

US IRS releases final regulations addressing partnership allocations of creditable foreign tax expenditures

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Executive summary

On 24 July 2019, the United States (US) Internal Revenue Service (IRS) published final regulations ([T.D. 9871](#)) under Internal Revenue Code¹ Section 704(b) relating to the allocation of creditable foreign tax expenditures (CFTEs) by a partnership (the 2019 final regulations). The 2019 final regulations adopt, with minor changes, the temporary ([T.D. 9748](#)) and proposed ([REG-100861-15](#)) regulations addressing CFTEs published on 4 February 2016 (the 2016 temporary and proposed regulations).

Detailed discussion

Background

CFTEs are generally foreign income taxes paid or accrued by a partnership that are eligible for a credit under Section 901(a) or a US income tax treaty. The IRS and Treasury determined that a partnership's allocation of CFTEs cannot have substantial economic effect within the meaning of Section 704(b) and the regulations. Thus, CFTEs must be allocated in accordance with the partners' interest in the partnership to be respected. The existing regulations under Section 704(b) provide a safe harbor rule for a partnership to allocate CFTEs in a manner deemed to be in accordance with the partners' interest in the partnership. To apply the safe harbor, a partnership must: (i) determine the

partnership's CFTE categories, (ii) determine the partnership's net income in each CFTE category, and (iii) allocate the partnership's CFTEs to each category. To satisfy the safe harbor, a partnership's allocations of CFTEs in a category must be in proportion to the allocations of the partnership's net income in the CFTE category.

2019 final regulations

The 2019 final regulations, like the 2016 temporary and proposed regulations, address: (i) the effect of a transferee partner's Section 743(b) adjustment on a partnership's net income in a CFTE category, (ii) the effect of certain allocations and guaranteed payments in computing a partnership's net income in a CFTE category, and (iii) certain disregarded payments within a partnership. The 2019 final regulations are effective 24 July 2019.

The preamble to the 2019 final regulations notes that the regulations are necessary to improve the operation of the existing CFTE safe harbor.

Changes from the 2016 temporary and proposed regulations

The 2019 final regulations adopt the following changes to the 2016 temporary and proposed regulations.

First, the definition of "activity" (in Treas. Reg. Section 1.704-1(b)(4)(viii)(c)(2)(iii)) was modified. In response to a comment, the Treasury and IRS added a cross-reference to Treas. Reg. Section 1.704-1T(b)(4)(viii)(c)(3)(iv), which contains the "disregarded payment rule," with a parenthetical explanation stating that "special allocations related to disregarded payments can give rise to subdivision of an activity into divisible parts." The purpose of the cross reference and parenthetical is to clarify the interaction between disregarded payments and the computation of net income in a CFTE category. The Government indicated that income in a CFTE category is determined first by assigning items of income to activities. Activities are then grouped together in a CFTE category to the extent the income attributable to activities is allocated using the same allocation percentages. The Government clarified that although disregarded payments are not taken into account in determining income assigned to an activity (as items of gross income are assigned to activities that generate those items for US federal income tax purposes), if a partnership makes allocations to give economic regard to a disregarded payment, those allocations can result in more than one allocation percentage being applied to income within the same activity. This in turn will result in the activity being

subdivided, with the subdivided portions being assigned to different CFTE categories. Thus, the Government concluded that although the 2016 temporary and proposed regulations do not literally provide that a disregarded payment "reduces" the net income in a CFTE category, the existing framework reaches a similar result and is left largely intact.

Second, the 2019 final regulations, restore, without change, Treas. Reg. Section 1.704-1(b)(4)(viii)(d)(1)(i) and (ii), which were inadvertently deleted from the 2016 temporary and proposed regulations.

Third, the 2019 final regulations renumber certain examples.

Section 743(b) adjustments

The 2019 final regulations, in Treas. Reg. Section 1.704-1T(b)(4)(viii)(c)(3)(i), provide that a transferee partner's Section 743(b) is not taken into account when computing a partnership's net income in a CFTE category. The final regulations further provide that if a partnership has a Section 743(b) adjustment in its capacity as a direct or indirect partner in a lower tier partnership, such adjustment is taken into account in determining the partnership's net income in a CFTE category. The rules with respect to Section 743(b) adjustments in the 2019 final regulations are identical to the rules with respect to Section 743(b) adjustments in the 2016 temporary and proposed regulations.

Deductible allocations and guaranteed payments

The 2016 temporary and proposed regulations also include special rules regarding how deductible allocations (allocations that give rise to a deduction under foreign law) and nondeductible guaranteed payments (guaranteed payments that do not give rise to a deduction under foreign law) impact a partnership's net income in a CFTE category. The 2019 final regulations adopt such rules. Thus, under Treas. Reg. Section 1.704-1(b)(4)(viii)(c)(4), a partnership's net income in a CFTE category is reduced by an allocation (or distributions of allocated amounts) to a partner and guaranteed payments that are deductible in a foreign jurisdiction. Conversely, guaranteed payments that are deductible for US federal income tax purposes but not deductible under foreign law are added back to the partnership's net income in a CFTE category. In the case of a guaranteed payment that is deductible under both US and foreign law, the partnership's net income in the CFTE category is increased only to the extent the amount allowed as a deduction for US federal income tax purposes exceeds the amount allowed as deduction for purposes of foreign tax.

Disregarded payments

The 2019 final regulations adopt the rules and examples related to disregarded payments (i.e., inter-branch payments among partnership branches) found in the 2016 temporary and proposed regulations. The 2016 temporary and proposed regulations addressed transactions involving serial disregarded payments in which withholding taxes are assessed on the first payment in a series of back-to-back disregarded payments. Prior to the 2016 temporary and proposed regulations, some taxpayers had taken the position that such withholding taxes need not be apportioned among the CFTE categories that included the income out of which the payment was made. The 2019 final regulations, like the 2016 temporary and proposed regulations, make clear that withholding taxes must be apportioned among the CFTE categories that include the related income.

Implications

The 2019 final regulations adopt the 2016 temporary and proposed regulations, with the three changes discussed above. Given the limited scope of the changes, taxpayers who rely on the CFTE safe harbor are unlikely to be surprised. The CFTE safe harbor, however, continues to be complex and taxpayers impacted by these rules and their advisors seeking to apply the safe harbor need to carefully study the rules, as amended.

Endnote

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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

Ernst & Young LLP, Partnerships and Joint Ventures Group

- | | |
|---|---------------------------|
| ▶ Jeff Erickson, <i>Washington, DC</i> | jeff.erickson@ey.com |
| ▶ Mark Oppen, <i>Washington, DC</i> | mark.opper@ey.com |
| ▶ Barksdale Penick, <i>Washington, DC</i> | barksdale.penick@ey.com |
| ▶ Wakesha Browne, <i>Washington, DC</i> | wakesha.browne@ey.com |
| ▶ Monisha Santamaria, <i>Los Angeles</i> | monisha.santamaria@ey.com |

Ernst & Young LLP, International Tax and Transaction Services

- | | |
|--|---------------------------|
| ▶ Joshua Ruland, <i>Washington, DC</i> | joshua.ruland@ey.com |
| ▶ Ben Orenstein, <i>New York</i> | benjamin.orenstein@ey.com |

International Tax and Transaction Services

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

Global ITTS Co-Leader, **Bridget Walsh**, *London*

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

ITTS Markets Leader, Americas, **Laynie Pavo**, *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*

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