KPMG report: Initial impressions about final and proposed foreign tax credit regulations

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Introduction

The U.S. Treasury Department and IRS on December 2, 2019, released final regulations related to the determination of the foreign tax credit ("FTC") that finalize the proposed regulations published on December 7, 2018 ("2018 proposed regulations").

The final regulations (T.D. 9882) were released by Treasury and the IRS prior to being released by the Federal Register. Read the **final regulations** [PDF 1.52 MB] (386 pages).

The final regulations provide guidance related to determining the FTC, including guidance related to changes made by the 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017, and often referred to as the "Tax Cuts and Jobs Act" or "TCJA"). The final regulations also finalize the proposed regulations related to overall foreign losses that were published on June 25, 2012, and finalize portions of the proposed regulations related to a U.S. taxpayer's obligation to notify the IRS of a foreign tax redetermination published on November 7, 2007, which were issued in conjunction with temporary regulations.

In addition to the final regulations, Treasury and the IRS also issued proposed regulations (REG-105495-19) that provide additional guidance relevant to FTCs, including with respect to the allocation and apportionment of research and experimentation (R&E) and stewardship expenses, foreign tax redeterminations under section 905(c), and base and timing differences. Read the **proposed regulations** [PDF 939 KB] (220 pages).

Final regulations

A number of features of the final regulations are noteworthy:

- **Expenses continue to be allocated to section 951A category.** Despite comments requesting that U.S. shareholder-level expenses not be allocated to section 951A category income in order to effectuate a "minimum tax," the final regulations do not change the approach of the 2018 proposed regulations and thus continue to require that expenses be allocated to the section 951A category, subject to the partial exempt asset treatment for GILTI stock, which the final regulations retain.

- **Income for which a section 250 deduction is allowed is exempt income.** The final regulations generally adopt the proposed treatment of income that is offset by a section 250 deduction (attributable to GILTI or FDII) as exempt income based on the amount of the deduction allowed, and the treatment of an equivalent portion of the domestic corporation's assets that give rise to FDII or the stock of the CFC that gives rise to the GILTI inclusion as an exempt asset. However, the final regulations modify the proposed rule that treats a portion of assets that give rise to FDII as exempt by instead referring to assets that produce gross FDDEI. The final regulations, like the proposed rules, do not limit exempt assets for purposes of FDII to intangible property; any asset—tangible or intangible—can produce gross FDDEI. The final regulations also retain the rule that no portion of the stock of a CFC is exempt by reason of PTEP.

- **Section 250 deduction is allocated to gross income included in FDDEI.** The final regulations retain the proposed rule that the portion of the section 250 deduction attributable to FDII is allocated to the specific class of gross income included in FDDEI, and the deduction is apportioned between the statutory and residual groupings based on the FDDEI in each grouping. Because FDDEI can consist of both U.S. source and foreign source income, the section 250 deduction for FDII may have the result of reducing a taxpayer's ability to claim foreign tax credits.

- **Allocation and apportionment of interest expense related to specified partnership loans.** The final regulations clarify that the requirement to match the source and separate category of the interest income and expenses applies solely to match existing income and expenses related to the loan and does not create additional gross income. The 2018 proposed regulations included an anti-abuse rule which provides that certain loans to a partnership held by a CFC that was made or transferred with a principal purposes of avoidance will be treated as if held directly by the U.S. shareholder. The final regulations clarify that this rule applies when the loan receivable is held by the CFC and merely disregarding the loan receivable would not affect the interest expense allocated by the U.S. shareholder. Appropriate adjustments should be made to the value and characterization of the U.S. shareholder's stock in the CFC to reflect the amount of the loan that is disregarded.

- **Additional time to change method for allocating and apportioning R&E expenses.** The final regulations provide that taxpayers may change to the sales method up to their last tax year that begins before January 1, 2020. This election is of additional significance due to the proposed changes to the R&E apportionment rules (discussed below).

- **Gross tested income tiers up for purposes of modified gross income method.** The final regulations eliminate the proposed rule that would have excluded gross tested income from tiering up to high-tier corporations for purposes of allocating and apportioning interest expense of a CFC. This addresses the concern that, under the modified gross income method, the interest expense of a CFC without gross tested income (for example, a holding company) would not be allocated and apportioned to gross tested income, and thus would not create a tested loss.

- **Characterization of stock of certain foreign corporations.** The final regulations adopt the proposed rules that characterize stock of a CFC but clarify that for purposes of characterizing stock of a CFC in the various statutory groupings, the U.S. shareholder of the CFC must use the same method (i.e., asset method or modified gross income method) that the CFC uses to apportion its interest expense.

- **Stock basis associated with hybrid instruments are assigned to the section 245A subgroup.** The final regulations retain the proposed rules which determine the amount of stock in a section 245A subgroup without regard to whether a section 245A deduction is or would be allowed with respect to dividends paid with respect to the stock (for example, because of the hybrid dividend rules or the holding period requirements).

- **Additional flexibility and simplification of carryover "reconstruction."** The final regulations generally adopt the "reconstruction option" of the proposed regulations that would allow carryovers from pre-2018 tax years to interact with the branch basket, but provide some new rules intended to simplify their operations.

- **Minor modifications to branch basket rules.** The final regulations generally retain the proposed rules governing foreign branches and determinations of income in the foreign branch category, including the limitation that such rules apply only for purposes of determining the category of income and not the source or character of such income. However, the final regulations modify these rules in some respects.

- **Disregarded payments other than interest are generally taken into account for foreign branch category income.** The final regulations generally retain the disregarded payment rule which adjusts gross income attributable to a foreign branch that is not passive category income to reflect disregarded payments between a foreign branch and its foreign branch owner and between foreign branches. However, the final regulations clarify the ordering rule when a transaction involves multiple back-to-back disregarded payments between foreign branch and foreign branch owner. The final regulations also clarify that, in the case when there is no disregarded payment between the foreign branch and foreign branch owner, disregarded payments between foreign branches have no effect.

- **Section 367(d) applies to impute payments for certain disregarded transfers of intangible property.** The final regulations retain the intangible property rule with some modifications to apply to any disregarded transfer between foreign branch owner and foreign branch, as well as transfers between foreign branches. The anti-abuse rule does not apply to disregarded transfers that occurred before December 7, 2018, or to transitory transfers. The final regulations also provide a specific example illustrating how the rules apply to a remittance of intangible property from foreign branch to foreign branch owner.

- **Special rule for certain disregarded payments.** The final regulations clarify that disregarded payments that would be capitalized into amortizable or depreciable basis may produce adjustments in the year or years that the amortization or depreciation deductions would be allowed if those payments had been regarded. The final regulations also provide additional guidance regarding certain disregarded payments that would, if regarded, not be deductible, including guidance regarding disregarded sales of property that reattribute gross income when basis would be recovered other than through depreciation, amortization, or other disregarded cost recovery deductions.

- **Activities that constitute a permanent establishment is a trade or business outside the United States.** Under the 2018 proposed regulations, if activities conducted outside the United States constituted a permanent establishment under an income tax treaty, those activities were presumed to meet to trade or business standard of the foreign branch definition. The final regulations go further and provide that activities conducted outside the United States that constitute a permanent establishment meet the trade or business standard of the foreign branch definition.

- **Attribution of income items to deemed set of books and records.** The final regulations include a standard to construct hypothetical books and records when a foreign branch does not have separate books and records.

- **Gain from the sale of an interest in a foreign branch is not attributable to that branch.** The final regulations retain the proposed rules attributing income to the foreign branch if it is reflected on the books and records of the foreign branch with clarification with respect to the ordinary course of business exception. Therefore, the sale of an interest in the foreign branch by the foreign branch owner is not attributable to the income of the foreign branch as it is income properly reflected on the books and records of the foreign branch owner.

- **Future guidance with respect to foreign branch category.** Treasury intends to issue guidance coordinating the allocation and apportionment of expenses with the determination of foreign branch category income.

- **Items resourced under treaties.** The final regulations confirm that taxes imposed by non-treaty jurisdictions on items resourced under a treaty follow the item of income to the separate treaty basket. The final regulations also extend the grouping rules to income subject to section 865(h).

- **Corporate general partners' distributive share characterized without regard to ownership threshold.** The final regulations do not adopt the rule which would assign a corporate general partner's distributive share to passive category if the partner owns less than 10% of the value in the partnership. As a result, under the final regulations, all general partners apply the general rule which characterizes a distributive share of partnership income as passive category income to the extent it is earned by the partnership in the passive category.

- **Look-through rules under section 904(d)(3) cannot produce section 951A category income.** The preamble reinforces that the rules under section 904(d)(3) cannot produce section 951A category income. The look-through rules under section 904(d)(3) provide that certain dividends, interest, rents, and royalties (i.e., passive income) of the taxpayer received or accrued from a CFC are not treated as passive category income. Under the proposed regulations, such income is assigned to a separate category other than the passive category based on the general rules of Reg. §1.904-4. Comments requested that Reg. §1.904-4 be revised to apply the look-through rule to characterize interest, rents, and royalties paid from a CFC to a U.S. shareholder to section 951A category. The final regulations reject this comment on the grounds that, based on the statute, section 951A category income only includes amounts includible in gross income under section 951A and therefore look-through cannot give rise to section 951A category income.

- **Taxes associated with base differences are assigned to foreign branch category.** Despite comments stating that the cross reference to section 904(d)(1)(B) was inadvertent, the final regulations confirm that taxes attributable to a base difference are assigned to the foreign branch category as specified in the statute. Note, however, that the regulations continue to refer to section 904(d)(2)(H)(i), so that if Congress enacts a technical correction the regulations will automatically reflect the corrected statutory language.

- **Additional guidance on base and timing differences in new proposed regulations.** The final regulations finalize the rules with respect to what constitutes a base or timing difference but new rules relating to the allocation and apportionment of foreign income taxes are contained in the new proposed regulations (see below).

- **Proposed regulations under sections 905(c) and 986(a) finalized.** The following portions of the 2007 section 905(c) proposed regulations are now final—(1) the currency translation rules (which are moved from Reg. §1.905-3T(b) to Reg. §1.986(a)-1)), (2) the definition of foreign tax redetermination in Reg. §1.905-3T(c), (3) the rules under Reg. §1.905-3T(d)(1) requiring a redetermination of U.S. tax liability with respect to foreign income taxes other than those that are deemed paid under section 960, and (4) the rules in Reg. §1.905-3T(e) relating to foreign income taxes imposed on foreign tax refunds. Changes made in the context of finalizing these rules include:

    - **Clarification of what constitutes a foreign tax redetermination.** First, a foreign tax redetermination includes certain situations covered by section 905(c) that do not involve a change in the foreign tax liability, such as the failure to pay accrued taxes within two years and the subsequent payment of any such accrued but unpaid taxes. Second, a foreign tax redetermination includes adjustments such as a correction to an accrual that determined the tax due with reasonable accuracy, but is revised after additional consideration to reflect the correct final tax liability. Third, the regulations clarify that a foreign tax redetermination occurs if any tax that is claimed as a credit or added to PTEP group taxes is subsequently refunded, regardless of whether the tax was properly treated as paid within the meaning of Reg. §1.901-2(e) (which includes, among other requirements, that the tax was owed and not refundable) when claimed as a credit or added to PTEP group taxes. Finally, the final regulations clarify that taxes that first accrue after the date 24 months after the close of the tax year to which such taxes relate may not be claimed as a credit or added to PTEP group taxes until they are paid.

  - **Adjustments for foreign tax redetermination apply to year credit claimed and any carryback or carryforward year.** The final regulations provide that, if a foreign tax redetermination occurs with respect to foreign tax claimed as a direct credit, then a redetermination of U.S. tax liability is required for the tax year in which the credit was claimed and any year to which unused foreign taxes from such year were carried under section 904(c).

  - **The reference to "two years" for purposes of sections 905(c) and 986(a) means "24 months."** Treasury determined that a short tax year should not reduce the period within which a taxpayer can pay an accrued tax without triggering a foreign tax redetermination thereby requiring the tax to be translated into dollars at the exchange rate on the date of payment. Therefore, the final regulations replace "two years" with "24 months." A coordinating change was made to the rules for when accrued taxes must be paid.

  - **Currency translation occurs at partnership not partner level.** The relevant tax year to which taxes relate for purposes of determining the applicable exchange rate is the relevant tax year of the person, including a partnership or trust that has legal liability.

  - **Spot rate applies to foreign taxes denominated in inflationary currency.** The final regulations clarify that the spot rate on the date of payment applies if the currency is inflationary in the accrual year or any subsequent year until the tax is paid.

  - **Section 988 gain or loss when there is a change in functional currency.** When there is a change in functional currency between the time a tax is paid or accrued and when it is refunded, the final regulations provide that the QBU uses the exchange rate used when the QBU's functional currency changed to determine its basis in the nonfunctional currency and recognized section 988 gain or loss that would have been recognized if the refund had been received immediately before the change in functional currency.

- **Section 951A category is not excluded for purposes of OFL recapture.** The rules governing SLL and OFLs remain unchanged as they reflect the intended application of section 904(f)(1). TCJA did not modify application of these rules with respect to section 951A category and there is nothing to indicate that Congress intended for these rules to apply differently to section 951A category income. Therefore, SLL, OFL, and ODL may reduce section 951A category income.

- **No change to scope of current year taxes.** Despite numerous comments suggesting changes to the proposed rule, the final regulations maintain the definition of current year taxes as foreign income taxes that a CFC pays or accrues in its tax year (i.e., the U.S. tax year of a CFC that either is an inclusion year or during which the CFC receives or makes a distribution described in sections 959(a) or (b)).

  - **Current year taxes are not attributable to PTEP.** Associating current year taxes with PTEP rather than current year items of income would be inconsistent with Congress's intent to eliminate pooling and calculate deemed paid FTCs on a current year basis. The final regulations adopt the proposed rule which deems a corporate U.S. shareholder of a CFC to pay foreign income taxes of the CFC only if there is an inclusion under section 951(a)(1)(A) or 951A that is attributable to net income in the income group.

- **Retains reduction of foreign income tax deemed paid to the extent subpart F inclusion is reduced by qualified deficit.** Despite comments requesting adjustments to the computation of deemed paid taxes if a domestic corporation's subpart F inclusion is reduced by a qualified deficit, the final regulations retain the rule that reduces the amount of foreign income taxes deemed paid to the extent the U.S. shareholder reduces its subpart F inclusion by reason of a qualified deficit. Otherwise, taxpayers could be allowed a deemed paid credit in excess of the amount of foreign income taxes the CFC paid with respect to the income that was included.

- **Current year taxes assigned as if current section 904 categories existed when the income was included.** The final regulations revise the proposed regulations to eliminate any inference that the timing difference rule assigns tax on the basis of the separate categories that existed in the inclusion year. Therefore, a tax imposed in a post-TCJA year with respect to pre-TCJA income is assigned to a tested income group if the pre-TCJA income, if recognized in the year the tax was imposed, would be tested income. Additional changes clarify that in order to allocate and apportion a current year tax to the section 904 categories and income groups within those categories, all of the foreign taxable income for the period with respect to which the tax is imposed under foreign law is characterized under federal income tax law and assigned to the categories or groups as though that foreign taxable income were recognized under federal income tax law in the year in which the tax is paid or accrued.

- **The FTC regulations apply to other provisions.** The final regulations clarify that these regulations apply to any provision where a taxpayer is treated as a domestic corporation that is deemed to pay foreign taxes or treats a foreign corporation as a CFC.

- **Separate subpart F income groups retained.** The grouping rules under the proposed regulations are necessary to properly coordinate deemed paid foreign taxes with the subpart F high tax exception and the section 904 high tax kickout. These rules ensure the same amount of foreign tax is treated as attributable to a particular item of a CFC's foreign base company income for all three Code sections.

- **No deemed paid credit for income inclusion under section 956.** The final regulations maintain the proposed rule which provides that no foreign income taxes are deemed paid under section 960(a) with respect to a section 956 inclusion. An inclusion under section 956 is not an item of income of the CFC therefore the taxes of the CFC would not be attributable to such income as it is the income of the U.S. shareholder. Further, allowing a deemed paid credit would be contrary to legislative intent to eliminate tax pooling and move to a FTC system based solely on current year taxes and income.

- **Final regulations provide for 10 PTEP groups.** The final regulations consolidate the PTEP groups from the proposed regulations and Notice 2019-01. The final regulations modify the transition rule for foreign income taxes deemed paid with respect to PTEP groups by eliminating a condition that could be read to provide that taxes imposed after 2017 on a distribution from a PTEP group from an inclusion year before 2018 are not treated as PTEP group taxes.

- **Section 960(c) applies to inclusions under section 951A.** The increase in section 904 limitation under section 960(c)(1) is reduced by the amount which would have been section 904 limitation in the inclusion year if the amounts had not been included in gross income under section 951(a) or

951A(a). This provision applies to GILTI inclusions as statutory language contemplates that all or part of a GILTI inclusion could be passive category income.

- **Coordination rule for section 965(g) and section 960(b).** The final regulations finalize the rule to disallow credits for the applicable percentage of foreign income taxes deemed paid under section 960(b) with respect to distributions to the domestic corporation of section 965(a) previously taxed earnings and profits or section 965(b) previously taxed earnings and profits, and provide a coordination rule with proposed Reg. §1.960-3, which provides rules for section 960(b).

- **Treatment of section 78 dividend as foreign oil related income.** The regulations under section 907 have not been revised since 1991 and Treasury expects to revise regulations in future guidance.

- **Taxpayers must obtain certified translations or foreign receipt or return in a foreign language.** This requirement was inadvertently deleted by the Federal Register on January 27, 1998.

- **Applicability dates.** Portions that relate to statutory amendments made by the TCJA apply to tax years beginning after December 31, 2017. The provisions that do not relate to a statutory amendment made by the TCJA apply to tax years ending on or after December 4, 2018. Provisions that contain rules that relate to TCJA and rules not related to TCJA apply to tax years that begin after December 31, 2017, and end on or after December 4, 2018. Final OFL and foreign tax redetermination regulations apply to tax years ending on or after the date final regulations are published on the Federal Register.

Additional FTC proposed regulations

Initial impressions of the proposed regulations are as follows:

- **Allocation and apportionment of R&E.** The proposed regulations make substantial changes to the allocation and apportionment of R&E that impact the allocation and apportionment of R&E to the section 951A category enacted by the TCJA.

    - The proposed regulations provide that R&E expenses (including both deductions under section 174 and amortization of amounts capitalized under section 59(e)) are allocated to all "gross intangible income" related to the relevant SIC code category. For this purpose, "gross intangible income" generally includes all income attributable to intangible property (e.g., direct sales and royalties), but does not include dividends or subpart F/GILTI inclusions. "Intangible property" is defined by reference to section 367(d)(4).

    - The gross income method for allocating and apportioning R&E is eliminated by the proposed regulations.

    - In an effort to simplify the R&E regulations, the proposed regulations provide that the exclusive apportionment rule (that applies when a taxpayer performs more than 50% of its R&E in a particular geographic location) is only applicable when section 904 is the operative section and eliminates the increased exclusive apportionment rule and the legally mandated R&E rule.

    - Finally, the proposed regulations provide that the tax exempt asset rule under section 864(e)(3) does not apply for purposes of Reg. §1.861-17.

- **Allocation and apportionment of stewardship expense.** Existing regulations for the allocation of stewardship expense provide that such expense is allocated to "dividends received, or to be received from" the corporation's subsidiaries. The proposed regulations provide that stewardship expense is allocated to a class of gross income that includes not only dividends, but also inclusions from the related subsidiary including current income inclusions of a shareholder under section 951, section 951A, the related section 78 gross-up for foreign tax credits in respect of such inclusions, as well as similar current inclusions of a shareholder resulting from an interest in any PFIC it holds. Additionally, the proposed regulations provide an explicit rule for the apportionment of stewardship expenses between the statutory and residual groupings based on the relative values of the stock in each grouping held by the taxpayer, following the stock classification rules provided in the interest allocation and apportionment rules.

- **Allocation and apportionment of interest expense.** Existing regulations provide that in the case of any asset in connection with which interest expense on a loan is capitalized, deferred, or disallowed, the value of such asset is reduced by the principal amount of the indebtedness on which such interest is capitalized, deferred, or disallowed. The proposed regulations provide that an asset is connected with such an indebtedness only if using the debt proceeds to acquire or produce the asset causes the interest to be so capitalized, deferred, or disallowed. As a result of this modification, the proposed regulations would not reduce the value of CFC stock acquired by a corporation in exchange for a debt instrument the interest for which is disallowed under section 163(l) (because payable at the option of the debtor in the stock of the debtor or a related party) because it is not the acquisition of the CFC stock, but rather the terms of the instrument, that caused the disallowance. Additionally, comments are requested with respect to numerous aspects of the interest allocation and apportionment rules, including their interaction with the worldwide affiliated group methodology provided under section 864(f) which is currently scheduled to take effect after December 31, 2020.

- **Allocation and apportionment of expenses in respect of insurance companies.** The proposed regulations provide guidance as to how certain expenses of insurance companies are to be apportioned. Numerous deductions of insurance companies (such as reserve adjustments, death benefits and deduction for policyholder dividends) are treated as items which cannot definitely be allocated to an item or class of gross income and thus are apportioned ratably between U.S. source and foreign source income. For purposes of this apportionment, the determination of the taxpayer's relative gross income from each source depends on whether such gross income is computed on a separate entity basis, affiliated group basis, or an insurance company subgroup. The proposed regulations adopt a separate entity approach, but comments are requested as to whether a life insurance company sub-group would be more appropriate. Further, guidance is provided with respect to the application of the exempt asset and income rule of Reg. §1.861-8 to certain dividend and interest income earned by insurance companies.

- **Allocation and apportionment of damages and settlement payments.** Guidance is provided on the allocation and apportionment of damage awards, settlements, and pre-judgment interest. When the deductions relate to product liability or similar claims, they are allocated to the class of gross income resulting from the **sales** of the products or services giving rise to the damage or injury. In contrast, if the claims arise from an event incident to the production of products or provision of services rather than from injury caused by the product or service, the payments are allocated to the class of gross income ordinarily produced by the **assets** used to produce the products or services involved in the event. In either case, if necessary, the deductions are apportioned between statutory and residual groupings based on the value of the assets in each grouping. For claims made by investors that arise from corporate negligence, fraud, or other malfeasance, damage awards, settlements, and pre-judgment interest are allocated and apportioned based on the value of all the corporation's assets. In general, deductions are allocated and apportioned to the same statutory and residual groupings to which the related income would be assigned if recognized in the tax year in which the deduction is allowed. Thus, for example, a settlement payment related to sales of a product occurring pre-TCJA would be allocated to the branch basket if such sales would generate branch category income if made in the year the settlement is incurred.

- **Upstream partnership loans.** A rule is proposed which matches the interest income with the allocation and apportionment of the related interest expense that is accrued by a taxpayer with respect to a loan made to it by a partnership in which it is a partner (a so-called, "Upstream Partnership Loan"). The Upstream Partnership Loan rule is the converse of the rule provided in the 2018 proposed regulations (and finalized in the final regulations) with respect to loans made by a taxpayer to a partnership in which it is a partner. The proposed regulations provide an identical result in respect of guaranteed payments, thereby preventing a taxpayer from increasing its foreign tax credit limitation by converting its existing partnership loan to an equity interest with a guaranteed payment.

- **Financial service entities.** Under existing law, financial services income (as defined under section 904(d)(2)(C)) does not constitute passive category income for purposes of the foreign tax credit limitation and is not included in DEI for purposes of determining the deduction under section 250 attributable to FDII. Under section 904(d)(2)(C), financial services income includes passive income and "income derived in the active conduct of a banking, financing, or similar business" ("active financing income"), but only if the entity earning such income is "predominantly engaged in the active conduct of a banking, insurance, financing, or similar business" or a member of an affiliated group that is predominately engaged (in either case, a "financial services entity"). Existing regulations (Reg. §1.904-4(e)) provide rules for the determination of whether an entity is a financial services entity, and provide a specific list of income that is treated as active financing income. The proposed regulations provide that whether an entity is predominantly engaged in an active financing business, and whether income is financial services income, are determined under the same standard as the active financing exception of section 954(h)(2)(B).

- **Allocation and apportionment of foreign income taxes.** The proposed regulations provide significant additional guidance on the allocation and apportionment of foreign income taxes and harmonize the rules provided under Reg. §1.904-6 with respect to the basketing of foreign income taxes with the allocation and apportionment of such foreign tax expense. Very generally, the rules look to foreign law to determine the base upon which foreign tax is imposed but categorize such amounts under federal income tax principles. Specific rules are provided when the recognition event occurs in different years for foreign and federal tax purposes. Further, Prop. Reg. §1.861-20 provides that where an item of foreign income results in gross income that is recognized but excluded from income for federal income tax purposes such tax is apportioned to the category that the related income would belong to if it was not so excluded. Further, the proposed regulation provides an exclusive list of items that constitute "base differences" (the related taxes with respect to which are apportioned to the residual basket). As well, this proposed regulation includes rules for the treatment of foreign income and taxes that arise from mismatches between entity classification for foreign and federal income tax purposes, such as payments between a branch and its owner and foreign taxes imposed on the owner of a reverse hybrid.

- **Foreign tax redeterminations.** The proposed regulations provide essential guidance relating to foreign tax redeterminations and section 905(c) necessitated by the repeal of section 902 foreign tax credit pooling by the TCJA. Accordingly, under these proposed changes, all changes in foreign taxes of a foreign corporation require a U.S. tax redetermination. Also, the regulation provides that an adjustment to the foreign tax liability of a foreign corporation requires a recalculation of its income and the related inclusions of a shareholder and the consequences thereof, such as qualification for the high-tax exception provided by section 954(b)(4). Finally, the proposed regulations provide extensive guidance on the procedures taxpayers must follow to comply with the notification requirements provided by section 905(c) and the related penalty provisions. Specific rules are provided for various types of entities, such as pass-through entities and entities subject to the jurisdiction of the IRS Large Business & International (LB&I) division.

- **Haircut on credits related to section 965(a) and 965(b) PTEP.** The proposed regulations include specific guidance aimed at clarifying the application of section 965(g). These rules provide that foreign income taxes related to section 965(a) and 965(b) PTEP are subject to the credit disallowance rule of section 965(g) even though the taxes may be imposed at a time that does not correspond to the actual distribution of such PTEP, such as in the instance of consent dividends. Mechanics under Prop. Reg. §§1.861-20 and 1.904-6 are utilized to implement this rule.

- **Consolidated group foreign tax credit limitation.** The proposed regulations also include guidance relating to the calculation of the consolidated group foreign tax credit limitation (generally provided for in Reg. §1.1502-4). Among other items, the rules clarify that the foreign source income in the various categories is determined on a group-wide, rather than a separate member, basis.

- **Applicability dates.** Various applicability dates apply to the proposed regulations.

  - **In general.** Rules contained in Prop. Reg. §§1.861-8, 1.861-9, 1.861-12, 1.861-14, 1.904-4(c)(7) and (8), 1.904(b)-3, 1.954-1 and 1.954-2 apply to tax years that end on or after the date the proposed regulations are filed with the Federal Register.

  - **R&E and association of foreign taxes.** In general, the rules relating to the allocation and apportionment of R&E expense and the association of foreign taxes to income that are contained in Reg. §§1.704-1(b)(4)(viii)(d)(1), 1.861-17, 1.861-20, 1.904-6, and 1.960-1, apply to tax years beginning after December 31, 2019. However, taxpayers that are on the sales method for R&E apportionment for tax years beginning after December 31, 2017, and before January 1, 2020, may rely on Prop. Reg. §1.861-17 for those years, as long as they apply it consistently.

  - **Financial services income.** Rules proposed to change the determination of financial services income under Reg. §1.904-4(e) apply to tax years ending on or after the date the final regulations are filed with the Federal Register.

  - **Credits related to Section 965 PTEP**. Prop. Reg. §1.965-5(b)(2), which clarifies the application of section 965(g) with respect to credits related to section 965(a) and 965(b) PTEP, applies to tax years of foreign corporations that end on or after the date the proposed regulations are filed with the Federal Register, and to tax years of a U.S. person in which or with which such tax year ends.

  - **Foreign tax redeterminations under section 905.** Regulations proposed under section 905 apply to foreign tax redeterminations occurring in tax years that end with or within a tax year of a U.S. shareholder ending on or after the date the regulations are filed in the Federal Register. However, in the case of foreign tax redeterminations of foreign corporations, Prop. Reg. §1.905-3 is only applicable to foreign tax determinations that relate to tax years of foreign corporations beginning after December 31, 2017, and Prop. Reg. §1.905-5 instead applies to foreign tax redeterminations that related to tax years of a foreign corporation beginning before January 1, 2018.

Definition of terms

CFC = controlled foreign corporation

GILTI = global intangible low-taxed income

FDII = foreign derived intangible income

R&E = research and experimentation

PTEP = previously taxed earnings and profits

E&P = earnings and profits

FTC = foreign tax credit

FDDEI = foreign derived deduction eligible income

DEI = deduction eligible income

OFL = overall foreign loss

SLL = separate limitation loss

ODL = overall domestic loss

SIC = standard industrial classification

QBU = qualified business unit

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