



KPMG report:
Initial
impressions of
proposed
regulations on
foreign tax
credits under
new law

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The Treasury Department on Wednesday, November 28, 2018, released proposed regulations (REG-105600-18) relating to sections 78, 864, 901, 904, and 960, as amended by Pub. L. No. 115-97, enacted December 22, 2017 (“the new law”).

Read the text of the [proposed foreign tax credit regulations](#) [PDF 1.8 MB] (312 pages) as published on the IRS webpage. This report provides initial impressions and observations about these proposed regulations. KPMG will host a [webcast](#) on December 6 that will cover, in part, the proposed foreign tax credit regulations.

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Effective dates and reliance

Different effective date rules are provided for different provisions of the proposed regulations but generally fall into three categories—(1) tax years beginning after December 31, 2017, (2) tax years ending after the date on which the proposed regulations were filed with the Federal Register or (3) tax years which meet both of those criteria. For a summary of the effective dates of the proposed rules see the table in [Appendix A](#).

Significantly, taxpayers are not entitled to rely on the proposed regulations as having the force of law.

Comment period and hearing

The preamble to the proposed rules includes over 20 requests for comment, and any comments or requests for a public hearing must be submitted within 60 days after the date of publication in the Federal Register.

Background

The new law involved substantial changes to the foreign tax credit (“FTC”) regime under section 904 of the Code. It added two new categories of income (GILTI inclusions and foreign branch income) to section 904(d), thereby doubling the number of statutory FTC “baskets” from two to four. Furthermore, each of these new categories involves a class of income that can be earned only by an actual U.S. taxpayer and not a controlled foreign corporation (“CFC”). The new law also provided that dividends qualifying under section 245A (and stock producing such dividends), and deductions allocated and apportioned thereto, should be disregarded for certain purposes under section 904(d).

As a result of the statutory changes, significant regulatory changes needed to be made to the operation of the “look-through” rules of section 904(d)(3). Additionally, the proposed regulations would amend the existing expense allocation rules of the section 861 regulations. These changes relate primarily to GILTI, and while perhaps not going as far as some commentators had hoped, may provide some relief from expense allocation in the computation of the GILTI FTC limitation.

In addition to changing the rules under section 904(d), the new law entirely repealed section 902 and its “pooling” mechanism for imputing foreign taxes paid by a CFC to its U.S. shareholders upon a dividend or subpart F inclusion. Deemed paid credits are now governed solely by section 960 which applies an “attributable to” standard rather than pooling. The proposed regulations contain detailed rules implementing this new regime, which generally associate taxes with items of income using a combination of the existing regulations under section 904 and grouping rules that exist under subpart F.

Finally, the proposed regulations include a number of provisions that are unrelated to the new law but address longstanding rules and results that the government apparently viewed as problematic.

Section 960

As amended by the new law, section 960 is now the only provision that allows a corporate U.S. shareholder to claim a deemed paid credit with respect to taxes paid by its CFCs. Taxes are deemed paid by a corporate U.S. shareholder to the extent they are attributable to subpart F inclusions and GILTI inclusions. Section 960 also provides rules that treat foreign taxes imposed on a distribution of “previously taxed earnings and profits” (“PTEP” under the proposed rules – perhaps signaling a more general and somewhat ironic break from the colloquial section 959 term “PTI”) as deemed paid by the U.S. shareholder or upper tier CFC. In effect, amended section 960 entirely replaces the pooling regime of former section 902.

The proposed regulations under section 960 generally would provide two sets of computational rules, one for determining deemed paid taxes attributable to subpart F and GILTI inclusions based on current year CFC taxes, and the other for calculating deemed paid taxes attributable to PTI distributions based on current and prior year CFC taxes. The proposed regulations would provide a multi-step process for computing the deemed paid credit for subpart F and GILTI inclusions for each CFC in a chain of ownership, calculated first for the lowest tier CFC and then repeated for each CFC up the chain. The process generally would calculate deemed paid taxes by dividing a CFC’s income into tested income, various subcategories of subpart F income, and residual income (which is neither subpart F income nor tested income).

Grouping of income

Under the proposed rules, a CFC’s income for its current U.S. tax year (other than gross income relating to a PTEP distribution (discussed below)) and taxes for its current year would be assigned to a section 904 category (for CFCs, generally either the general limitation or the passive limitation category). Income and taxes then would be further assigned to an “income group” within a section 904 category or to a “PTEP group” (discussed below). “Income groups” would consist of the subpart F income groups, the tested income group, and the residual income group.

The subpart F income groups would comprise several separate income groups including, most significantly, separate groups for each separate “item” of foreign base company income identified under section 1.954-1(c)(1)(iii).

Allocation and apportionment of expenses and foreign taxes

Deductions would be allocated and apportioned to the various income groups (under section 861 rules) to arrive at the net income (or loss) within each income group. Likewise, current year taxes would be allocated to the groups under the principles of

proposed section 1.904-6. Current year taxes would be limited to the taxes paid or accrued by the CFC during its current U.S. tax year, even when a portion of the CFC's foreign tax year to which the taxes relate does not overlap with its U.S. tax year. As a result, when a CFC has different tax years for U.S. and foreign purposes, the CFC's "current year" taxes for a particular U.S. tax year could be based in part on foreign taxes imposed on income earned by the CFC in a different U.S. tax year. The proposed rules provide that current year taxes for these purposes would include subsequently redetermined foreign income taxes that "relate back" to the current year under section 905(c), which was revised by the new law. Only current year taxes allocated to a specific income group would be deemed paid with respect to an income inclusion (for example, under sections 951(a) or 951A(a)) that is sourced from the income group. Current year taxes that are assigned to the residual group would not be deemed paid, and thus, would be lost.

KPMG observation: An example of a subpart F income group is foreign base company sales income, which could include income earned from sales by separate qualified business units (QBUs) of the CFC located in various foreign jurisdictions. Under these rules, sales by separate QBUs would be aggregated into a single group, rather than segregating such income into multiple income groups based on the location of the sale or identity of the QBU conducting such sale.

KPMG observation: These grouping rules will be of much more significance going forward than they have been in the past. In particular, grouping was of very limited relevance in determining if an item of subpart F income qualified for the high-tax exception of section 954(b)(4) because the determination was ultimately driven by the pooling regime of old section 902. Under the proposed section 960 rules, the association of taxes with a particular group of subpart F income will directly determine whether that group qualifies for the high-tax exception.

KPMG observation: The proposed rules would assign current year taxes that are attributable to a "base difference," as determined under proposed section 1.904-6(a)(1)(iv), to the residual income group. The effect of this assignment is that any taxes incurred as a result of a base difference would not be eligible to be claimed as a deemed paid credit under section 960. The proposed regulations would "clarify" that base differences arise only in the limited circumstance of a foreign tax imposed on a type of item that does not constitute income under federal income tax principles, such as a gift or insurance proceeds.

KPMG observation: A taxpayer would be able to claim a section 960 credit only to the extent there is current year income in the income group to which current year taxes are attributed. Thus, taxes could be stranded when a CFC has a different U.S. and foreign tax year, or when there is a timing difference under foreign law. For example, assume a CFC with an 11/30 year-end for U.S. tax purposes, but a 12/31 year-end for local country purposes, engages in an extraordinary transaction in June of Year 1 that generates subpart F income in a non-recurring income group. The CFC would accrue the local taxes imposed on the transaction on 12/31 of Year 1, which would be within the CFC's 11/30

Year 2 tax year. Although foreign taxes would be assigned to the non-recurring subpart F income group, because the extraordinary subpart F income to which the taxes relate was taken into account in the U.S. shareholder's gross income as a subpart F inclusion in Year 1, there may not be any income in the relevant income group in Year 2 to permit the U.S. shareholder to claim a deemed paid credit for such taxes. Consequently, the only way to claim the credits would be to generate gross income in the same subpart F income group in the 11/30 Year 2 tax year.

Previously taxed earnings and profits

The proposed rules set forth a separate set of mechanical rules that would apply to CFC taxes attributable to PTEP. These rules would determine the amount of deemed paid taxes that a U.S. shareholder would take into account when it receives a PTEP distribution, based on attributable taxes paid or accrued by either the distributing CFC or a lower-tier CFC in a current or prior year. The creditability of taxes paid or accrued on PTEP distributed through tiers of CFCs is an area that lacked specific guidance prior to the change in law, and requires rules distinct from those applicable to subpart F and GILTI inclusions, which only give rise to credits for current year taxes.

The proposed rules would track PTEP on an annual basis based on the separate limitation category assigned to the inclusion that generated the PTEP. Within each annual layer for each separate limitation category, PTEP would be further assigned to one of ten "PTEP groups," based on the underlying subpart F, GILTI, or section 956 inclusion that generated the PTEP (taking into account reclassifications of PTEP from section 959(c)(2) to section 959(c)(1)). For example, PTEP attributable to GILTI inclusions would be assigned to a PTEP group separate from PTEP attributable to subpart F inclusions, which would be tracked in three distinct PTEP groups (with two separate PTEP groups related to section 965 mandatory repatriation inclusions).

The proposed rules do not provide ordering rules for determining the PTEP group from which a distribution is made, although the preamble states that Treasury and the IRS anticipate addressing ordering rules in future guidance under section 959. The preamble also notes that the ten PTEP groups could change based on future section 959 guidance. Proposed rules under section 959 are expected to be issued in early 2019.

KPMG observation: Prior to the change in law, PTEP generally has been classified in only two categories, often referred to as "(c)(1) PTI" and "(c)(2) PTI." After the change in law, additional subgroups are necessary, due in part to different substantive rules that can apply to distributions of the various PTEP groups for foreign tax credit purposes, including reductions in creditable taxes attributable to PTEP groups related to mandatory repatriation inclusions, as well as the lack of carryforwards or carrybacks for PTEP groups related to GILTI inclusions assigned to the GILTI category.

Consistent with the statute, the proposed rules do not haircut creditable taxes on GILTI PTEP distributions, even though taxes attributable to GILTI inclusions are subject to a 20% reduction.

Section 956

The proposed rules would eliminate the ability to claim deemed paid credits for section 956 inclusions. Proposed rules under section 956 published in early November would limit the ability of corporate taxpayers to include amounts in income under section 956, while the proposed rule under section 960 would deny foreign tax credits in the limited cases in which the corporation has a section 956 inclusion.

Foreign tax credit limitation—Basket rules

The actual regulatory changes required under section 904 to accommodate the new category of income for GILTI inclusions were relatively modest given that the category is simply defined as the amount of income included under section 951A (plus, in a regulatory clarification that had been widely foretold, the amount of section 78 gross-up attributable to such inclusions). In contrast, the rules added to address foreign branch income are much more elaborate. In addition, substantial changes were made to the “look-through” rules under section 1.904-5 to bring the provisions in line with statutory changes made as part of the new law (and other legislation since the regulations were last updated).

Foreign branch basket and income

Prior to the enactment of the new law, the fact that foreign source income was earned through a foreign branch was generally irrelevant to the computation of a U.S. person’s foreign tax credit limitation. Such income, along with the associated taxes, was assigned to the general category or passive category depending upon the nature of the income that was earned. The new law establishes a new foreign tax credit limitation category for foreign branch income, generally effective for tax years beginning after 2017. The statute defines foreign branch income (subject to an exclusion for passive category income) as “business profits ... attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries.” The foreign branch category is maintained on an aggregate foreign branch basis – that is, there are not separate categories for separate foreign branches or foreign jurisdictions.

Significantly, foreign branch income, defined by cross reference to the new foreign tax credit category, is excluded from income that is eligible to be treated as foreign-derived intangible income (FDII) under section 250(b)(3)(A).

Definition of a foreign branch

The proposed rules define a foreign branch by reference to the section 989 regulations, with modifications, such that a foreign branch must carry on a trade or business outside the United States and maintain a separate set of books and records. Thus, activities undertaken within the United States would be excluded when determining whether activities rise to the level of a trade or business outside the United States.

Under section 1.989(a)-1(c), for activities to constitute a trade or business, they “must ordinarily include the collection of income and payment of expenses.” This requirement created the possibility that a branch that does not earn any regarded income is not a QBU under section 989, regardless of the level of activity within the branch (for example, a maquiladora). In contrast, the proposed rules provide that, for purposes of determining whether this test is met in the context of section 904, disregarded transactions **are** taken into account and may give rise to a trade or business for this purpose.

KPMG observation: The decision to provide a rule taking into account disregarded transactions in determining whether the trade or business test is met for purposes of the foreign tax credit rules represents a departure from the current regulations under section 989. Accordingly, a branch that does not earn any regarded income (for example, because all of its transactions are with its owner) may constitute a foreign branch for purposes of the foreign tax credit limitation and section 250, but might not be treated as a QBU for purposes of section 987, which applies the definition in the section 989 regulations.

Notably, the foreign branch definition would not import the section 989 regulations’ *per se* QBU rule for partnerships, but rather would provide that if a partnership’s activities constitute a trade or business conducted outside the United States, then those activities will constitute a foreign branch even if the partnership does not maintain books and records for the trade or business that are separate from the partnership’s books and records. Activities that constitute a permanent establishment in a foreign country under a bilateral U.S. income tax treaty would be presumed to constitute a trade or business conducted outside the United States.

Foreign branch gross income—The basics

Under the new law, foreign branch category income is limited to the income of a U.S. person attributable to foreign branches held directly or indirectly (via disregarded entities, partnerships, or other pass-through entities) by such U.S. person. Foreign persons (including CFCs) cannot have foreign branch income. The proposed rules would define a U.S. person for this purpose to exclude pass-through entities (for example, partnerships). As such, foreign branch category income would be determined at the U.S. corporate / individual level, applying an aggregate theory for partnerships. Generally, the proposed rules would attribute gross income to a foreign branch to the extent such gross income is reflected on the foreign branch’s separate books and records, but would exclude the following:

- Income attributable to activities carried out in the United States.
- Income relating to stock held by the foreign branch, such as dividends, CFC and passive foreign investment company (PFIC) inclusions (for example, sections 951(a), 951A(a), and 1293(a)), and gain from the disposition of such stock (unless the stock is dealer property).

- Income from the sale of interests in entities that are treated as pass-throughs or disregarded for U.S. federal tax purposes, except in the case of a disposition of a partnership interest that is in the ordinary course of the foreign branch owner's trade or business. The ordinary course standard is deemed satisfied if there is at least 10% ownership of the entity and the owner and the entity are in the same or related businesses.
- Income or payments reflected (or not reflected) on the books and records if "a principal purpose" of recording (or not recording) the item is tax avoidance and the books and records do not reflect the substance of the transaction. For this purpose, a foreign branch's related party interest income (other than certain financial services income) is presumed to be excluded from foreign branch category income.

KPMG observation: These exclusions from foreign branch category income, and in particular the presumption for related party interest, seem motivated by a concern that taxpayers may try to artificially shift mobile, low-taxed income into an otherwise high-taxed foreign branch category, resulting in cross-crediting that would be contrary to the purpose underlying the enactment of the branch category.

Foreign branch gross income—Disregarded payments

In addition to respecting disregarded transactions in determining the existence of a branch, the proposed rules would generally take such transactions into account for purposes of determining the amount of gross income attributable to a branch. The preamble explains this rule as necessary for an accurate reflection of the gross income attributable to a branch, noting that this determination also governs the income that qualifies as FDII. The proposed rules generally would provide that gross income attributable to a foreign branch must be adjusted for otherwise disregarded payments between a foreign branch and its owner or between two foreign branches owned by the same owner if the payment would be deductible or capitalized if it were regarded for federal income tax purposes. The proposed rules would not treat such disregarded transactions as "regarded." Accordingly, such payments would continue to have no effect on the source, character, or total amount of the U.S. person's gross income. Instead, they are merely used to allocate that existing gross income between the foreign branch owner and the foreign branch. As a general matter, to determine the geographic source and character of an amount that is reallocated as a result of a disregarded payment, the principles of section 861 are applied to determine the gross income against which the disregarded payment would have been allocated if it were a regarded payment.

For example, a payment made by a foreign branch to its foreign branch owner (such as a disregarded royalty payment) may result in a downward adjustment to the gross income attributable to the foreign branch and an increase in the general category gross income of its owner. If a hypothetical regarded royalty would have been allocable against foreign source income of the branch, then the reallocation will be of the branch's foreign source income to the general category income of the owner.

KPMG observation: In this example, the ability to reallocate some of the foreign branch income to be general category income may give rise to a FDII benefit. The disregarded royalty itself cannot qualify for FDII because it is not regarded as such for U.S. purposes. However, if the foreign branch used the licensed IP to export products, a portion of the regarded gross income from the export sales would potentially be deduction eligible income as it would no longer be disqualified foreign branch income. This result makes sense from a policy perspective because the U.S. person retained ownership of foreign use IP in the United States.

KPMG observation: This rule may result in U.S. source gross income being reallocated from the general category to the foreign branch category, in particular in situations where the U.S. owner makes disregarded payments to the branch. In addition, if the U.S. source income is properly subject to foreign tax (as may likely be the case since it is reflected on the books and records of a foreign branch), it may be eligible to be treated as foreign source income under the terms of an income tax treaty, in which case the resourced income would be subject to a separate foreign tax credit limitation for income resourced under a tax treaty. See section 904(d)(6).

In the case of otherwise disregarded transfers of intangible property to or from a foreign branch (regardless of any consideration exchanged) the proposed rules would also require the application of the principles under sections 367(d) and 482 to re-determine the appropriate allocation of income between the foreign branch and the foreign branch owner.

Certain disregarded payments, including certain interest and interest equivalents, would be excluded and thus not taken into account for purposes of determining the amount of gross income attributable to a foreign branch.

KPMG observation: The foreign branch disregarded payment rules are among the most remarkable provisions in the proposed regulations package. They are notable for their complexity in creating a “virtual” company to determine the appropriate amount of income in the foreign branch. Such complexity may in some ways be justified by the importance of the foreign branch and its income in determining what income can qualify as “foreign derived deduction eligible income” that gives rise to the section 250 deduction.

Treatment of financial services income

The proposed rules provide that financial services income would be treated as foreign branch income to the extent attributable to a foreign branch, rather than automatically defaulting to the general category.

Allocation and apportionment of taxes to the foreign branch category

The proposed rules provide special provisions for allocating and apportioning foreign taxes related to disregarded payments to or from a foreign branch. In the case of disregarded payments or transfers that result in an adjustment to the gross income

attributable to a foreign branch, a corresponding adjustment is required to allocate associated foreign taxes in the same manner as the reallocated foreign income to which such foreign taxes relate. For example, in the case of a disregarded royalty payment from a foreign branch to its owner that resulted in a reallocation of income from the foreign branch category to the general category, any foreign tax imposed solely by reason of that payment (for example, withholding taxes on the royalty) would be allocated to the general category. However, foreign tax imposed on disregarded payments from a foreign branch owner to a foreign branch that **would not** result in a reallocation of gross income would be allocated and apportioned to the foreign branch category. For other disregarded payments from the foreign branch to the foreign owner, the foreign tax imposed by reason of such payments would be allocated and apportioned to a separate category based on the nature of the item under general tax principles. For example, a remittance of an appreciated asset from a foreign branch to its owner that results in taxable gain under foreign law would be allocated and apportioned to the separate category to which such taxable asset gain would be allocable if the asset were sold in a recognition transaction.

Withholding tax imposed by a foreign jurisdiction upon a remittance from a foreign branch is attributable to a timing difference in the 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 section 1.987-6(b).

Foreign tax credit limitation—Look-through rules

The proposed rules would modify existing “look-through” rules that apply to certain payments from CFCs to their U.S. shareholders and certain related parties. In keeping with section 904(d)(3), which was amended in 2004 but not revised by the new law, the proposed rules would apply look-through principles only to payments allocable to passive income; all other payments would be assigned to a separate category other than the passive category under the general rules of section 1.904-4. Under proposed section 1.904-4, amounts are assigned to the GILTI category only to the extent such amounts are included in income under section 951A. Importantly, a look-through rule was not provided to treat interest, rents or royalties paid by a CFC and which reduce tested income (that would otherwise be includible as GILTI) as GILTI category income.

KPMG observation: Numerous commentators had suggested that interest, rent, and royalty payments made to U.S. shareholders by CFCs should be characterized as GILTI category income to the extent attributable to tested income taxable under section 951A. Such a look-through rule would have increased the amount of limitation in the GILTI category FTC calculation, which would have been welcome relief to many corporations that have excess GILTI category taxes and nonetheless owe residual U.S. tax on GILTI inclusions due to the effect of expense allocation on their FTC capacity in the GILTI category. Treasury and the IRS apparently determined, either that they lacked the statutory authority to provide such rules and/or that such rules were inconsistent with the policies that led to very restrictive treatment (for example, the lack of carry-forwards) of taxes attributable to GILTI.

The modified look-through rules would apply to payments of dividends, interest, rents and royalties from a CFC to its U.S. shareholder, as well as subpart F and GILTI inclusions. Consistent with the statute, the proposed rules would provide that dividends, interest, rents and royalties received by a U.S. Shareholder from a CFC would be excluded from the passive category unless the look-through rules provide otherwise. Again, such income that would be excluded from passive category income is assigned to another separate category under the rules of section 1.904-4. In most cases, such income would be assigned to the general category or the foreign branch income category. However, unlike under prior law, such amounts would not automatically be assigned to the general category.

Interest. Under existing rules that would remain unchanged, related person interest is first allocated by a CFC to passive foreign personal holding company income and characterized by the recipient accordingly. Remaining related person interest is proportionally allocated by the payor to separate categories other than passive. This treatment would not be altered under the proposed rules. Interest received by a U.S. shareholder from a CFC that is not characterized as passive category income under the look-through rules would be characterized under section 1.904-4.

Rents and royalties. Rents and royalties received by a U.S. shareholder from a CFC would be passive category income to the extent allocated to passive income of the CFC under the expense allocation and apportionment rules. Remaining rents and royalties would be characterized under section 1.904-4.

Dividends. Dividends from a CFC to a U.S. shareholder would generally be treated as passive category in proportion to the passive category E&P of the CFC to the total E&P of the CFC. The proposed rules would provide that a dividend from a CFC would not be attributable to passive category income to the extent the underlying income was subject to a rate of foreign tax in excess of 90% of the maximum U.S. rate under section 11.

KPMG observation: Due to the enactment of section 245A and its accompanying disallowance of foreign taxes, look-through for dividends will be of very limited significance.

Subpart F income. Subpart F inclusions would be treated as passive category income to the extent attributable to passive income received or accrued by the CFC. Remaining amounts would be treated as general category income or as otherwise prescribed under section 1.904-4.

GILTI inclusions. GILTI inclusions would similarly be treated as passive category income to the extent attributable to passive income received or accrued by the CFC. Remaining amounts are treated as GILTI category income or as otherwise prescribed under section 1.904-4.

Application to payments from partnerships. Payments of interest, rents, or royalties from a partnership to a 10% or greater partner acting in a non-partner capacity would generally be characterized under section 1.904-4 except to the extent they are attributable to passive category income of the partnership. Such attribution would be done under the principles of the section 861 regulations' expense allocation and apportionment rules by treating the partnership as a foreign corporation. This rule also applies to partnership payments made to a member of such a 10% partner's controlled group.

Extension of look-through rules. Consistent with the existing rules, the proposed rules would apply the look-through rules where an entity to which the look-through rules apply makes a payment to certain related entities to which the look through rules also apply.

Foreign tax credit limitation—Transition rules

As described above, the new law added two new additional section 904 income categories, or “baskets,” for foreign branch income and GILTI income. The new law did not, however, provide explicit transition rules to address carryovers of FTC attributes from pre- to post-reform years, and vice versa. Such attributes include foreign tax credit carryovers under section 904(c), as well as overall foreign loss (OFL), overall domestic loss (ODL), and separate limitation loss (SLL) accounts that were created and “basketed” based upon the pre-reform categories.

The proposed regulations provide a relatively narrow set of transition rules addressing this issue. Specifically, taxpayers may elect, but are not required, to treat a portion of their pre-2018 general category FTC carryforwards as foreign branch category taxes to the extent the taxes would have been so allocated if they had arisen in a post-reform year. The proposed regulations contemplate that taxpayers who make this election must “roll back” to pre-reform years the complex computation and reallocation methods for determining the amount of foreign branch income and taxes in order to characterize the taxes, but the preamble requests comments on whether a simplified alternative method would be appropriate. If such election is made, other pre-2018 general category tax attributes such as OFLs and ODLs would be re-basketed to the foreign branch category in the same proportion as carryover FTCs are. Thus, if the taxpayer does not make the election discussed above, or has no FTC carryover attribute, there is no reallocation of the loss account attributes, regardless of the extent to which the taxpayer's prior general category losses were attributable to foreign branch activities. In addition, taxpayers that generate excess foreign branch credits in their first post-reform year are entitled to carry those taxes back to their last pre-reform year, and upon doing so the taxes are re-basketed as general category.

KPMG observation: The decision to permit through election, but not require, re-basketing between general and foreign branch attributes will be welcome news to many taxpayers, as is the confirmation that 2018 excess foreign branch category taxes will be

useable in the general category when carried back to 2017. Earlier in the year there had been some speculation that the government was considering whether to require re-basketing of a portion of general category attributes into the GILTI category, but happily for taxpayers the proposed regulations do not take such a draconian approach.

Expense allocation

The general framework of the current expense allocation and apportionment rules under section 861 was retained but was revised to take into account the new GILTI category and the addition of section 904(b)(4) (which disregards certain income and expenses in calculating the various FTC limitations). In a favorable change for domestic corporations, and based in part on language in the legislative history, the proposed rules would treat the portion of a GILTI inclusion that is offset by a section 250 deduction (as adjusted for the section 250 taxable income limitation) and a portion of the CFC stock giving rise to such portion of the GILTI inclusion as, respectively, exempt income and an exempt asset. As a result, section 864(e)(3) and the proposed rules would ignore such income and such asset for purposes of allocating and apportioning deductions. This will reduce the amount of expenses that are allocated and apportioned to the GILTI category, thereby generally making GILTI FTCs easier to claim.

Exempt income and assets also would include a portion of a domestic corporation's gross FDII and assets that produce gross income included in FDII, respectively. The portion of the asset that produces FDII that is treated as exempt is equal to the product of the value of the assets that produce gross income included in FDII and a fraction equal to the FDII deduction over FDII income.

KPMG observation: This formula appears to generally treat 37.5% of the "FDII producing assets" as exempt assets. The proposed regulations do not, however, provide a methodology for identifying the assets (or the portion of the assets) that produce FDII. It would be reasonable to expect the allocation rule to focus more narrowly on assets that produce "foreign derived deduction eligible income" as that is the income that is intended to be benefited by the section 250 deduction. Nevertheless, the proposed rules are unclear. Treating FDII assets as exempt assets would generally be expected to counteract some of the benefit of the GILTI rules, and could on a given taxpayer's facts, actually result in more of a taxpayer's interest expense being allocated against GILTI than would occur without these rules.

Subject to the foregoing change, interest expense generally continues to be allocated and apportioned under the asset method as required by section 864(e). As provided in the new law, taxpayers may no longer use the fair market value method for valuing assets and must instead use the tax book value method or the alternative tax book value method for their first tax year beginning after December 31, 2017. Approval of the Commissioner would not be required for taxpayers currently on the fair market value method to change to one of the two allowable methods for that first tax year. Because the value of assets used for purposes of the assets method is an average of the beginning year and ending year value and the fair market value method would no longer be allowed, an elective

transition rule would allow taxpayers to use as the beginning of year value the recomputed value as of the end of the taxpayer's first quarter in the first year the new method was used. Helpfully (and in contrast to the wording of current rules) the tax book value of an asset is specifically described as the adjusted basis of the asset.

It also is currently unclear how the allocation and apportionment of expenses would work for purposes of calculating the section 250 deduction related to FDII. The proposed regulations specifically provide, however, that the tax exempt rule does not apply for that purpose.

Treatment of CFC stock

The rules for characterizing CFC stock (located in proposed section 1.861-13) continue to look through to the assets or gross income of CFCs; however, the current rules would be significantly revised, mainly to ensure that a portion of the stock of a CFC will be characterized as a GILTI category asset if the taxpayer has a GILTI inclusion from such CFC (something the current rules would fail to do because CFCs do not themselves earn GILTI income).

Such rules would also characterize a portion of the stock of a CFC (or 10% owned foreign corporation) as stock that could give rise to a section 245A dividend for purposes of applying section 904(b)(4), which excludes expenses allocated and apportioned to such portion from the FTC limitation for each basket. As a result, interest expense apportioned to this grouping would not reduce general, passive, or (importantly) GILTI basket income; a taxpayer favorable result because the amount of foreign source taxable income in each of these baskets would be higher. However, section 904(b)(4) also requires that such expenses be added back to worldwide taxable income. Because worldwide taxable income is the denominator of the FTC limitation fraction, this adjustment would unfavorably take back some of the benefit of disregarding expenses allocated to section 245A dividends in the numerator of the FTC limitation fraction.

Special rules for section 965

Absent a special rule, the application of section 965 and the proposed rules thereunder would cause an uneconomic increase in the tax book value of the stock of specified foreign corporations where a deficit of one specified foreign corporation was used to offset the untaxed earnings of another specified foreign corporation. This is because section 965(b)(4)(B) creates a net increase in the aggregate E&P of the two corporations without any change in net asset basis or net stock basis. For example, if a taxpayer did not make the basis adjustment election, the basis in the stock of a taxpayer's E&P deficit foreign corporation would not be reduced and, in any case, such corporation's E&P would be increased to the extent that the corporation's specified deficit was utilized to offset deferred foreign income. As a result, the tax book value of the corporation's stock (which is generally reduced by deficits) would be higher even though, economically, the entity's value has not changed. If a basis election was made, the tax book value of the stock of an E&P deficit foreign corporation may not be distorted because such election would

cause a reduction in the basis of the corporation's stock equal to the increase in its E&P; however, the corresponding basis increase in the stock of a deferred foreign income corporation could cause that corporation's tax book value to be distorted.

To correct for these uneconomic effects and solely for purposes of valuing the stock of a CFC or 10% owned foreign corporation, the proposed rules would treat the taxpayer as having elected to apply the basis adjustment rule if it had not done so. Any increase in the basis of the stock that results from the elected application or deemed application of the basis adjustment rule is treated as a section 961 increase that is excluded from the tax book value of the stock.

The proposed rules contain several proposed rules regarding the effect of taxpayers making the section 965(n) election to waive the use of carryover, carryback, or current-year net operating losses (NOLs) against their net 965 income inclusion. Specifically, the proposed rules would prevent an electing taxpayer's net section 965 inclusion from being "walled off" or un-reduced by allocated and apportioned expenses for section 904 limitation purposes. The proposed rules would instead require that taxpayers treat the NOL that is not absorbed because of the section 965(n) election as being comprised of a proportionate amount of deductions in each of the respective limitation categories (including deductions allocated to U.S. source income). As a result, any electing taxpayer with expenses allocated or apportioned to foreign source income would have to treat those expenses as partially absorbed against the net section 965 inclusion for FTC limitation purposes, thus yielding a less than 100% section 904 capacity.

KPMG observation: Numerous taxpayers have already filed their 2017 calendar year returns reflecting a section 965(n) election, and may have determined their section 904 limitation in a manner different than the "clarification" set forth in the proposed regulation. Such taxpayers would now have to perform a more detailed analysis to implement the new guidance and consider the effects on their 2018 return reporting, section 965(h) installment payments, and the potential need to file an amended 2017 return.

Other expense allocation issues

The proposed rules would amend a number of provisions that the government appears to believe led to inappropriate results. Included in these provisions are rules providing for an exclusion of hybrid stock from the definition of related group indebtedness in the current CFC netting rules. The proposed regulations also would amend the treatment of interest (and interest equivalents including guaranteed payments) between partnerships and their partners or other related parties. Under current regulations, those payments fall within the look-through rules, but the deductions are allocated and apportioned at the partner level under section 1.861-9(e)(2). As a result, purely internal transactions can result in reallocations of net income from one foreign tax credit category to another. Under the proposed regulations, these amounts will be directly netted against each other to avoid any overall impact on foreign tax credit capacity.

The proposed rules would not address (but request comments with respect to) the allocation and apportionment of many other expenses, including R&D, stewardship, and G&A expenses.

Section 78

Prior to amendment by the new law, section 78 provided that if a domestic corporation elects to take a foreign tax credit then the amount of taxes deemed paid by the domestic corporation shall be treated as a dividend received by the taxpayer (a “section 78 gross-up”) for all purposes of the Code, except with respect to section 245. The new law amended section 78 to exclude the section 78 gross-up from dividend treatment for purposes of section 245A, effective for tax years of foreign corporations beginning after December 31, 2017 and for tax years of U.S. shareholders in which or with which such tax years end. Section 245A applies to distributions of foreign source E&P from a 10% owned foreign corporation to its corporate U.S. shareholder made after December 31, 2017 and, as a result under the Code, a section 78 gross-up from a 10% owned foreign corporation with a fiscal year ending in 2018 may qualify for a section 245A DRD. The proposed rules provide that a section 78 gross-up is not treated as a dividend for purposes of section 245A and would make such exclusion effective for section 78 gross-ups with respect to dividends received after December 31, 2017.

KPMG observation: While the mismatch between the effective date of new section 78 and section 245A appears to be an unintended drafting error, it is unclear whether a regulation alone can change the apparent result under the statute or if a congressional technical correction is needed instead.

Appendix A

Reg. Section	Effective date is . . .
1.78-1	Tax years of foreign corporations that begin after December 31, 2017, and to tax years of United States shareholders in which or with which such tax years of foreign corporations end. Except that the second sentence of paragraph (a) of this section also applies to section 78 dividends that are received after December 31, 2017, by reason of taxes deemed paid under section 960(a) with respect to a tax year of a foreign corporation beginning before January 1, 2018.
1.861-8, -9, -11, -13, -17; 1.904-1, -3, -4, -5, -6	Tax years that both begin after December 31, 2017, and end on or after the date the proposed regulations are filed in the Federal Register.
1.861-10 & 1.901(j)-1	Tax years that end on or after the proposed regulations are filed in the Federal Register.
1.861-12	Tax years that both begin after December 31, 2017, and end on or after the proposed regulations are filed in the Federal Register. Except that Reg. section 1.861-12(c)(2)(i)(B)(1)(ii) also applies to the last tax year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, the tax year in which or with which such tax year of the foreign corporation ends.
1.904-2	Paragraphs (a) through (i)— Tax years that both begin after December 31, 2017, and end on or after the proposed regulations are filed in the Federal Register. Paragraph (j)— Tax years beginning after December 31, 2017. Except that paragraph (j)(2) of this section also applies to the last tax year beginning before January 1, 2018.
1.904(b)-3	Tax years beginning after December 31, 2017. Except that for a tax year that both begins before January 1, 2018, and ends after December 31, 2017, this section applies without regard to the rules relating to inclusions arising under section 951A.
1.904(f)-12(j)	Tax years beginning after December 31, 2017.
1.954-1	Paragraphs (d)(3)(i) and (ii) of this section apply to tax years of a controlled foreign corporation ending on or after the proposed regulations are filed in the Federal Register. Paragraph (g) of this section applies to tax years of a controlled foreign corporation beginning on or after July 23, 2002.
1.960-1–1.960-6	Tax years of a foreign corporation beginning after December 31, 2017, and a tax year of a domestic corporation that is a United States shareholder of the foreign corporation in which or with which such tax year of such foreign corporation ends.
1.965-5	Tax years of controlled foreign corporations beginning after December 31, 2017, and to tax years of United States persons in which or with which such tax years of foreign corporations end.

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