

## US final and proposed regulations provide additional guidance for determining allowable foreign tax credits

---

### EY Tax News Update: Global Edition

EY's Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration [here](#).

Also available is our [EY Global Tax Alert Library](#) on ey.com.

---

### Executive summary

On 2 December 2019, the United States (US) Treasury Department (Treasury) released final and proposed regulations on determining allowable foreign tax credits under the Internal Revenue Code (IRC).<sup>1</sup> The regulations are expected to be published in the Federal Register soon.

The final foreign tax credit (FTC) regulations are largely consistent with the proposed regulations released in 2018, with some modifications. In particular, the final regulations include a new safe harbor provision for transitioning pre-2018 FTC carryforwards to post-2017 tax years to account for the new foreign branch income category and provide for accounting for foreign tax redeterminations in prior tax years.

The proposed FTC regulations (New Proposed Regulations) would change the manner in which deductions for research and experimental (R&E) activities are allocated and apportioned. In particular, the New Proposed Regulations would require R&E expenditures to be allocated to the taxpayer's gross intangible income, which does not include dividends, subpart F income, or Global Intangible Low-Taxed Income (GILTI) inclusions, under a new gross-receipts based method. This proposal should generally reduce a taxpayer's US tax liability by reason of a GILTI inclusion, so should generally be well

received. Further, and perhaps more important, Prop. Reg. Sections 1.861-20 and 1.904-6 would provide detailed guidance for allocating and apportioning current-year foreign taxes to separate Section 904(d) categories of income. Prop. Reg. Section 1.861-20 also provides specific allocation and apportionment rules for foreign taxes attributable to:

- ▶ Timing or base differences (an exclusive list of base differences is provided)
- ▶ Various transactions that are disregarded for US purposes
- ▶ Income of entities that are fiscally transparent under foreign law but treated as corporations for US tax purposes (a reverse hybrid)
- ▶ Gains from the sale or exchange of a foreign disregarded entity

The New Proposed Regulations also provide guidance under Section 905(c) for applying the “relation back” doctrine to foreign tax redeterminations that relate to pre-*Tax Cuts and Jobs Act* (TCJA) tax years.

## Detailed discussion

The TCJA introduced two additional income limitations under Section 904: (i) the Section 951A category (GILTI basket); and (ii) the IRC foreign branch income category.

### New final regulations and proposed regulations

The following discussion describes the final regulations and the New Proposed Regulations. The discussion of the final regulations focuses on the provisions that deviate from the original proposed regulations.

### Modifications to the foreign tax credit provisions

#### Transition rules – addition of safe harbors

As a result of the TCJA’s addition of the foreign branch category, the 2018 proposed regulations included transition rules for FTC carryforwards, loss accounts for overall foreign losses (OFLs), overall domestic losses (ODLs), separate limitation losses (SLLs), and net operating losses (NOLs) with respect to the general category. The final regulations retain those rules but helpfully provide flexibility by including safe harbors.

In all cases, the default rule provides that carryovers in the general category remain in the general category.<sup>2</sup> So, unused pre-2018 foreign tax credits in the general category are allocated to the post-2017 general category; pre-2018

OFL, ODL and SLL accounts in the general category are allocated to the post-2017 general category and recaptured in that category; and pre-2017 foreign losses that are part of a general-category NOL are carried forward to post-2018 years as general-category NOLs. Nevertheless, taxpayers may choose to reconstruct these items for pre-2018 years as if the foreign branch category existed to determine the extent to which they would relate to the foreign branch category, and by applying all the rules for allocating income to a foreign branch, including the disregarded payment rules.

Acknowledging the complexities of the reconstruction option, the final regulations include simplified safe harbors. For foreign tax credit carryovers, pre-2018 unused general category foreign income taxes for each year are allocated to the post-2017 foreign branch category based on the ratio of foreign income taxes paid or accrued by all foreign branches divided by foreign income taxes in the general category that were paid or accrued in that year. The amounts of foreign income taxes paid or accrued by a foreign branch in a pre-2018 year are those foreign income taxes properly reflected as an expense on the branch’s separate books and records. Similarly, SLL and ODL accounts in the pre-2018 general category, may be allocated to, and recaptured in, the post-2017 general category or foreign branch category based on the proportion of pre-2018 unused foreign income taxes allocated under the FTC safe harbor (or reconstruction).

For SLLs and OFLs, the safe harbor allows the pre-2018 amounts to be recaptured in the post-2017 general category or foreign-branch category by recharacterizing the first available income in those categories in a post-2017 year. If the income available for recapture in both categories exceeds the loss account, the loss account is recaptured proportionately from each category. Similarly, NOL carryforwards attributable to foreign losses from the pre-2018 general category may be attributed to the post-2017 general category and branch category to the extent thereof. NOL carryforwards that offset any other income in a post-2017 year are treated as attributable to the general category; if general category and foreign branch category income in the post-2017 year exceed the NOL carryforward, the offset is determined on a proportionate basis.

#### Branch basket rules

The rules for attributing income to the foreign-branch category generally follow the 2018 proposed regulations, with some important clarifications and modifications. The disregarded payment rules, which increase or decrease

foreign branch income by reallocating gross income, are retained, including for intangible property, and expanded for tangible property. In addition to reallocation between a branch and branch owner, reallocation between foreign branches of the same branch owner is also required, but, in the general rule, only if there is at least one disregarded transaction between one branch and the branch owner. The final regulations reiterate that the disregarded payment rules do not change the total amount, character, or source of a US person's gross income.

The final regulations now provide specific rules for certain disregarded transfers of tangible property, which are separated into tangible non-inventory property and inventory property. For a disregarded sale of non-inventory property from a branch to a branch owner or another branch, the final regulations generally defer the reallocation of income until the branch owner would have been allowed a deduction for depreciation or until the branch owner disposes of the property in a transaction recognized for federal income tax purposes. When a branch sells depreciable non-inventory property to the branch owner, gross income is reallocated from the branch owner (or transferee) to the branch (or transferor) to the extent of the depreciation that would have been allowed to the branch owner had the sale from the branch to the branch owner been regarded. At the time of the regarded disposal, the branch owner's gross income recognized on the regarded disposal is reallocated to the branch to the extent of the "adjusted disregarded gain." The "adjusted disregarded gain" is the lesser of (1) the basis of the property if the disregarded transaction had been regarded (i.e., its cost) less its actual basis at that time, subject to certain adjustments, and (2) the gain the branch owner recognizes on the regarded disposition. Attributions of gross income under this rule must be adjusted to the extent basis would have been recovered by the branch owner. Similar rules apply for sales of non-inventory property from a branch owner to a branch.

The reallocation of income related to inventory property relies on the same principles. Thus, when inventory is sold by a branch to a branch owner (or vice versa), the income on the eventual regarded sale of inventory property is reallocated at the time of the regarded sale. For purposes of reallocating the gross income on the regarded inventory sale, any costs of goods sold incurred by the branch before the disregarded sale is treated like the basis in non-inventory property.

As noted earlier, the reallocation rules for disregarded transfers of intangible property between branch and branch owner are retained in the final regulations. However, two favorable changes were made. First, the rules do not apply to transactions occurring before 7 December 2018 (the date the 2018 proposed regulations were published), thus providing relief from having to apply the rules to prior transactions, including for purposes of reconstruction under the transition rules (see earlier). Second, no reallocation is required when the transferor's ownership of intangible property is transitory (e.g., when a controlled foreign corporation (CFC) elects to be disregarded as an entity separate from its owner and transfers intangible property to its owner shortly thereafter). This exception is intended to make it easier for taxpayers to repatriate intangible property to the US that is currently held offshore. When the rules do apply, the final regulations rely on the principles of Section 367(d) (governing outbound transfers of intangible property) and Section 482 (governing allocation of income among taxpayers) to reallocate income between the branch and the branch owner. These principles apply regardless of whether the transfer is from the branch owner to the branch or the branch to the branch owner.

### Foreign tax redeterminations

Final and proposed regulations under Section 905(c) were issued to replace the expired 2007 temporary regulations and reflect the repeal of Section 902 (no pooling adjustments). The final and proposed regulations under Section 905(c) largely follow the 2007 temporary regulations with helpful clarifications and modifications.

The final regulations address foreign tax redeterminations under Section 905(c), as well as currency translation rules for foreign income taxes under Section 986(a). The final regulations on currency translation rules address several items, including the 24-month change noted later, inflationary currencies, the election to translate accrued taxes on the date of payment, and Section 988 gain or loss when functional currency is changed.

Generally, a foreign tax redetermination is defined as a (1) change in foreign tax liability, and (2) certain other changes that affect a taxpayer's foreign tax credit. Among other events, this includes additional taxes paid as a result of a contested tax liability and refunds. The final regulations revise the definition of foreign tax redetermination to include accrued taxes that are not paid on or before the date that

is “24 months” (previously more than two years) after the close of the tax year to which the taxes relate, as well as the subsequent payment of those taxes. This change better coordinates the foreign tax redetermination and currency translation rules.

The New Proposed Regulations would further modify the definition of foreign tax redetermination to include changes that may affect a taxpayer’s US tax liability (rather than only its foreign tax credit), including by reason of a change in:

- ▶ The amount of foreign tax credit
- ▶ The amount of distributions or inclusions under Sections 951, 951A, and 1293
- ▶ The high-tax exception of Section 954(d)(4) (including for purposes of determining tested income)
- ▶ Certain amounts determined under Section 1291

If a foreign tax redetermination occurs for direct taxes (i.e., Section 901 taxes), the final regulations generally require a taxpayer to redetermine its US tax liability for the tax year in which the tax was claimed as a foreign tax credit and any year to which the taxes were carried. No redetermination of US tax liability is required if (1) the difference results solely from fluctuating foreign exchange rates between the date of accrual and the date of payment, and (2) the net dollar amount of the foreign currency fluctuations attributable to the foreign tax redeterminations for each and every foreign country is less than the lesser of \$10,000 or 2% of the dollar amount of the initially accrued foreign tax liability for that foreign country for that year. In that case, adjustments are made to the taxpayer’s US tax liability in the year that the foreign tax redetermination occurs, and no notification to the Internal Revenue Service (IRS) is required.

Because of the repeal of Section 902, the New Proposed Regulations would require taxpayers to redetermine their US tax liability to account for the effect of a foreign tax redetermination of foreign income taxes taken into account by a foreign corporation. Previously, taxpayers could prospectively adjust to their Section 902 pools in most cases. Under the New Proposed Regulations, a redetermination of US tax liability would require the taxpayer to adjust the foreign corporation’s taxable income, earnings and profits (E&P) and current-year taxes for the year to which the redetermined tax relates, by treating the amount of redetermined foreign tax as paid or accrued in that year. In redetermining US tax liability, taxpayers must account for:

- ▶ The effect of the foreign tax redetermination on the characterization and amount of distributions, subpart F inclusions, GILTI inclusions, and QEF inclusions
- ▶ Whether the high-tax exception applies
- ▶ Tax amounts determined under Section 1291
- ▶ Foreign taxes deemed paid under Section 960

In addition, a redetermination of US tax liability is required for any affected subsequent year. All of this must be done even if there is no change to the FTC amount originally claimed.

The New Proposed Regulations also provide a transition rule for post-2018 redeterminations for pre-2017 years. The transition rule is similar to the rules described previously in that taxpayers must redetermine their US tax liability for the year to which the foreign tax redetermination relates (and other affected years), taking into account the effects of the foreign tax redetermination on the foreign corporation’s taxable income, E&P, foreign income taxes, the amount of taxes deemed paid, the character and amount of distributions and inclusions, and the high-tax exception. No rule is provided for taking such redeterminations into account in the last year beginning before 1 January 2018, although comments are requested.

The New Proposed Regulations would add a new rule on foreign tax redeterminations of “successor entities.” When a foreign tax redetermination occurs and the technical taxpayer (successor) is not the same as the technical taxpayer in the year to which the foreign tax redetermination relates (original taxpayer), the redetermination would be made as if it occurred to the original taxpayer. Federal income tax principles would apply to determine the consequences if the successor paid the tax or received the refund.

Finally, the New Proposed Regulations follow the 2007 temporary regulations with respect to IRS notification requirements for foreign tax redeterminations and penalties. Taxpayers would generally be required to notify the IRS of a foreign tax redetermination by filing an amended return, Form 1118, and statement for the affected year(s). If the redetermination increased the US tax liability, the amended return would have to be filed by the due date (including extensions) of the original return for the taxpayer’s tax year in which the foreign tax redetermination occurs. If the redetermination decreased the US tax liability, the amended return would have to be filed within the period

specified by Section 6511 (generally within 10 years from the affected year). If there is no change to the US tax liability, the taxpayer may adjust its carryforward attributed and attach a statement to the tax return for the year in which the redetermination occurs in lieu of filing an amended return. Special rules apply where the taxpayer has multiple foreign tax redeterminations within the same year or within two consecutive years (relief from filing an amended return for all years) and if the taxpayer is under the jurisdiction of LB&I (only a statement required if certain conditions are satisfied).

## **Modifications to expense allocation and apportionment provisions**

### **R&E expenditures**

The New Proposed Regulations make significant changes to how R&E expenditures are allocated and apportioned. Under the New Proposed Regulations, R&E expenditures would first be allocated to the taxpayer's "gross intangible income" related to the relevant SIC code category as a class. Gross intangible income includes all gross income earned by the taxpayer attributable to intangible property, including gross income from sales, services, royalties and amounts taken into account under Section 367(d). Under the New Proposed Regulations, R&E expenditures would not be allocated or apportioned to dividends, subpart F income or GILTI.

R&E expenditures would then be apportioned to the statutory and residual groupings within the class of gross income in a two-step process. First, R&E expenditures in a SIC category would be subject to 50% exclusive geographic apportionment, determined by reference to where research and experimentation that accounts for at least 50% of the R&E expenditures is performed. Next, the remaining R&E expenditures would be apportioned to statutory (Section 904 baskets) and residual (US-source) groupings based on gross receipts (including those benefitting controlled and uncontrolled parties) related to the taxpayer's gross intangible income.

For this purpose, gross receipts would be assigned to the grouping to which the taxpayer's gross intangible income attributable to the license, sale, or other transfer of intangible property to such party is assigned (e.g., foreign general for royalties paid by a benefitting CFC to the taxpayer). Thus, if a US corporation licensed intangible

property to a CFC that, in turn, sold products or services incorporating the intangible property, the CFC's gross receipts would be assigned to a grouping based on the source and character of the related royalty included by the US corporation.

The New Proposed Regulations would eliminate the optional gross income method of apportionment for R&E expenditures.

In the Preamble to the New Proposed Regulations, Treasury and the IRS state that they intend to address the allocation and apportionment of R&E expenditures for purposes of Section 250 when final Section 250 regulations are issued.

The provisions of the New Proposed Regulations that apply to R&E expenditures are effective for tax years beginning after 31 December 2019. The Preamble to the New Proposed Regulations states that taxpayers that are on the sales method for tax years beginning after 31 December 2017, and before 1 January 2020, may rely on the proposed regulations for R&E expenditures if they apply them consistently. The final regulations permit taxpayers to change to the sales method up to their last tax year beginning before 1 January 2020, without prior IRS consent.

### **Stewardship expenses**

The New Proposed Regulations would retain the definition of stewardship as a duplicative activity or a shareholder activity related to overseeing an investment in a subsidiary. Under the New Proposed Regulations, stewardship expenses would be allocated to dividends and inclusions received or accrued, or to be received or accrued, from related corporations. Thus, stewardship expenses would be allocated to subpart F inclusions, GILTI inclusions, PFIC inclusions and Section 78 gross-up amounts. Stewardship expenses would be apportioned between the statutory and residual groupings based on relative values of stock, determined under the rules that apply for interest expense apportionment purposes. The New Proposed Regulations would extend the treatment of stewardship expenses to cover expenses incurred regarding a partnership interest.

The treatment of stewardship expenses under the New Proposed Regulations would apply to tax years ending on or after the date the New Proposed Regulations are filed in the Federal Register.

### **Litigation damages awards, prejudgment interest, and settlement payments**

The New Proposed Regulations would require deductions for product liability and similar claims to be allocated to the class of gross income produced by the specific sales or services that give rise to the claims, as if that gross income were recognized in the year in which the deduction is allowed. Thus, the settlement or payment of any pre-TCJA claim in a post-TCJA year would be allocated to the class of gross income to which the sale or service would be allocated in the post-TCJA year.

The New Proposed Regulations provide an example in which a foreign disregarded entity pays for damages related to its operations in a pre-TCJA year. The example concludes that the payments are allocated to the foreign branch income category. Had the damage payment been allocated based on the year to which the claim related, the damages would have been allocated to the general limitation category.

### **Interest expense apportionment**

**Modified gross income method:** CFCs can generally allocate and apportion their interest expense using either the asset method described in Treas. Reg. Section 1.861-9T(g) or the modified gross income method described in Treas. Reg. Section 1.861-9T(j). Under the modified gross income method, when computing a CFC's gross income in an ownership chain, an upper-tier CFC generally "tiers" up the income (net of interest expense) of its lower-tier subsidiaries before allocating and apportioning its interest expense. Under the prior proposed FTC regulations, gross tested income of a lower-tier CFC did not tier up to a higher-tier corporation and was instead added to the gross income of the first-tier CFC in the ownership chain for purposes of characterizing the stock. The final regulations now provide that the gross tested income (net of interest expense) of a lower-tier CFC is taken into account by an upper-tier CFC for purposes of allocating and apportioning its interest expense under the modified gross income method.

**Specified partnership loans:** For a "downstream partnership loan" (partner loan to the partnership), the final regulations require matching the interest income paid to the partner to the statutory and residual categories to which the interest expense is attributable. The New Proposed Regulations would extend this matching treatment to an upstream partnership loan (partnership loan to its partner). The

extension of the matching requirement to an upstream partnership loan would eliminate the negative tax arbitrage on loans by a partnership to its US owner.

**Guaranteed payments for the use of capital:** The New Proposed Regulations would treat a guaranteed payment for the use of capital as interest for purposes of the interest expense allocation and apportionment provisions. Similarly, a guaranteed payment would be treated as an "interest equivalent" that gives rise to foreign personal holding income under Section 954(c).

**Assets connected with capitalized, deferred or disallowed interest:** When interest expense is capitalized, deferred or disallowed, under the asset method for interest expense allocation and apportionment, the adjusted basis of the asset to which the interest expense is "connected" is reduced by the principal amount of the indebtedness. The New Proposed Regulations would treat assets as connected to a debt instrument only where the debt proceeds were used to acquire or produce the asset that causes the interest to be capitalized or disallowed. For example, when interest was disallowed under Section 163(l) because the interest on the underlying loan could, at the option of debtor, be paid using foreign corporation stock related to the debtor, there is no basis adjustment in the related-party stock held by the debtor. The Preamble to the New Proposed Regulations maintains that the limitation on when an asset is treated as connected to a debt instrument is a clarification of existing law.

### **Allocation and apportionment of foreign income taxes**

Prop. Reg. Section 1.861-20 would provide specified guidance for allocating and apportioning foreign income taxes in various transactional fact patterns, especially when differences exist between the foreign income item and the corresponding US item. These proposed rules are based generally on the principles of existing Treas. Reg. Section 1.904-6. The stated purpose of Prop. Reg. Section 1.861-20 is to accurately match current-year foreign income taxes with the related items of income or gain; in some fact patterns, however, the results under the proposed allocation method will prove surprising. In particular, taxpayers with foreign branches (whether disregarded entities or true branches) may face considerable compliance burdens; in some cases, as discussed later, a credit would not be allowed for certain foreign income taxes.

The New Proposed Regulations would generally apply a three-step process for allocating and apportioning current-year foreign income taxes. However, the special rules to be discussed would apply for allocating and apportioning foreign taxes to: (1) foreign income included by a taxpayer in its capacity as a shareholder, (2) foreign taxes imposed on certain disregarded payments, (3) reverse hybrid entities, and (4) gain on the sale of a disregarded entity.

In the first step, foreign gross income items (foreign items) would be assigned to the relevant statutory and residual groupings based on any positive corresponding US item. A corresponding US item is the gross income or loss under US tax law from the same event that gave rise to the foreign item. If the corresponding US item were a loss (or zero), the foreign item would be assigned to the grouping that a gain would be assigned had the transaction given rise to gain. If no corresponding US item arose in the year the tax was paid or accrued, the foreign item would be characterized and assigned as if a corresponding US item had been recognized in that year (this is the general timing difference rule). If the corresponding US item were excluded from US gross income under US tax law, the foreign item would be assigned as if it were includible in US gross income (see the later discussion of base differences).

Second, deductions allowed under foreign law (foreign law deductions) would be allocated and apportioned to the foreign item based on foreign law. If foreign law did not provide rules for allocating and apportioning the foreign law deductions, the principles of the Section 861 regulations would apply.

Finally, the current-year foreign income taxes would be allocated and apportioned to the foreign taxable income in the statutory and residual groupings (as determined after Step 2). If foreign law exempted a foreign item from tax, no foreign income tax would be allocated to that item.

*Shareholder distributions:* The first special rule (i.e., when foreign income is included by a taxpayer in its capacity as a shareholder) differentiates three situations, depending on whether the distribution is recognized for US and/or foreign purposes. When the distribution is recognized for US and foreign tax purposes, the tax would be assigned to the same category as the corresponding US dividend and capital gain amounts (to the extent thereof). As noted later, any portion of a distribution that corresponds to a Section 301(c)(2) return of a capital distribution would be a base difference.

When the distribution is recognized only for foreign tax purposes, the tax would be assigned as if a distribution were made for US purposes in the year the foreign tax was paid. Finally, foreign income taxes imposed under foreign law subpart F regimes would be assigned to the same grouping as the gross income of the foreign law CFC.

*Disregarded transactions:* Special rules are provided for three types of disregarded transactions. First, disregarded payments by a foreign branch to its owner would be deemed to be made ratably out of the branch's accumulated after-tax income, which would be treated as having arisen in the statutory and residual groupings by reference to the relative tax book values of the branch's assets (including stock) in each grouping.

In contrast, any current foreign income taxes paid or accrued with respect to disregarded payments by a foreign branch owner to a foreign branch would be allocated to the residual grouping. For purposes of Section 904, a taxpayer that is a US person would allocate the foreign taxes to the foreign branch category. If the taxpayer were a CFC, the foreign taxes would be allocated to the CFC's residual income group and therefore not creditable.

For example, a CFC pays a service fee to its foreign disregarded entity. Any foreign income taxes on the disregarded services payment seemingly would be assigned to the residual income group of the CFC, thereby denying a Section 960 credit for the foreign income tax. On the other hand, a service fee paid by the disregarded entity to the CFC would be categorized according to the branch's accumulated after-tax income, which is treated as arising in the relevant groupings based on the relative tax-book values of the branch's assets. Assuming all of the assets of the disregarded entity are categorized to general tested income, the foreign tax imposed on the service fee in the hands of the CFC would be categorized as general tested income taxes that may potentially be deemed paid under Section 960(d) with respect to a GILTI inclusion.

The Preamble does not explain this result, but it may follow from the stated goal of accurately matching foreign income taxes to the items of income on which the taxes are levied. Because no additional income is generated from these "downstream" payments, Treasury appears to have concluded it is more accurate to allocate these foreign taxes to income of a CFC that will not be subject to US tax, generally because of the potentially availability of a Section 245A deduction (i.e., the CFC's residual income).

Lastly, when a foreign item arises by reason of a disregarded payment from the sale of property between a foreign branch and its owner, foreign income taxes on the receipt of the payment would be allocated as if the disregarded payment resulted in recognition of income in that year (in the same manner as the general timing difference rule).

The special rule for reverse hybrid entities would allocate foreign income taxes by referencing the reverse hybrid's foreign income and treating the reverse hybrid as the taxpayer. For a foreign income tax directly paid or accrued by a US corporate shareholder under Section 901 for income of a reverse hybrid CFC (i.e., a partnership for foreign tax law purposes and a corporation for US tax purposes) this rule, in conjunction with Prop. Reg. Section 1.904-6(f), would assign the taxes to the GILTI basket for Section 904 purposes based on the taxpayer's GILTI inclusion percentage.

Finally, gain from the sale of disregarded entity would be assigned as if the disregarded entity's assets were sold for foreign tax purposes (e.g., by reference to the DRE's inside asset basis under foreign law).

*Base differences:* Prop. Reg. Section 1.861-20 provides an exclusive list of items that constitute base differences, ending the debate generally on determining whether foreign income tax is imposed on an item that is not an item of gross income for US tax purposes. The items on this exclusive list are:

- ▶ Capital contributions under Section 118
- ▶ The receipt of property in exchange for stock described in Section 1032 (including by reason of a Section 351 contribution)
- ▶ The receipt of money or other property in a Section 721 contribution to a partnership
- ▶ The portion of a distribution that is a return of basis under Section 301(c)(2)

In all these cases, any foreign income taxes would be assigned to the taxpayer's residual grouping. As such, if the taxpayer were a CFC, no credit would be allowed for those taxes under Treas. Reg. Section 1.960-1(d)(3)(ii)(B). In contrast, if the taxpayer were a US person, the foreign income tax would be assigned to the branch basket under Section 904(d)(2)(H)(i).

## Implications

The final regulations and New Proposed Regulations provide highly anticipated guidance on many open questions about the FTC regime post-TCJA. Helpfully, the final regulations expand the transition rules for carryovers of foreign tax credits, OFLs, ODLs, SLLs and NOLs by creating safe harbors that do not require taxpayers to apply the foreign branch rules under the final regulations. The safe harbors are particularly useful because the foreign branch rules in the final regulations require the reattribution of income to and/or from the foreign branch category for many disregarded transactions. Disregarded transfers of both tangible and intangible property are included in these rules, although the latter only applies to transfers of intangible property on or after 7 December 2018.

The final regulations and New Proposed Regulations under Section 905(c) provide important guidance on foreign tax redeterminations and the need to redetermine a taxpayer's US tax liability, including notifying the IRS, following the repeal of Section 902 pooling adjustments. Nevertheless, the compliance burden on taxpayers will be significant. The requirement to fully reflect the impact of all foreign tax redeterminations for foreign income taxes paid or accrued by a foreign corporation, in the year to which the taxes relate, means that taxpayers will need to carefully track these matters and regularly file amended returns to avoid losing foreign tax credits or incurring penalties.

For expense allocation and apportionment, the New Proposed Regulations would not allocate any R&E expenditures to the GILTI category, which may benefit taxpayers with excess credits in that category. Pending the forthcoming regulations under Section 250, consideration should be given to both the FTC and FDII impact of retroactively applying Prop. Reg. Section 1.861-17. It is important to model the alternative approaches currently available for years preceding the effective date of the New Proposed Regulations, years beginning before 1 January 2020, to determine whether to early adopt them.

The New Proposed Regulations would adopt a rigid approach to allocating and apportioning stewardship expenses, mandating allocation of the expense to dividends and inclusions, including subpart F and GILTI. It is now more important for taxpayers to determine which expenses are properly identified as stewardship. Frequently, taxpayers treat supportive expenses as stewardship expenses even when the expenses do not meet the narrow definition of stewardship. Again, modeling is important to determine the effect of these new rules.

The rules for allocating and apportioning foreign income taxes under Prop. Reg. Section 1.861-20 (together with Prop. Reg. Section 1.904-6 and 1.960-1) would introduce another complex regime, particularly the special rules for disregarded transactions. While the rules provide needed guidance in certain cases - reverse hybrids, for example - the inclusion of additional items as base differences and the increased likelihood of more foreign income taxes being non-creditable undoubtedly surprised many taxpayers and practitioners.

---

## Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. Carryovers in other categories always remain in their respective categories.

For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP, National Tax**

- ▶ Marjorie Rollinson, *Washington, DC* marjorie.rollinson@ey.com

**Ernst & Young LLP, International Tax and Transaction Services**

- ▶ José Murillo, *Washington, DC* jose.murillo@ey.com
- ▶ John Morris, *Washington, DC* john.morris@ey.com
- ▶ Martin Milner, *Washington, DC* martin.milner@ey.com
- ▶ JD Hamilton, *Washington, DC* jd.hamilton@ey.com
- ▶ Scott Johnson, *Baltimore* scott.johnson@ey.com
- ▶ Anna Voortman, *Chicago* anna.voortman@ey.com
- ▶ Ben Orenstein, *New York* benjamin.orenstein@ey.com
- ▶ Mary Koser, *New York* mary.koser@ey.com

**Ernst & Young LLP, Financial Services Organization**

- ▶ Chris Ocasal, *Washington, DC* chris.ocasal@ey.com

---

**International Tax and Transaction Services**

Global ITTS Leader, **Jeffrey Michalak**, *Detroit*

ITTS Director, Americas, **Craig Hillier**, *Boston*

ITTS Markets Leader, Americas, **Laynie Pavio**, *San Jose, CA*

ITTS NTD Leader, **Jose Murillo**, *Washington, DC*

**ITTS Regional Contacts, Ernst & Young LLP (US)**

West  
**Sadler Nelson**, *San Jose*

East  
**Colleen O'Neill**, *New York*

Central  
**Aaron Topol**, *Atlanta*

Financial Services  
**Chris J Housman**, *New York*

Canada - Ernst & Young LLP (Canada)  
**Warren Pashkowich**, *Calgary*

**About EY**

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit [ey.com](http://ey.com).

© 2019 EYGM Limited.  
All Rights Reserved.

EYG no. 005618-19Gbl

1508-1600216 NY  
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

**[ey.com](http://ey.com)**