnership. The remaining 5% of PRS is owned by US2, a domestic corporation that is unrelated to US1. PRS owns all of the stock of CFC1, a controlled foreign corporation. In addition, US1 owns all of the stock of CFC2, a controlled foreign corporation. US1, US2, PRS, CFC1, and CFC2 all use the calendar year as their taxable year. CFC1 and CFC2 both use the ''u'' as their functional currency. At all relevant times, 1u=$1x. For its U.S. taxable year ending December 31, 2018, after application of the rules in § 1.960–1(d), the income of CFC1 is assigned to a single income group: 300u of income from the sale of goods in a tested income group within the general category (''CFC1's tested income group''). CFC1 has current year taxes, translated into U.S. dollars, of $100x that are all allocated and apportioned to CFC1's tested income group. The income of CFC2 is also assigned to a single income group: 200u of income from the sale of goods in a tested income group within the general category (''CFC2's tested income group''). CFC2 has current year taxes, translated into U.S. dollars, of $20x that are allocated and apportioned to CFC2's tested income group.

(*2*) Under § 1.951A–1(e)(1), for purposes of determining the GILTI inclusion amount of US1 and US2, PRS is not treated as owning (within the meaning of section 958(a)) the stock of CFC1; instead, PRS is treated in the same manner as a foreign partnership for purposes of determining the stock of CFC1 owned by US1 and US2 under section 958(a)(2). Therefore, only US1 is a United States shareholder of CFC1. Taking into account both CFC1 and CFC2, US1 has a GILTI inclusion amount in the general category of $485x, and an aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i) within the general category of $485x. 285u (95% × 300u) of the income in CFC1's tested income group and 200u of the income in CFC2's tested income group is included in computing US1's aggregate amount described in section 951A(c)(1)(A) and § 1.951A–1(c)(2)(i) within the general category. Because US2 is not a U.S. shareholder with respect to CFC1, US2 does not take into account CFC1's tested income in determining its GILTI inclusion amount.

(B) *Analysis*—(*1*) *US1*—(*i*) *CFC1.* Under paragraphs (c)(5) and (6) of this section, US1's proportionate share of the current year taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to CFC1's tested income group is $95x ($100x × 285u/300u). Therefore, under paragraph (c)(4) of this section, the amount of the current year taxes properly attributable to tested income taken into account by US1 under section 951A(a) and § 1.951A–1(b) is $95x. Under paragraph (c)(3) of this section, US1's tested foreign income taxes with respect to CFC1 are $95x. Under paragraph (c)(2) of this section, US1's inclusion percentage is 100% ($485x/$485x). Accordingly, under paragraph (c)(1) of this section, US1 is deemed to have paid $76x of the foreign income taxes of CFC1 (80% × 100% × $95x).

(*ii*) *CFC2.* Under paragraph (c)(5) of this section, US1's proportionate share of the foreign income taxes that are allocated and apportioned under § 1.960–1(d)(3)(ii) to CFC2's tested income group is $20x ($20x × 200u/200u). Therefore, under paragraph (c)(4) of this section, the amount of foreign income taxes properly attributable to tested income taken into account by US1 under section 951A(a) and § 1.951A–1(b) is $20x. Under paragraph (c)(3) of this section, US1's tested foreign income taxes with respect to CFC2 are $20. Under paragraph (c)(2) of this section, US1's inclusion percentage is 100% ($485x/$485x). Accordingly, under paragraph (c)(1) of this section, US1 is deemed to have paid $16 of the foreign income taxes of CFC2 (80% × 100% × $20x).

(*2*) *US2.* US2 is not a United States shareholder of CFC1 or CFC2. Accordingly, under paragraph (c)(1) of this section, US2 is not deemed to have paid any of the foreign income taxes of CFC1 or CFC2.

■ **Par. 36.** Section 1.960–3 is revised to read as follows:

§ 1.960–3 Foreign income taxes deemed paid under section 960(b).

(a) *Scope.* Paragraph (b) of this section provides rules for computing the amount of foreign income taxes deemed paid by a domestic corporation that is a United States shareholder of a controlled foreign corporation, or by a controlled foreign corporation, under section 960(b). Paragraph (c) of this section provides rules for the establishment and maintenance of PTEP groups within an annual PTEP account. Paragraph (d) of this section defines the term PTEP group taxes. Paragraph (e) of this section provides examples illustrating the application of this section.

(b) *Foreign income taxes deemed paid under section 960(b)*—(1) *Foreign income taxes deemed paid by a domestic corporation with respect to a section 959(a) distribution.* If a controlled foreign corporation makes a distribution to a domestic corporation that is a United States shareholder with respect to the controlled foreign corporation and that distribution is, in whole or in part, a section 959(a) distribution with respect to a PTEP group within a section 904 category, the domestic corporation is deemed to have paid the amount of the foreign corporation's foreign income taxes that are properly attributable to the section 959(a) distribution with respect to the PTEP group and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year. See § 1.965–5(c)(1)(iii) for rules disallowing credits in relation to a distribution of certain previously taxed earnings and profits resulting from the application of section 965. For each section 904 category, the domestic corporation is deemed to have paid foreign income taxes equal to the sum of the controlled foreign corporation's foreign income taxes that are properly attributable to section 959(a) distributions with respect to all PTEP groups within the section 904 category. See § 1.904–6(b)(2) for rules on assigning the foreign income tax to a section 904 category.

(2) *Foreign income taxes deemed paid by a controlled foreign corporation with respect to a section 959(b) distribution.* If a controlled foreign corporation (*distributing controlled foreign corporation*) makes a distribution to another controlled foreign corporation (recipient controlled foreign corporation) and the distribution is, in whole or in part, a section 959(b) distribution from a PTEP group within a section 904 category, the recipient controlled foreign corporation is deemed to have paid the amount of the distributing controlled foreign corporation's foreign income taxes that are properly attributable to the section 959(b) distribution from the PTEP group and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year. See § 1.904–6(b)(3) for rules on assigning the foreign income tax to a section 904 category.

(3) *Properly attributable.* The amount of foreign income taxes that are properly attributable to a section 959 distribution from a PTEP group within a section 904 category equals the domestic corporation's or recipient controlled foreign corporation's proportionate share of the PTEP group taxes with respect to the PTEP group within the section 904 category. No other foreign income taxes are considered properly attributable to a section 959 distribution.

(4) *Proportionate share.* A domestic corporation's or recipient controlled foreign corporation's proportionate share of the PTEP group taxes with respect to a PTEP group within a section 904 category is equal to the total amount of the PTEP group taxes with respect to the PTEP group multiplied by a fraction (not to exceed one), the numerator of which is the amount of the section 959 distribution from the PTEP group, and the denominator of which is the total amount of previously taxed earnings and profits in the PTEP group, both determined in the functional currency of the controlled foreign corporation. If the numerator or denominator of the fraction is zero or less than zero, then the proportionate share of the PTEP group taxes with respect to the PTEP group is zero.

(5) *Domestic partnerships.* For purposes of applying this paragraph (b), in the case of a domestic partnership that is a U.S. shareholder partnership with respect to a partnership CFC, the distributive share of a U.S. shareholder partner of a U.S. shareholder partnership's section 959(a) distribution from the partnership CFC is treated as a section 959(a) distribution received by the U.S. shareholder partner from the partnership CFC.

(c) *Accounting for previously taxed earnings and profits*—(1) *Establishment of annual PTEP account.* A separate, annual account (*annual PTEP account*) must be established for the previously taxed earnings and profits of the controlled foreign corporation to which inclusions under section 951(a) and GILTI inclusion amounts of United States shareholders of the CFC are attributable. Each account must correspond to the inclusion year of the previously taxed earnings and profits and to the section 904 category to which the inclusions under section 951(a) or GILTI inclusion amounts were assigned at the level of the United States shareholders. Accordingly, a controlled foreign corporation may have an annual PTEP account in the section 951A category or a treaty category (as defined in § 1.861–13(b)(6)), even though income of the controlled foreign corporation that gave rise to the previously taxed earnings and profits cannot initially be assigned to the section 951A category or a treaty category.

(2) *PTEP groups within an annual PTEP account.* The amount in an annual PTEP account is further assigned to one or more of the following groups of previously taxed earnings and profits (each, a *PTEP group*) within the account:

(i) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 965(a) (''reclassified section 965(a) PTEP'');

(ii) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 965(b)(4)(A) (''reclassified section 965(b) PTEP'');

(iii) Earnings and profits described in paragraphs (c)(2)(iii)(A) through (C) of this section (which are aggregated into a single PTEP group, ''general section 959(c)(1) PTEP''):

(A) Earnings and profits described in section 959(c)(1)(A) by reason of section 951(a)(1)(B) and not by reason of section 959(a)(2);

(B) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 951(a)(1)(A) (other than earnings that were initially described in paragraphs (c)(2)(vi) through (ix) of this section); and

(C) Earnings and profits described in section 959(c)(1)(B), including by reason of section 959(a)(3) (before its repeal);

(iv) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 951A(f)(2) (''reclassified section 951A PTEP'');

(v) Earnings and profits described in paragraphs (c)(2)(v)(A) through (C) of this section (which are aggregated into a single PTEP group, ''reclassified section 245A(d) PTEP''):

(A) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 245A(e)(2);

(B) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 959(e); and

(C) Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 964(e)(4);

(vi) Earnings and profits described in section 959(c)(2) by reason of section 965(a) (''section 965(a) PTEP'');

(vii) Earnings and profits described in section 959(c)(2) by reason of section 965(b)(4)(A) (''section 965(b) PTEP'');

(viii) Earnings and profits described in section 959(c)(2) by reason of section 951A(f)(2) (''section 951A PTEP'');

(ix) Earnings and profits described in paragraphs (c)(2)(ix)(A) through (C) of this section (which are aggregated into a single PTEP group, ''section 245A(d) PTEP''):

(A) Earnings and profits described in section 959(c)(2) by reason of section 245A(e)(2);

(B) Earnings and profits described in section 959(c)(2) by reason of section 959(e); and

(C) Earnings and profits described in section 959(c)(2) by reason of section 964(e)(4); and

(x) Earnings and profits described in section 959(c)(2) by reason of section 951(a)(1)(A) not otherwise described in paragraph (c)(2)(vi) through (ix) of this section (''section 951(a)(1)(A) PTEP'').

(3) *Accounting for distributions of previously taxed earnings and profits.* With respect to a recipient controlled foreign corporation that receives a section 959(b) distribution, such distribution amount is added to the annual PTEP account, and PTEP group within the annual PTEP account, that corresponds to the inclusion year and section 904 category of the annual PTEP account, and PTEP group within the annual PTEP account, from which the distributing controlled foreign corporation is treated as making the distribution under section 959. Similarly, with respect to a controlled foreign corporation that makes a section 959 distribution, such distribution amount reduces the annual PTEP

account, and PTEP group within the annual PTEP account, that corresponds to the inclusion year and section 904 category of the annual PTEP account, and PTEP group within the annual PTEP account, from which the controlled foreign corporation is treated as making the distribution under section 959. Earnings and profits in a PTEP group are reduced by the amount of current year taxes that are allocated and apportioned to the PTEP group under § 1.960–1(d)(3)(ii), and the U.S. dollar amount of the taxes are added to an account of PTEP group taxes under the rules in paragraph (d)(1) of this section.

(4) *Accounting for reclassifications of earnings and profits described in section 959(c)(2) to earnings and profits described in section 959(c)(1).* If an amount of previously taxed earnings and profits that is in a PTEP group described in paragraphs (c)(2)(vi) through (x) of this section (each, a section 959(c)(2) PTEP group) is reclassified as previously taxed earnings and profits described in section 959(c)(1) (reclassified previously taxed earnings and profits), the section 959(c)(2) PTEP group is reduced by the functional currency amount of the reclassified previously taxed earnings and profits. This amount is added to the corresponding PTEP group described in paragraph (c)(2)(i), (ii), (iii) (by reason of paragraph (c)(2)(iii)(B) of this section), (iv) or (v) of this section (each, a reclassified PTEP group) in the same section 904 category and same annual PTEP account as the reduced section 959(c)(2) PTEP group.

(d) *PTEP group taxes*—(1) *In general.* The term *PTEP group taxes* means the U.S. dollar amount of foreign income taxes (translated in accordance with section 986(a)) that are paid, accrued, or deemed paid with respect to an amount in each PTEP group within an annual PTEP account. The foreign income taxes that are paid, accrued, or deemed paid with respect to a PTEP group within an annual PTEP account of a controlled foreign corporation are—

(i) The sum of—

(A) The current year taxes paid or accrued by the controlled foreign corporation that are allocated and apportioned to the PTEP group under § 1.960–1(d)(3)(ii);

(B) Foreign income taxes that are deemed paid under section 960(b)(2) and paragraph (b)(2) of this section by the controlled foreign corporation with respect to a section 959(b) distribution received by the controlled foreign corporation, the amount of which is added to the PTEP group under paragraph (c)(3) of this section; and

(C) In the case of a reclassified PTEP group of the controlled foreign corporation, reclassified PTEP group taxes that are attributable to the section 959(c)(2) PTEP group that corresponds to the reclassified PTEP group.

(ii) Reduced by—

(A) Foreign income taxes that were deemed paid under section 960(b)(2) and paragraph (b)(2) of this section by another controlled foreign corporation that received a section 959(b) distribution from the controlled foreign corporation, the amount of which is subtracted from the controlled foreign corporation's PTEP group under paragraph (c)(3) of this section;

(B) Foreign income taxes that were deemed paid under section 960(b)(1) and paragraph (b)(1) of this section by a domestic corporation that is a United States shareholder of the controlled foreign corporation that received a section 959(a) distribution from the controlled foreign corporation, the amount of which is subtracted from the controlled foreign corporation's PTEP group under paragraph (c)(3) of this section; and

(C) In the case of a section 959(c)(2) PTEP group of the controlled foreign corporation, reclassified PTEP group taxes.

(2) *Reclassified PTEP group taxes.* Reclassified PTEP group taxes are foreign income taxes that are initially included in PTEP group taxes with respect to a section 959(c)(2) PTEP group under paragraph (d)(1)(i)(A) or (B) of this section multiplied by a fraction, the numerator of which is the portion of the previously taxed earnings and profits in the section 959(c)(2) PTEP group that become reclassified previously taxed earnings and profits, and the denominator of which is the total previously taxed earnings and profits in the section 959(c)(2) PTEP group.

(3) *Foreign income taxes deemed paid with respect to PTEP groups established for pre-2018 inclusion years.* In the case of foreign income taxes paid or accrued in a taxable year of the controlled foreign corporation that began before January 1, 2018, with respect to an annual PTEP account, and a PTEP group within such account, that was established for an inclusion year that begins before January 1, 2018, the foreign income taxes are treated as PTEP group taxes of a controlled foreign corporation for purposes of this section only if those foreign income taxes were—

(i) Not included in a controlled foreign corporation's post-1986 foreign income taxes (as defined in section 902(c)(2) as in effect on December 21, 2017) used to compute foreign taxes deemed paid under section 902 (as in effect on December 21, 2017) in any taxable year that began before January 1, 2018; and

(ii) Not treated as deemed paid under section 960(a)(3) (as in effect on December 21, 2017) by a domestic corporation that was a United States shareholder of the controlled foreign corporation.

(e) *Examples.* The following examples illustrate the application of this section.

(1) *Example 1: Establishment of PTEP groups and PTEP accounts*—(i) *Facts.* USP, a domestic corporation, owns all of the stock of CFC1, a controlled foreign corporation. CFC1 owns all of the stock of CFC2, a controlled foreign corporation. USP, CFC1, and CFC2 each use the calendar year as their U.S. taxable year. CFC1 and CFC2 use the ''u'' as their functional currency. At all relevant times, 1u = $1x. With respect to CFC2, USP includes in gross income a subpart F inclusion of 1,000,000u = $1,000,000x for the taxable year ending December 31, 2018. The inclusion is with respect to passive category income. In its U.S. taxable year ending December 31, 2019, CFC2 distributes 1,000,000u to CFC1. CFC2 has no earnings and profits except for the 1,000,000u of previously taxed earnings and profits resulting from USP's 2018 taxable year subpart F inclusion. CFC2's country of organization, Country X, imposes a withholding tax on CFC1 of 300,000u on CFC2's distribution to CFC1. Under § 1.960–1(d)(3)(ii), CFC1's 300,000u of current year taxes are allocated and apportioned to the PTEP group within the annual PTEP account within the section 904 category to which the 1,000,000u of previously taxed earnings and profits are assigned.

(ii) *Analysis*—(A) Under paragraph (c)(1) of this section, a separate annual PTEP account in the passive category for the 2018 taxable year is established for CFC2 as a result of USP's subpart F inclusion. Under paragraph (c)(2) of this section, this account contains one PTEP group, section 951(a)(1)(A) PTEP.

(B) Under paragraph (c)(3) of this section, in the 2019 taxable year, the 1,000,000u related to the section 959(b) distribution from CFC2 is added to CFC1's annual PTEP account for the 2018 taxable year in the passive category and to the section 951(a)(1)(A) PTEP within such account. Similarly, CFC2's 2018 taxable year annual PTEP account within the passive category, and the section 951(a)(1)(A) PTEP within such account, is reduced by the amount of the 1,000,000u section 959(b) distribution to CFC1. Additionally, CFC1's annual PTEP account for the 2018 taxable year in the passive category, and the section 951(a)(1)(A) PTEP within such account, is reduced by the 300,000u of withholding tax imposed on CFC1 by Country X. Therefore, CFC1's annual PTEP account for the 2018 taxable year within the passive category and the section 951(a)(1)(A) PTEP within such account is 700,000u.

(C) Under paragraph (d)(1) of this section, the 300,000u of withholding tax is translated into U.S. dollars and $300,000x is added to the PTEP group taxes with respect to CFC1's section 951(a)(1)(A) PTEP within the annual PTEP account for the 2018 taxable year within the passive category.

(2) *Example 2: Foreign income taxes deemed paid under section 960(b)*—(i) *Facts.* USP, a domestic corporation, owns 100% of the stock of CFC1, which in turn owns 60% of the stock of CFC2, which in turn owns 100% of the stock of CFC3. USP, CFC1, CFC2, and CFC3 all use the calendar year as their U.S. taxable year. CFC1, CFC2, and CFC3 all use the ''u'' as their functional currency. At all relevant times, 1u = $1x. On July 1, 2020, CFC2 distributes 600u to CFC1 and the entire distribution is a section 959(b) distribution (''distribution 1''). On October 1, 2020, CFC1 distributes 800u to USP and the entire distribution is a section 959(a) distribution (''distribution 2''). CFC1 and CFC2 make no other distributions in the year ending December 31, 2020, earn no other income, and incur no taxes on distribution 1 or distribution 2. Before taking into account distribution 1, CFC2 has 1,000u of section 951(a)(1)(A) PTEP within an annual PTEP account for the 2016 taxable year within the general category. The previously taxed earnings and profits in CFC2's PTEP group relate to subpart F income of CFC3 that was included by USP in 2016. CFC3 distributed the earnings and profits to CFC2 before the 2020 taxable year and, solely as a result of the distribution of the previously taxed earnings and profits, CFC2 incurred withholding and net basis tax, resulting in $150 of PTEP group taxes with respect to section 951(a)(1)(A) PTEP. Before taking into account distribution 1 and distribution 2, CFC1 has 200u in section 951A PTEP within an annual PTEP account for the 2018 taxable year within the section 951A category. The previously taxed earnings and profits in CFC1's PTEP group relate to the portion of a GILTI inclusion amount that was included by USP in 2018 and allocated to CFC2 under section 951A(f)(2) and § 1.951A–6(b)(2). CFC2 distributed the earnings and profits to CFC1 before the 2020 taxable year and, solely as a result of the distribution of the previously taxed earnings and profits, CFC1 incurred withholding and net basis tax, resulting in $25x of PTEP group taxes with respect to section 951A PTEP.

(ii) *Analysis*—(A) *Foreign income taxes deemed paid by CFC1.* With respect to distribution 1 from CFC2 to CFC1, under paragraph (b)(4) of this section CFC1's proportionate share of PTEP group taxes with respect to CFC2's section 951(a)(1)(A) PTEP within an annual PTEP account for the 2016 taxable year within the general category is $90x ($150x × 600u/1,000u). Under paragraph (b)(3) of this section, the amount of foreign income taxes that are properly attributable to distribution 1 is $90x. Accordingly, under paragraph (b)(2) of this section, CFC1 is deemed to have paid $90x of general category foreign income taxes of CFC2 with respect to its 600u section 959(b) distribution in the general category.

(B) *Adjustments to PTEP accounts of CFC1 and CFC2.* Under paragraph (c)(3) of this section, the 600u related to distribution 1 is added to CFC1's section 951(a)(1)(A) PTEP within an annual PTEP account for the 2016 taxable year within the general category. Similarly, CFC2's section 951(a)(1)(A) PTEP within an annual PTEP account for the 2016 taxable year within the general category is reduced by 600u, the amount of the section 959(b) distribution to CFC1. Additionally, under paragraph (d) of this section, CFC1's PTEP group taxes with respect to its section 951(a)(1)(A) PTEP within an annual PTEP account for the 2016 taxable year within the general category are increased by $90 and CFC2's PTEP group taxes with respect to section 951(a)(1)(A) PTEP within an annual PTEP account for the 2016 taxable year within the general category are reduced by $90x.

(C) *Foreign income taxes deemed paid by USP.* With respect to distribution 2 from CFC1 to USP, because CFC1 has PTEP groups in more than one section 904 category, this section is applied separately to each section 904 category (that is, distribution 2 of 800u is applied separately to the 200u of CFC1's section 951A PTEP and 600u of CFC1's section 951(a)(1)(A) PTEP).

(*1*) *Section 951A category.* Under paragraph (b)(4) of this section, USP's proportionate share of PTEP group taxes with respect to CFC1's section 951A PTEP within an annual PTEP account for the 2018 taxable year within the section 951A category is $25x ($25x × 200u/200u). Under paragraph (b)(3) of this section, the amount of foreign income taxes within the section 951A category that are properly attributable to distribution 2 is $25x. Accordingly, under paragraph (b)(1) of this section USP is deemed to have paid $25x of section 951A category foreign income taxes of CFC1 with respect to its 200u section 959(a) distribution in the section 951A category.

(*2*) *General category.* Under paragraph (b)(4) of this section, USP's proportionate share of PTEP group taxes with respect to CFC1's section 951(a)(1)(A) PTEP within an annual PTEP account for the 2016 taxable year within the general category is $90x ($90x × 600u/600u). Under paragraph (b)(3) of this section, the amount of foreign income taxes that are properly attributable to distribution 2 is $90x. Accordingly, under paragraph (b)(1), USP is deemed to have paid $90x of general category foreign income taxes of CFC1 with respect to its 600u section 959(a) distribution in the general category.

■ **Par. 37.** Section 1.960–4 is amended by:

■ 1. Removing the language ''960(b)(1)'' and adding the language ''960(c)(1)'' in its place wherever it appears.

■ 2. In paragraph (a)(1):

■ i. Removing the language ''he'' and adding the language ''the taxpayer'' in its place.

■ ii. Removing the language ''subparagraph (2) of this paragraph'' and adding the language ''paragraph (a)(2) of this section'' in its place.

■ iii. Adding two sentences at the end.

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

■ 4. Revising paragraph (f).

The addition and revisions read as follows:

§ 1.960–4 Additional foreign tax credit in year of receipt of previously taxed earnings and profits.

(a) * * * (1) * * * For purposes of this section, an amount included in gross income under section 951A(a) is treated as an amount included in gross income under section 951(a). The amount of the increase in the foreign tax credit limitation allowed by this section is determined with regard to each separate category of income described in § 1.904–5(a)(4)(v).

* * * * *

(d) * * * For purposes of this paragraph (d), the term ''foreign income taxes'' includes foreign income taxes paid or accrued, foreign income taxes deemed paid or accrued under section 904(c), and foreign income taxes deemed paid under section 960 (or section 902 with respect to taxable years of foreign corporations beginning before January 1, 2018), for the taxable year of inclusion.

* * * * *

(f) *Examples.* The application of this section may be illustrated by the following examples:

(1) *Example 1.* USP, a domestic corporation, owns all of the one class of stock of CFC, a controlled foreign corporation that uses the U.S. dollar as its functional currency. CFC, after paying foreign income taxes of $10x, has earnings and profits for Year 1 of $90x, all of which are attributable to an amount required under section 951(a) to be included in USP's gross income for Year 1 because the income is general category foreign base company services income of CFC. Both corporations use the calendar year as the taxable year. For Year 2 and Year 3, CFC has no earnings and profits attributable to an amount required to be included in USP's gross income under section 951(a); for each such year it makes a distribution of $45x (from its section 951(a)(1)(A) PTEP within the annual PTEP account for Year 1) from which a foreign income tax of $6x is withheld. For each of Year 1, Year 2, and Year 3, USP derives taxable income of $50x from sources within the United States and claims a foreign tax credit under section 901, subject to the limitation under section 904. The U.S. tax payable by USP is determined as follows, assuming a corporate tax rate of 21%:

TABLE 1 TO PARAGRAPH (f)(1)

Year 1		
Taxable income of USP:		
U.S. sources		$50.00x
Sources without the U.S.:		
Amount required to be included in USP's gross income under section 951(a)	$90.00x	
Foreign income taxes deemed paid by USP under section 960(a) and included in USP's gross income under section 78 ($10x × $90x/$90x)	10.00x	100.00x
Total taxable income		150.00x
U.S. tax payable for Year 1:		
U.S. tax before credit ($150x × 21%)		31.50x
Credit: Foreign income taxes of $10x, but not to exceed the limitation of $21x for Year 1 ($100x/$150x × $31.50x)		10.00x
U.S. tax payable		21.50x

TABLE 2 TO PARAGRAPH (f)(1)

Year 2		
Taxable income of USP, consisting of income from U.S. sources		$50.00x
U.S. tax before credit ($50x × 21%)		10.50x
Section 904 limitation for Year 2:		
Limitation for Year 2 before increase under section 960(c)(1) ($10.50x × $0/$50x)		10
Plus: Increase in limitation for Year 2 under sec. 960(c)(1):		
Amount by which Year 1 limitation was increased by reason of inclusion in USP's gross income under section 951(a) for Year 1 ($21x − [($50x × 21%) × $0/$50x])	21.00x	
Less: Foreign income taxes allowed as a credit for Year 1 which were allowable solely by reason of such section 951(a) inclusion ($10x − $0)	10.00x	
Balance	11.00x	
But: Such balance not to exceed foreign income taxes paid by USP for Year 2 with respect to $45x distribution excluded under section 959(a)(1) ($6x tax withheld)	6.00x	6.00x
Limitation for Year 2		6.00x
U.S. tax payable for Year 2:		
U.S. tax before credit ($50x × 21%)		10.50x
Credit: Foreign income taxes of $6x, but not to exceed limitation of $6x for Year 2		6.00x
U.S. tax payable		4.50x

TABLE 3 TO PARAGRAPH (f)(1)

Year 3		
Taxable income of USP, consisting of income from U.S. sources		$50.00x
U.S. tax before credit ($50x × 21%)		10.50x
Section 904 limitation for Year 3:		
Limitation for Year 3 before increase under section 960(c)(1) ($10.50x × $0/$50x)		0
Plus: Increase in limitation for Year 3 under section 960(c)(1):		
Amount by which Year 1 limitation was increased by reason of inclusion in USP's gross income under section 951(a) for Year 1 ($21x − [($50 × 21%) × $0/$50x])	$21.00x	
Less: Foreign income taxes allowed as a credit for Year 1 which were allowable solely by reason of such section 951(a) inclusion ($10x − $0)	10.00x	
Tentative balance	11.00x	
Less: Increase in limitation under section 960(c)(1) for Year 2 by reason of such sec. 951(a) inclusion	6.00x	
Balance	5.00x	
But: Such balance not to exceed foreign income taxes paid by USP for Year 3 with respect to $45x distribution excluded under section 959(a)(1) ($6x tax withheld)	6.00x	5.00x
Limitation for Year 3		5.00x
U.S. tax payable for Year 3:		
U.S. tax before credit ($50x × 21%)		10.50x
Credit: Foreign income taxes of $6, but not to exceed section 904(a) limitation of $5x		5.00x
U.S. tax payable		5.50x

(2) *Example 2.* The facts for Year 1 and Year 2 are the same as in paragraph (f)(1) of this section (the facts in *Example 1*), except that in Year 0, in which USP also claimed a foreign tax credit under section 901, USP pays $11x of foreign income taxes in excess of the general category limitation and such excess is not absorbed as a carryback to the prior year under section 904(c). Therefore, there is no increase under section 960(c)(1) in the limitation for Year 2 since the amount ($21x) by which the Year 1 limitation was increased by reason of the inclusion in USP's gross income for Year 1 under section 951(a), less the foreign income taxes ($21x) allowed as a credit which were allowable solely by reason of such inclusion, is zero. The foreign income taxes so allowed as a credit for Year

1 which were allowable solely by reason of such section 951(a) inclusion consist of the $10 of foreign income taxes deemed paid for Year 1 under section 960(a) and the $11x of foreign income taxes for Year 0 carried over and deemed paid for Year 1 under section 904(c).

■ **Par. 38.** Section 1.960–5 is amended by:

■ 1. In paragraph (a)(1):

■ i. Removing the language ''951(a)'' and adding the language ''951(a) or 951A(a)'' in its place.

■ ii. Removing the comma and adding a semicolon in its place.

■ 2. Revising paragraph (b).

The revision reads as follows:

§ 1.960–5 Credit for taxable year of inclusion binding for taxable year of exclusion.

* * * * *

(b) *Example.* The application of this section may be illustrated by the following example:

(1) *Facts.* USP, a domestic corporation, owns all the one class of stock of CFC, a controlled foreign corporation. Both corporations use the calendar year as the taxable year and the functional currency of CFC is the U.S. dollar. All of CFC's earnings and profits of $80x for Year 1 (after payment of foreign income taxes of $20x on its total income of $100x for such year) are attributable to amounts required under section 951(a) to be included in USP's gross income for Year 1 because such income is general category foreign base company services income of CFC. For Year 1, USP chooses to claim a foreign tax credit for the $20x of foreign income taxes which for such year are paid by CFC and deemed paid by USP under section 960(a) and § 1.960–2(b). In Year 2, CFC distributes the entire $80x of Year 1 previously taxed earnings and profits, from which a foreign income tax of $8x is withheld. Also in Year 2, CFC pays $40x of interest to USP, from which a foreign income tax of $4x is withheld. For Year 2, USP chooses to claim deductions for its creditable foreign income taxes under section 164 rather than a foreign tax credit under section 901.

(2) *Analysis.* Although USP does not choose to claim a foreign tax credit for Year 2, under section 960(c)(4) and paragraph (a) of this section it may not deduct the $8x of foreign income taxes under section 164. USP may, however, deduct under such section the foreign income tax of $4x which is withheld from the interest paid by CFC in Year 2.

■ **Par. 39.** Section 1.960–6 is amended by removing the language ''960(b)(1)'' and adding the language ''960(c)(1)'' in its place in paragraph (a) and revising paragraph (b) to read as follows:

§ 1.960–6 Overpayments resulting from increase in limitation for taxable year of exclusion.

* * * * *

(b) *Example.* The application of this section may be illustrated by the following example:

(1) *Facts.* USP, a domestic corporation, owns all of the one class of stock of CFC, a controlled foreign corporation. Both corporations use the calendar year as the taxable year, and the functional currency of CFC is the U.S. dollar. For Year 1, CFC has total income of $100,000x on which it pays foreign income taxes of $20,000x. All of CFC's earnings and profits for Year 1 of $80,000x are attributable to an amount which is required under section 951(a) to be included in USP's gross income for Year 1 because such income is general category foreign base company services income of CFC. By reason of such income inclusion USP is deemed for Year 1 to have paid under section 960(a), and is required under section 78 to include in gross income for such year, the $20,000x ($20,000x × $80,000x/$80,000x) of foreign income taxes paid by CFC for such year. USP also derives $100,000x of taxable income from sources within the United States for Year 1. For Year 2, USP has $4,000x of taxable income, all of which is derived from sources within the United States. No part of CFC's earnings and profits for Year 2 is attributable to an amount required under section 951(a) or section 951A(a) to be included in USP's gross income. During Year 2, CFC makes one distribution consisting of its $80,000x earnings and profits for Year 1, all of which is excluded under section 959(a)(1) from USP's gross income for Year 2, and from which distribution foreign income taxes of $1,000x are withheld. For Year 1 and Year 2, USP claims the foreign tax credit under section 901, subject to the limitation of section 904.

(2) *Analysis.* The U.S. tax liability of USP is determined as follows for such years, assuming a corporate tax rate of 21%:

TABLE 1 TO PARAGRAPH (b)(2)

Year 1		
Taxable income of USP:		
U.S. sources		$100,000.00x
Sources without the U.S.:		
Amount required to be included in USP's gross income under section 951(a)	$80,000.00x	
Foreign income taxes deemed paid by USP under section 960(a) and included in USP's gross income under section 78 ($20,000x × $80,000x/$80,000x)	20,000.00x	100,000.00x
Total taxable income		200,000.00x
U.S. tax payable for Year 1:		
U.S. tax before credit ([$200,000x × 21%])		42,000.00x
Credit: Foreign income taxes of $20,000x, but not to exceed limitation of $21,000x ($42,000x × $100,000x/$200,000x)		20,000.00x
U.S. tax payable		22,000.00x

TABLE 2 TO PARAGRAPH (b)(2)

Year 2		
Taxable income of USP, consisting of income from U.S. sources		$4,000x
U.S. tax before credit ($4,000x × 21%)		840x
Section 904 limitation for Year 2:		
Limitation for Year 2 before increase under section 960(c)(1) ($840x × $0/$4,000x)		0
Plus: Increase in section 904 limitation for Year 2 under section 960(c)(1):		
Amount by which Year 1 limitation was increased by reason of inclusion in USP's gross income under section 951(a) for Year 1 ($21,000x–[$21,000x × $0/$100,000x])	$21,000x	
Less: Foreign income taxes allowed as a credit for Year 1 which were allowable solely by reason of such section 951(a) inclusion ($20,000x–$0)	20,000x	
Balance	1,000x	

TABLE 2 TO PARAGRAPH (b)(2)—Continued

But: Such balance not to exceed foreign income taxes paid by USP for Year 2 with respect to $80,000x distribution excluded under section 959(a)(1) ($1,000x tax withheld)	1,000x	1,000x
Limitation for Year 2		1,000x
U.S. tax payable for Year 2:		
U.S. tax before credit ($4,000x × 21%)		840x
Credit: Foreign income taxes of $1,000x, but not to exceed limitation of $1,000x for Year 2		1,000x
U.S. tax payable		None
Overpayment of tax for Year 2:		
Increase in limitation under section 960(c)(1) for Year 2		1,000x
Less: Tax imposed for Year 2 under chapter 1 of the Code		840x
Excess treated as overpayment		160x

■ **Par. 40.** Section 1.960–7 is revised to read as follows:

§ 1.960–7 Applicability dates.

Sections 1.960–1 through 1.960–6 apply to each taxable year of a foreign corporation that both begin after December 31, 2017, and ends 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.

■ **Par. 41.** Section 1.965–5 is amended by adding paragraph (c)(1)(iii) to read as follows:

§ 1.965–5 Allowance of a credit or deduction for foreign income taxes.

* * * * *

(c) * * *

(1) * * *

(iii) *Foreign income taxes deemed paid under section 960(b) (as applicable to taxable years of controlled foreign corporations beginning after December 31, 2017, and to taxable years of United States persons in which or with which such taxable years of foreign corporations end).* Paragraph (c)(1)(i) of this section applies to foreign income taxes deemed paid under section 960(b) (as in effect for a taxable year of a controlled foreign corporation beginning after December 31, 2017, and a taxable year of a United States person in which or with which such controlled foreign corporation's taxable year ends) only if such taxes are deemed paid under § 1.960–3(b)(1) with respect to distributions to a domestic corporation of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits. *See also* § 1.960–3(c)(2)(i), (ii), (vi), or (vii). Foreign income taxes that would have been deemed paid under section 960(a)(1) (as in effect on December 21, 2017) with respect to the portion of a section 965(a) earnings amount that was reduced under § 1.965–1(b)(2) or § 1.965–8(b) are not eligible to be deemed paid under section 960(b) and § 1.960–3(b) or any other section of the Code.

* * * * *

§ 1.965–7 [Amended]

■ **Par. 42.** Section 1.965–7 is amended by removing the language ''§ 1.904–5(a)'' and adding in its place the language ''§ 1.904–5(a)(4)(v)'' in the last sentence of paragraph (e)(1)(i).

■ **Par. 43.** Section 1.965–9 is amended by:

■ 1. Removing the language ''Sections 1.965–1 through 1.965–8 apply'' and adding in its place the language ''Except as otherwise provided in this section, §§ 1.965–1 through 1.965–8 apply'' in paragraph (a).

■ 2. Adding paragraph (c).

The addition reads as follows:

§ 1.965–9 Applicability dates.

* * * * *

(c) *Applicability date for certain portions of § 1.965–5.* Paragraph (c)(1)(iii) of § 1.965–5 applies to taxable years of foreign corporations that both begin after December 31, 2017, and end on or after December 4, 2018, 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.

§ 1.985–3 [Amended]

■ **Par. 44.** Section 1.985–3 is amended by removing the language ''§ 1.904–5(a)(1)'' and adding in its place the language ''§ 1.904–5(a)(4)(v)'' in the second sentence of paragraph (e)(2)(iv).

■ **Par. 45.** Section 1.986(a)–1 is added to read as follows:

§ 1.986(a)–1 Translation of foreign income taxes for purposes of the foreign tax credit.

(a) *Translation of foreign income taxes taken into account when accrued*—(1) *In general.* For purposes of this section, the term *section 901 taxpayer* means the ''taxpayer'' described in § 1.901–2(f)(1) and so includes a partnership or a specified 10-percent owned foreign corporation (as defined in section 245A(b)) that has legal liability under foreign law for foreign income tax. Except as provided in paragraph (a)(2) of this section, in the case of a section 901 taxpayer that takes foreign income taxes (as defined in section 986(a)(4) (including taxes described in section 903)) into account when accrued, the amount of any foreign income taxes denominated in foreign currency that has been paid or accrued, including additional tax liability denominated in foreign currency, foreign income taxes withheld in foreign currency, or estimated foreign income taxes paid in foreign currency, are translated into dollars using the weighted average exchange rate (as defined in § 1.989(b)–1) (the ''average exchange rate'') for the section 901 taxpayer's U.S. taxable year (as defined in § 1.960–1(b)(37)) to which such foreign income taxes relate. *See* section 986(a)(1)(A). See section 988 and §§ 1.988–1(a)(2)(ii) and 1.988–2(c) for rules for determining whether and the extent to which there is a foreign currency gain or loss when an accrued functional currency amount of foreign income tax denominated in nonfunctional currency differs from the functional currency amount paid.

(2) *Exceptions*—(i) *Foreign income taxes not paid within 24 months.* Any foreign income taxes denominated in foreign currency that are paid more than 24 months after the close of the section 901 taxpayer's U.S. taxable year to which they relate are translated into dollars using the spot rate on the date of payment of the foreign income taxes. *See* section 986(a)(1)(B)(i) and (a)(2)(A). For purposes of this section and § 1.905–3, the term *spot rate* has the meaning provided in § 1.988–1(d). To the extent any accrued foreign income taxes denominated in foreign currency remain unpaid more than 24 months after the close of the taxable year to which they relate, see § 1.905–3 and paragraph (c) of this section for the required adjustments.

(ii) *Foreign income taxes paid before taxable year begins.* Any foreign income taxes denominated in foreign currency that are paid before the beginning of the section 901 taxpayer's U.S. taxable year to which such taxes relate are translated into dollars using the spot rate on the date of payment of the foreign income taxes. See section 986(a)(1)(B)(ii) and (a)(2)(A).

(iii) *Inflationary currency.* Any foreign income taxes denominated in a foreign currency that is an inflationary currency in the section 901 taxpayer's U.S. taxable year to which the foreign income taxes relate, or in any subsequent taxable year up to and including the taxable year in which the taxes are paid, are translated into dollars using the spot rate on the date of payment of such taxes. For purposes of section 986(a)(1)(C) and this paragraph (a)(2)(iii), the term *inflationary currency* means the currency of a country in which there is cumulative inflation during the base period of at least 30 percent, as determined under the principles of § 1.985–1(b)(2)(ii)(D), where the base period, with respect to any taxable year, is the 36 months ending on the last day of such taxable year (in lieu of the base period described in § 1.985–1(b)(2)(ii)(D), which ends on the last day of the preceding calendar year). Accrued but unpaid foreign income taxes denominated in a foreign currency that is an inflationary currency in the taxable year accrued are translated into dollars at the spot rate on the last day of the section 901 taxpayer's U.S. taxable year to which such taxes relate (provisional year-end rate). However, a U.S. taxpayer that claims a foreign tax credit under section 901 may choose to translate accrued but unpaid foreign income taxes (including foreign income taxes deemed paid under section 960) denominated in a foreign currency that is an inflationary currency into dollars at the spot rate on the date of payment, in lieu of the provisional year-end rate, if such taxes are paid prior to the due date (with extensions) of the original Federal income tax return for the taxable year for which the credit is claimed and such return is timely filed. In all other cases, see § 1.905–3 and paragraph (c) of this section for required adjustments upon payment of accrued foreign income taxes denominated in an inflationary currency.

(iv) *Election to translate foreign income taxes using the spot rate as of date of payment*—(A) *Eligibility to make election.* An individual or corporate taxpayer (including a specified 10-percent owned foreign corporation) that is otherwise required to translate foreign income taxes that are denominated in foreign currency using the average exchange rate may elect to translate foreign income taxes described in this paragraph (a)(2)(iv) into dollars using the spot rate on the date of payment of the foreign income taxes, provided that the liability for such taxes is denominated in nonfunctional currency. For purposes of section 986(a)(1)(D) and this paragraph (a)(2)(iv), whether the currency in which a tax liability attributable to a qualified business unit (within the meaning of section 989(a)) (QBU) is denominated is a nonfunctional currency is determined by reference to the functional currency of the individual or corporate taxpayer and not that of the QBU of the taxpayer. Accrued but unpaid foreign income taxes subject to the election under this paragraph (a)(2)(iv) are translated at the provisional year-end rate. However, a taxpayer that claims a foreign tax credit under section 901 may choose to translate accrued but unpaid foreign income taxes (including foreign taxes deemed paid under section 960 with respect to a specified 10-percent owned foreign corporation that has made an election under this paragraph (a)(2)(iv)) into dollars at the spot rate on the date of payment, in lieu of the provisional year-end rate, if such taxes are paid prior to the due date (with extensions) of the original return for the taxable year for which the credit is claimed and such return is timely filed. In all other cases, see § 1.905–3 and paragraph (c) of this section for required adjustments upon payment of accrued foreign income taxes that are translated into dollars at the spot rate on the date of payment.

(B) *Scope of election.* In general, an individual taxpayer may make an election under this paragraph (a)(2)(iv) for all foreign income taxes denominated in nonfunctional currency, or only for those foreign income taxes that are denominated in nonfunctional currency and that are attributable to the individual's non-QBU activities and all QBUs with dollar functional currencies. A corporate taxpayer may make an election under this paragraph (a)(2)(iv) for all foreign income taxes that are denominated in nonfunctional currency, or only for those foreign income taxes that are denominated in nonfunctional currency and that are attributable to all QBUs (including the corporate taxpayer) with dollar functional currencies. Therefore, an election under this paragraph (a)(2)(iv) may not be made for foreign income taxes that are denominated in a nonfunctional currency of the taxpayer and attributable to QBUs with non-dollar functional currencies, except as part of an election to translate all taxes denominated in nonfunctional currency at the spot rate on the date of payment. For purposes of this paragraph (a)(2)(iv)(B), foreign income tax is attributable to a QBU if the tax is properly recorded on the books and records of the QBU in accordance with sections 985 through 989. An election under this paragraph (a)(2)(iv) by a domestic corporation (or an individual that has made an election under section 962) does not apply to any taxes paid or accrued by foreign corporations with respect to which the individual or corporation is a United States shareholder. However, an election may be made on behalf of a foreign corporation to translate either all of the foreign corporation's foreign income taxes denominated in nonfunctional currency, or only the foreign income taxes denominated in nonfunctional currency that are attributable to the foreign corporation's QBUs with dollar functional currencies, using the spot rate on the date of payment. Such an election is made using the procedures under § 1.964–1(c)(3) that apply to permit controlling domestic shareholders to make or change a tax accounting election on behalf of a foreign corporation.

(C) *Time and manner of election.* The election under this paragraph (a)(2)(iv) must be made by attaching a statement to the taxpayer's timely filed Federal income tax or information return (including extensions) for the first taxable year to which the election applies. The statement must identify whether the election under this paragraph (a)(2)(iv) is made for all foreign income taxes denominated in nonfunctional currency or only for those foreign income taxes that are denominated in nonfunctional currency and that are either attributable to the taxpayer's QBUs with dollar functional currencies or, in the case of an individual, attributable to non-QBU activities. Once made, the election under this paragraph (a)(2)(iv) applies for the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Commissioner.

(D) *Example*—(*1*) *Facts.* USP, a domestic corporation that uses the calendar year as its taxable year, owns a partnership interest in PS, a non-hybrid partnership organized in Country X. USP also owns an equity interest in HPS, a Country X corporation that has filed an entity classification election under § 301.7701–3 of this chapter to be treated as a partnership for Federal income tax purposes. USP also owns 100% of CFC, a Country Y controlled foreign corporation that uses the U.S. dollar as its functional currency. PS and HPS each use a fiscal year ending November 30 as its taxable year both for Federal income tax purposes and for Country X tax purposes, and their functional currency is the Euro. HPS is the section 901 taxpayer of foreign income taxes denominated in Euros that it pays to Country X and properly records on its books and records. USP takes its distributive share of the HPS taxes into account under sections 702(a)(6) and 901(b)(5) and §§ 1.702–1(a)(6) and 1.704–1(b)(4)(viii) in computing its foreign tax credit. USP is the section 901 taxpayer of Euro-denominated foreign income taxes it pays to Country X with respect to its distributive share of the income of PS, and also pays Country X taxes withheld in Euros from distributions from HPS to USP and properly records these taxes on its books and records. Pursuant to § 1.985–1(b)(1)(iii), USP's functional currency is the dollar. USP timely elects under § 1.986(a)–1(a)(2)(iv) to use the spot rate on the date of payment to translate into dollars its foreign income taxes denominated in nonfunctional currency that are attributable to all QBUs with dollar functional currencies.

(*2*) *Result.* The Euro taxes paid by USP with respect to its distributive share of income from PS and the Euro taxes withheld from distributions from HPS are nonfunctional currency taxes attributable to USP, a QBU with a dollar functional currency. Accordingly, these taxes are translated into dollars at the spot rate on the date the taxes are paid. USP's distributive share of the Euro taxes paid by HPS are attributable to HPS, a Euro functional currency QBU of USP. Because these taxes are not attributable to a dollar QBU of USP, they are not covered by USP's election and so are translated into dollars at the average exchange rate for HPS's U.S. taxable year ending on November 30. See § 1.986(a)–1(a)(1). Foreign income taxes paid by CFC are not covered by USP's election; however, if USP so chooses it may make a separate election on behalf of CFC to use the spot rate on the date of payment to translate either all of CFC's nonfunctional currency taxes, or only those taxes that are attributable to CFC's dollar QBUs (which includes CFC). If instead USP had elected to use the spot rate on the date of payment to translate all of its foreign income taxes denominated in nonfunctional currency, rather than only those taxes attributable to QBUs with dollar functional currencies, then the spot rate on the date of payment would apply to translate all of the Euro taxes paid or accrued by USP, including its distributive share of taxes paid by HPS. However, this election would still not apply to taxes paid or accrued by CFC. See § 1.986(a)–1(a)(2)(iv)(B).

(v) *Regulated investment companies.* In the case of a regulated investment company (as defined in section 851) which takes into account income on an accrual basis, foreign income taxes paid or accrued with respect to such income are translated into dollars using the spot rate on the date the income accrues. See section 986(a)(1)(E).

(b) *Translation of foreign income taxes taken into account when paid.* In the case of a section 901 taxpayer that takes foreign income taxes into account when paid, the amount of any foreign income tax liability denominated in foreign currency, including additional income tax liability denominated in foreign currency or estimated foreign income taxes paid in foreign currency, are translated into dollars using the spot rate on the date of payment of such taxes. See section 986(a)(2)(A). Foreign income taxes withheld in foreign currency are translated into dollars using the spot rate on the date on which such taxes were withheld.

(c) *Refunds or other reductions of foreign income tax liability.* In the case of a section 901 taxpayer that takes foreign income taxes into account when accrued, a reduction in the amount of previously-accrued foreign income taxes that is attributable to a refund of foreign income taxes, a credit allowed in lieu of a refund, or a reduction in or other downward adjustment to an accrued amount, including an adjustment on account of accrued foreign income taxes that were not paid by the date 24 months after the close of the U.S. taxable year to which such taxes relate, is translated into dollars using the exchange rate that was used to translate such amount when claimed as a credit or added to PTEP group taxes (as defined in § 1.960–3(d)(1)). In the case of foreign income taxes taken into account when accrued but translated into dollars on the date of payment, see § 1.905–3(b) for required adjustments to reflect a foreign tax redetermination (as defined in § 1.905–3(a)) attributable to a reduction in the amount of previously-accrued foreign income taxes that is attributable to a difference in exchange rates between the date or taxable year of accrual and the date of payment. In the case of a section 901 taxpayer that takes foreign income taxes into account when paid, a refund or other reduction in or downward adjustment to the amount of foreign income taxes is translated into dollars using the exchange rate that was used to translate such amount when claimed as a credit. If a refund or other reduction of foreign income taxes relates to foreign income taxes paid or accrued on more than one date, then the refund or other reduction is deemed to be derived from, and reduces, the payments of foreign income taxes in order, starting with the most recent payment of foreign income taxes first, to the extent thereof.

(d) *Allocation of refunds of foreign income taxes.* Refunds of foreign income taxes are allocated to the same separate category as the foreign income taxes to which the refunded taxes relate. Refunds are related to foreign income taxes in a separate category if the foreign income tax that was refunded was imposed with respect to that separate category. See § 1.904–6 concerning the allocation of foreign income taxes to separate categories of income.

(e) *Basis of foreign currency refunded*—(1) *Nonfunctional currency tax liability and dollar functional currency.* If the functional currency of the QBU that paid the tax and received the refund is the dollar or the person receiving the refund is not a QBU, then the recipient's basis in the foreign currency refunded is the dollar value of the refund determined under paragraph (c) of this section by using the exchange rate that was used to translate such amount into dollars when claimed as a credit or added to PTEP group taxes.

(2) *Nonfunctional currency tax liability and non-dollar functional currency.* If the functional currency of the QBU receiving the refund is not the dollar and is different from the currency in which the foreign income taxes were paid, then the recipient's basis in the refunded foreign currency is equal to the functional currency value of the nonfunctional currency refund, translated into functional currency at the appropriate exchange rate between the functional currency and the nonfunctional currency. Such exchange rate is determined under the principles of paragraph (c) of this section, substituting the words ''functional currency'' for the word ''dollar'' and using the exchange rate that was used to translate such amount into the QBU's functional currency when claimed as a credit or added to PTEP group taxes (as defined in § 1.960–3(d)(1)). If a QBU receives a refund of nonfunctional currency tax that is denominated in a currency that was the functional currency of the QBU when the refunded tax was claimed as a credit or added to PTEP group taxes, the QBU's basis in the nonfunctional currency received in the refund is determined by using the exchange rate used under § 1.985–5(c) when the QBU's functional currency changed. See § 1.905–3(b)(1)(ii)(C) (*Example 3*).

(3) *Functional currency tax liabilities.* If the functional currency of the QBU receiving the refund is the currency in which the refund was made, then the recipient's basis in the currency received is the amount of the functional currency received. If the QBU receives a refund of functional currency tax that was denominated in a nonfunctional currency of the QBU when the tax was claimed as a credit or added to PTEP group taxes, the QBU will recognize the section 988 gain or loss that would have been recognized under § 1.985–5(b) if the refund had been received

immediately before the QBU's functional currency changed.

(4) *Foreign currency gain or loss.* For rules for determining subsequent foreign currency gain or loss on the disposition of nonfunctional currency, the basis of which is determined under this paragraph (e), see section 988(c)(1)(C).

(f) *Applicability dates.* This section applies to taxable years ending on or after December 16, 2019, and to taxable years of foreign corporations which end with or within a taxable year of a United States shareholder ending on or after December 16, 2019.

■ **Par. 46.** Section 1.988–2 is amended by:

■ 1. Removing the language ''paragraph (a)(2)(iii)(B)'' and adding the language ''paragraphs (a)(2)(iii)(B) and (C)'' in its place in paragraph (a)(2)(iii)(A).

■ 2. Adding paragraph (a)(2)(iii)(C).

The additions read as follows:

§ 1.988–2 Recognition and computation of exchange gain or loss.

(a) * * *

(2) * * *

(iii) * * *

(C) *Basis in refunded foreign income tax.* See § 1.986(a)–1(e) for rules relating to the determination of basis in refunded foreign income tax denominated in nonfunctional currency.

* * * * *

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: October 30, 2019.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2019–24848 Filed 12–16–19; 8:45 am]

BILLING CODE 4830–01–P