Foreign Tax Credits – TCJA Provisions and Proposed Regulations

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Introduction and Overview of Statutory Changes

Tax Cuts and Jobs Act of 2017

- On December 22, 2017, President Donald J. Trump signed H.R. 1, Tax Cuts and Jobs Bill Act, and H.R. 1370, into law (the “TCJA”). The TCJA made a number of significant changes to international tax provisions in the IRC, including changes that impact the calculation of the foreign tax credit.

- A U.S. person (including a U.S. corporation) generally is subject to U.S. income tax on all U.S. and foreign source income absent modification by a tax treaty between the U.S. and the source country of a particular item of foreign source income.

- The Internal Revenue Code provides for a foreign tax credit (“FTC”) to mitigate the impact of this double taxation by generally allowing a U.S. taxpayer to tax claim a credit for foreign taxes paid.

Direct v. Indirect (Deemed Paid) FTC

- U.S. taxpayers can claim a direct FTC under IRC Sec. 901 for foreign taxes actually paid by the U.S. taxpayer.

- Prior to the TCJA, a U.S. corporate shareholder owning 10% or more of the voting stock of a foreign corporation was deemed to have paid a portion of the foreign corporation's taxes and could claim an FTC under IRC Sec. 902 for those foreign taxes it was deemed to have paid when it received a dividend from that foreign corporation.

- In light of the enactment of the new IRC Section 245A dividends received deduction (discussed below) IRC Section 902 has been repealed for tax years beginning after December 31, 2017.

Foreign Tax Credit Limitation – Prior to the TCJA

- IRC Section 904 imposes an FTC limitation in order to confine the effects of the FTC to mitigating double taxation on foreign source income. (i.e., to prevent U.S. persons operating in high tax foreign countries from offsetting those higher foreign taxes against U.S. tax on U.S. source income).

Foreign Tax Credit Limitation Fraction

$$\frac{\text{Foreign-Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{US tax bill on WWTI (before FTC)} = \text{Foreign Tax Credit Limitation Amount}$$

- Prior to the TCJA, the FTC limitation was calculated separately for: (i) passive income ("foreign personal holding company" defined in IRC Section 954(c)); and (ii) non-passive income.

Statutory Changes Impacting the FTC

- Added two new IRC Sec. 904(d) FTC limitation categories for: (i) income includible under the new GILTI tax (discussed below) and (ii) foreign branch income (business profits attributable to one or more qualified business units (as defined in IRC Sec. 989(a)).

- Repealed the fair market value method of asset valuation for purposes of allocating and apportioning interest expense under IRC Sec. 864(e)(2).

- Added IRC Sec. 904(b) to address expense allocations to foreign source income eligible for the new dividends received deduction under IRC Sec. 245A (discussed below)

- Repealed IRC Sec. 902 (which allowed a deemed paid FTC for taxable dividends actually received by a domestic corporation from a CFC)

- Amended IRC Sec. 960, which allows a deemed paid FTC for subpart F income and IRC Sec. 956 income inclusions recognized by a domestic corporation, to apply the calculation of the credit on an item specific basis (*i.e.*, without regard to foreign earnings pools) and to provide a credit for amounts previously included in income under the new GILTI rules.

New Dividends Received Deduction under IRC Sec. 245A

- For tax years beginning after 2017, U.S. corporations now receive a 100% deduction for non-subpart F dividends received from Specified 10% Owned Foreign Corporations.

- A “Specified 10% Owned Foreign Corporation” is any foreign corporation in which the U.S. corporation owns at least 10% of the shares other than a passive foreign investment company (“PFIC”) that is not also a CFC under Subpart F.

- A U.S. corporation ***cannot claim an FTC*** for any taxes paid or accrued by a Specified 10% Owned Foreign Corporation with respect to the distributed amount to the extent that this new dividends received deduction applies.

- Accordingly, the deemed paid (or indirect) FTC under IRC Sec. 902 was repealed since corporate shareholders now have relief from double taxation via the IRC Sec. 245A deduction.

The GILTI Tax

- The TCJA enacted a new global intangible low-taxed income (GILTI) tax under IRC Sec. 951A. GILTI is a minimum tax intended to discourage U.S. multi-nationals from moving (or keeping) valuable intangibles offshore.
- GILTI requires a U.S. shareholder of any CFC to include the U.S. shareholder's GILTI for each tax year in gross income in a manner similar to an inclusion of subpart F income under IRC Section 951(a).
- GILTI is 50% (37.5% after 2025) of the excess of the U.S. shareholder's share of all of the CFC's non-subpart F and non-ECI income over a 10% presumed "routine return" on tangible depreciable property. This presumed return is referred to as qualified business asset income ("QBAI").
- The exempt QBAI is reduced by specified interest expense. QBAI is determined on a CFC by CFC basis.
- The effective tax rate on GILTI is initially 10.5% and increases to 13.125% for tax years beginning after 2025.
- An IRC Sec. 960 deemed paid FTC is allowed for foreign taxes paid with respect to the GILTI amount, but it is capped at 80% and the FTC cannot be carried back or forward if the taxpayer is in an excess FTC position.
- The addition of the GILTI tax and these limitations on the FTC for foreign taxes paid with respect to GILTI required the addition of a new FTC limitation "basket" in IRC Section 904(d).

FTCs and Expense Allocation and Apportionment

- Treas. Reg. Section 1.861-8 through -18 provide rules for allocating and apportioning expenses, losses, and other deductions for purposes of computing the net U.S. and foreign source income of a U.S. taxpayer (including rules for how CFCs allocate their expenses). Changes to these Regulations and additional Regulations are necessary to address amendments made by the TCJA regarding how interest expense is allocated under IRC Sec. 864(e)(2) and how expenses are allocated to income eligible for the new IRC Sec. 245A dividends received deduction.

- As amended by the TCJA, IRC Section 864(e)(2) now provides that interest expense must be allocated using the adjusted bases of assets rather than on the fair market value or gross income (previously the fair market value method was permitted).

- The TCJA also added IRC Sec. 904(b)(4), which contains special expense allocation rules for determining the amount of a U.S. shareholder's foreign source income for purposes of the IRC Sec. 904 FTC limitation with respect to stock of a Specified 10% Owned Foreign Corporation with foreign source income eligible for the new IRC Sec. 245A dividends received deduction upon receipt of such earnings by a U.S. corporation as a dividend from the foreign corporation.

New FTC Regulations –
Background & General Overview

New FTC Regulations - REG-105600-18 Background

- On November 28, 2018, the IRS released extensive proposed regulations (REG-105600-18) to primarily implement changes to the foreign tax credit regime in connection with the TCJA, and to address other statutory changes predating the TCJA.
- The proposed regulations were released under Sections 78, 861, 901, 904, 954, 960, and 965.
- 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 (apparently, November 28, 2018), or
    (3) tax years which meet both of those criteria.

New FTC Regulations - REG-105600-18 General Overview

- The proposed regulations address:
  - **Expense allocation and apportionment rules**
  - **Foreign tax credit limitation under Section 904 (new baskets)**
  - Treatment of reductions in tax in applying Section 954(b)(4) (refundable or integration regimes)
  - **Deemed paid taxes under Section 960 and Section 78**
  - Effect of Section 965(n) election (NOL election)

New FTC Regulations –
Expense Allocation and Apportionment

Expense Allocation Rules – Prop. Reg. §1.861 ; Prop. Reg. §1.904(b)-3

Expense Allocation and Apportionment Provisions	Prop. Reg.
Exempt Income and Exempt Assets	Prop. Reg. §1.861-8(d)(2)
Foreign Income Taxes and §250 Deduction	Prop. Reg. §1.861-8(e)
Repeal of Fair Market Value Method and Transition Relief	Prop. Reg. §1.861-8(c)(2), §1.861-9
Basis Adjustments	Prop. Reg. §1.861- 12
Characterization of CFC Stock	Prop. Reg. §1.861- 13
Gross Tested Income of CFCs	Prop. Reg. §1.861-9(j)(2)(ii)(C), §1.861-12(c)(3)(iii)
Stock of a Non-controlled 10% Owned Foreign Corporation	Prop. Reg. §1.861-12(c)(4)
Section 245A Dividends Received Deduction	Prop. Reg. §1.904(b)-3
CFC Netting Rule as Applied to Hybrid Debt	Prop. Reg. 1.861-10(e)(8)(vi)
Research and Experimental Expenditures	Prop. Reg. §1.861-17(e)(3)

Expense allocation rules – Exempt Income, Exempt Assets Prop. Reg. §1.861-8(d)(2)

- The proposed regulations revise the Sec. 861 regulations to take into account the new categories and the addition of Sec. 904(b)(4)
- Expenses, including interest expense, are allocated to the GILTI basket, subject to section 864(e)(3)
- Tax book value is the adjusted basis of the asset (plus E&P bump for foreign corporations)
- New rules for the treatment of CFC stock for expense allocation and apportionment purposes
- For purposes of apportioning deductions using a gross income method, gross income must be reduced by exempt income. Similarly, in using an asset basis of allocation and apportionment of deductions, assets need to be reduced by exempt assets.

Expense allocation rules – Exempt Income, Exempt Assets (cont'd)

- **Exempt Income** includes:
  - GILTI inclusion that is offset by a Sec. 250 deduction;
  - Foreign-derived intangible income ("FDII") that is offset by a Sec. 250 deduction; and
  - Any other gross income to the extent it is exempt, excluded or eliminated for federal income tax purposes.
- **Exempt Assets** include:
  - Assets that produce FDII income that is reduced by the Section 250 deduction;
  - Assets/stock that produces GILTI and is considered GILTI inclusion stock multiplied by the ratio of 250 deduction over total GILTI income; and
  - Any other assets that generate income that is treated as exempt, excluded or eliminated for federal income tax purposes.
- **GILTI Inclusion Stock** – aggregate of the portions of the value of CFC stock that are assigned (under 1.861-13) to:
  - the GILTI category (Sec. 951A);
  - a particular treaty category
  - the gross tested income statutory grouping within the foreign source passive category
  - the gross tested income statutory grouping within the US source general grouping within the US source general category
  - the gross tested income statutory grouping within the US source passive category

Characterization of CFC Stock – Reg. 1.861-13

- Proposed regulation 1.861-13 sets forth a five step process for purposes of applying both the asset method and the modified gross income method to allocate and apportion interests in CFC stock between the various categories (and subcategories).
  - These rules ensure that a portion of the stock of a CFC could be characterized as a GILTI basket asset.
  - Adds a "section 245A subgroup" to each category for purposes of determining the amount of interest expense that is subject to the adjustments mandated by section 904(b)(4).
  - Treatment of stock as section 904(b)(4) vs GILTI and as general/passive depends on current mix of assets or income (depending on apportionment method chosen), and not on historic untaxed E&P that would support a section 245A dividend.

The five step process for purposes of applying both the asset method and the modified gross income method to allocate and apportion interests in CFC stock include:

1. Categorizing the CFC's assets or gross income (depending on the taxpayer's chosen method) by the relevant categories in Prop. Reg. section 1.861-13(a)(1)(i)(A)(1)-(10);

2. Determining the amount of the gross tested income attributable to the GILTI basket and assigning a portion of the CFC stock to such separate category;

3. Determining the amount of U.S. source income resourced under a treaty and assigning a portion of the CFC stock to such separate category;

4. Aggregating stock within each separate category and assigning stock to the residual grouping; and

5. Determining, within each separate category, the amount that should be allocated to the section 245A subgroup for section 904(b)(4) purposes (i.e. the Sec. 245A and non-245A subgroups).

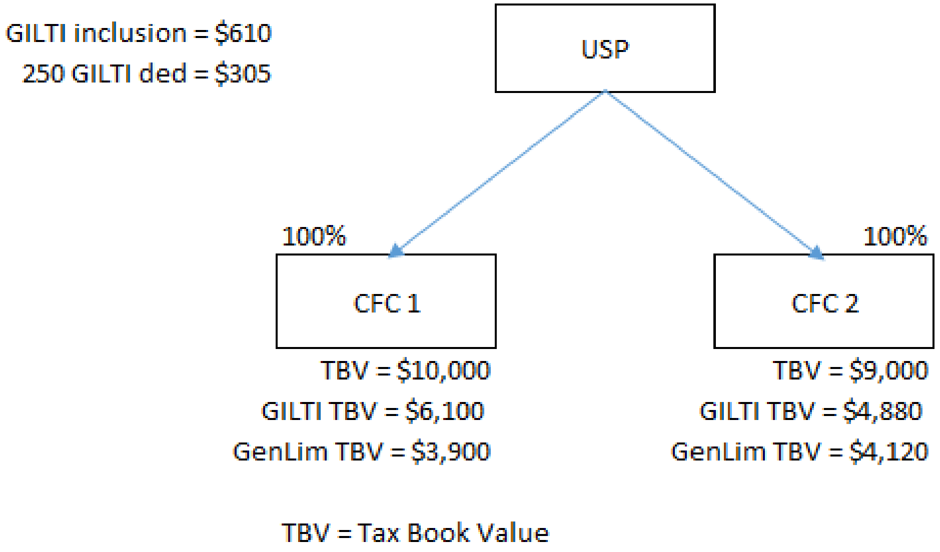
Exempt Assets, GILTI Inclusion Stock – Example (Prop. Reg. 1.861-8(d)(2)(ii)(C)(5))

<u>Facts</u>

- USP, a domestic corporation, directly owns all of the stock of CFC1 and CFC2. which have a tax book value of $10,000 and $9,000, respectively.
- $6,100 of the stock of CFC1 is assigned to the section 951A category and the remaining $3,900 of the stock of CFC1 is assigned to the general category.
- $4,880 of the stock of CFC2 is section 951A category stock and the remaining $4,120 of the stock of CFC2 is general category stock.
- USP's GILTI inclusion amount is $610 and USP's deduction under section 250 related to the GILTI inclusion is $305 (no taxable income limitation applies).

<u>Analysis</u>

- USP's exempt income for purposes of apportioning deductions for purposes of section 904 = $305 (= GILTI income reduced by Sec 250 deduction).
- CFC1's GILTI inclusion stock = $6,100
- CFC2's GILTI inclusion stock = $4,880
- The stock of CFC1 and CFC2 that is treated as an exempt asset equals the stock of CFC1 and CFC2 that is GILTI inclusion stock multiplied by 50% ($305/$610). =>
  - The exempt portion of CFC1's stock is $3,050 (50% x $6,100)
  - The exempt portion of CFC2's stock is $2,440 (50% x $4,880)
- The stock of CFC1 taken into account for purposes of apportioning deductions is $3,050 of non-exempt section 951A category stock and $3,900 of general category stock. The stock of CFC2 taken into account for purposes of apportioning deductions is $2,440 of non-exempt section 951A category stock and $4,120 of general category stock.



					Stock Value taken into acct for Deductions Approtionment	
	TBV	GILTI Inclusion Stock	Exempt Assets Ratio (*)	Exempt Assets	GILTI	GenLim
		A	B	C = AxB	A-C	
CFC1	10,000	6,100	50%	3,050	3,050	3,900
CFC2	9,000	4,880	50%	2,440	2,440	4,120

(*) Exempt Assets Ratio = $305/$610 = 50%

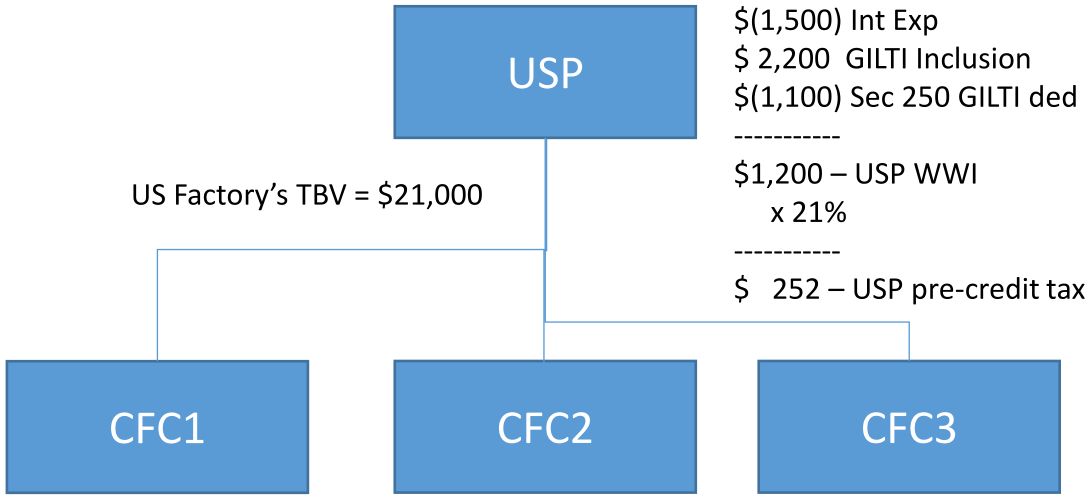
Expense Allocation Issues – Sec. 904(b)(4) & Sec. 245A DRD

- §245A provides a **100% DRD for the foreign portion of distributions received from specified 10% owned foreign corporations**; **no foreign tax credit** and **no deduction** are allowed for any taxes paid or accrued with respect to a 245A dividend.

- Under §904(b)(4) - when determining the foreign tax credit limitation, **both** the foreign source income and the worldwide taxable income are decreased/adjusted by:
  (1) any dividend for which a §245A DRD is allowed;
  (2) any deductions allocable or apportioned to gross income in the §245A subgroup; and
  (3) any deductions allocable or apportioned to stock of specified 10% owned foreign corporations in the §245A subgroup.

- By characterizing a portion of CFC stock (or 10% owned foreign corporation) as stock that could give rise to a 245A dividend, regardless of whether dividends are actually paid => any expenses apportioned based on TBV of the gross assets, such as interest expense, when apportioned to this grouping, would not reduce foreign source income (in the general, passive or GILTI baskets).
- However, section 904(b)(4) requires that such expenses are added back to worldwide income for purposes of **all** baskets (which results in a reduction of the benefit).

Expense Allocation Issues – Sec. 904(b)(4) & Sec. 245A Dividends Received Deduction – Example (Prop. Reg. Sec. 1.904(b)-3(e)): Facts



$ 1,600 US source GI
$(1,500) Int Exp
$ 2,200 GILTI Inclusion
$(1,100) Sec 250 GILTI ded

$1,200 – USP WWI
x 21%

$ 252 – USP pre-credit tax

					CFC Stock Value taken into acct for Deductions Apportionment		US Factory	TBV of USP Asstes
	TBV	GILTI Inclusion Stock	Exempt Assets Ratio (*)	Exempt Assets	GILTI	GenLim		
		A	B	C = AxB	A-C			
CFC1	10,000	7,300	50%	3,650	3,650	2,700		
CFC2	10,000	7,300	50%	3,650	3,650	2,700		
CFC3	10,000	7,300	50%	3,650	3,650	2,700		
TOTAL CFC Stock				**10,950**	**10,950**	**8,100**	**21,000**	**40,050**
Interest expense apportionment factor					27%	20%	52%	100%
Interest expense apportionment					410	303	787	1,500
Sec 250 deduction allocation					1,100	-	-	1,100

(*) Exempt Assets Ratio = $1,100/$2,200 = 50%

TBV $10,000 of which
$2,700 – GenLim, 245A subgroup
$7,300 – GILTI, non-245A =>
$3,650 – exempt asset

TBV $10,000 of which
$2,700 – GenLim, 245A subgroup
$7,300 – GILTI, non-245A =>
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$3,650 – exempt asset

Expense Allocation Issues – Sec. 904(b)(4) & Sec. 245A Dividends Received Deduction – Example (Prop. Reg. Sec. 1.904(b)-3(e)): Analysis

	US Source	GILTI	GenLim	WWI	
Income	1600	2,200	0	3800	
Expenses				0	
250 Ded		(1,100)		-1100	
Interest	(787)	(410)	(303)	-1500	
Taxable Inc	**813**	**690**	**(303)**	**1200**	before sec 904(b)(4)
904(b)(4) adj			303	303	(Note A)
Adj TI	813	690	0	1503	(Note A, B)
FTC Limitation		116	0	252	
		(Note B)		pre-credit tax liability	

Note A:

USP has no deductions properly allocable or apportioned to gross income in the section 245A subgroup because USP has no dividend income in the general category for which a deduction is allowed under section 245A.

Also, USP has $303 of deductions for interest expense that are properly allocable or apportioned to stock of specified 10-percent owned foreign corporations in the section 245A subgroup because USP's only general category assets are the general category stock of CFC1, CFC2, and CFC3, all of which are in the section 245A subgroup. Therefore, USP's foreign source taxable income in the general category and its worldwide taxable income are determined without regard to the $303 of deductions for interest expense. Accordingly, USP's foreign source taxable income in the general category is $0 and its worldwide taxable income is $1,503, and therefore, there is no separate limitation loss for purposes of section 904(f). USP's foreign tax credit limitation for the general category is $0.

Note B:

USP has no deductions properly allocable and apportioned to gross income in a section 245A subgroup of the section 951A category.

Also, USP has no deductions properly allocable and apportioned to stock of specified 10-percent owned foreign corporations in a section 245A subgroup of section 951A category stock because no portion of section 951A category stock is assigned to a section 245A subgroup. Therefore, no adjustment is made to USP's foreign source taxable income in the section 951A category.

However, the adjustments to USP's worldwide taxable income described in Note A above apply for purposes of calculating USP's foreign tax credit limitation for the section 951A category. Accordingly, USP's foreign source taxable income in the section 951A category is $690 and its worldwide taxable income is $1,503.

USP's foreign tax credit limitation for the section 951A category is $116 ($252 x $690/$1,503).

Foreign Tax Credit Limitation Under Section 904 – GILTI and Branch Basket

Foreign Branch Basket - Definitions

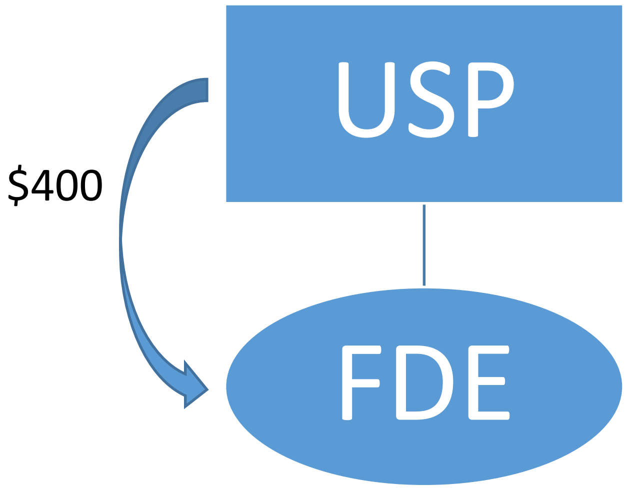
- Under the new regulations, two new foreign tax credit limitation categories are added to §904(d):
  - foreign branch income, and
  - global low-taxed intangible income (GILTI) inclusions under new §951A.
- Generally effective for tax years beginning after Dec 31, 2017.
- Foreign branch income is defined as "the business profits of a United States person attributable to a qualified business unit (QBU) in a foreign country (excluding passive category income)."
- A QBU is defined as "any separate and clearly identified unit of a **trade or business** of a taxpayer which maintains separate books and records", which "ordinarily includes the collection of income and the payment of expenses" (Sec. 989(a), Reg. Sec. 1.989(a)-1(c)).
- Partnerships or trusts that conduct a trade or business outside of the United States constitute a foreign branch even when they do not have separate books and records for the foreign activities.
- Activities that constitute a permanent establishment in a foreign country under a US tax treaty are presumed to be foreign branch related.

Foreign Branch Basket – Disregarded Payments

- Gross income attributable to a foreign branch that is not passive income must be adjusted to reflect certain transactions that are disregarded for federal income tax purposes, such as payments that would be deductible or capitalized if the payments were regarded for federal income tax purposes
- This rule applies to transactions between a foreign branch and its foreign branch owner, as well as transactions between or among foreign branches of the same owner (except for contributions, remittances, and payments of interest & certain interest equivalents)
- The rule would not make the payment regarded but would merely reallocate the gross income between the foreign branch and its owner
- The principles of Sec. 861 are applied to determine the source and character of an amount that is reallocated as a result of considering as regarded an otherwise disregarded payment.
- The proposed rules provide special provisions for allocating and apportioning foreign taxes related to disregarded payments to or from foreign branches.

Foreign Branch Basket – Disregarded Payments (Example 1 – Reg. Sec. 1.904-4(f)(4)(iii))

- USP has $1,000 of gross income from the performance of services to unrelated parties, of which $600 US source income, and $400 of foreign source income from services performed by FDE's employees
- USP pays FDE $400 for the services performed that generated USP's foreign services income (arm's length); the payment is disregarded for federal tax purposes, but the deduction would be allocated to USP's $400 of foreign source services income if the payment were regarded.



<u>$1,000 services income</u>
$600 US source
$400 Foreign source, generated by FDE

=>

- The $400 disregarded payment from USP to FDE is allocable to gross income attributable to USP because a deduction for the payment, if it were regarded, would be allocated to USP's $1,000 of gross services income and apportioned between U.S. and foreign source income under §1.861-8.
- $400 of USP's foreign source gross income from the performance of services is attributable to the FDE foreign branch => $400 of the foreign source gross income that USP earned with respect to its services constitutes gross income that is assigned to the foreign branch category

Foreign Branch Basket – FTC Transition Rules

- Generally, FTC carryforwards are allocated to the same post-2017 separate category as the pre-2018 separate category from which the unused foreign taxes are carried.
- However, under the **branch carryover exception,** a taxpayer that has carryforwards in the general income category, may **elect** to allocate those taxes to its post-2017 foreign branch income category if the taxes would have been foreign branch income category taxes had the taxes been paid or accrued in a post-2017 year
  - The election requires a “roll back” to pre-reform years involving complex computation and reallocation methods for determining the amount of foreign branch income and taxes; the IRS is considering whether a simplified alternative method would be appropriate.
  - The taxpayer effects the choice by attaching a statement to a timely filed return (including an amended return).
- Additional rules:
  - A taxpayer applying the exception must apply the exception to all of its unused foreign taxes paid or accrued with respect to its general category income that are carried forward to all taxable years beginning after December 31, 2017
  - A taxpayer that has excess foreign branch credits in its first post-2017 tax year can carry back such taxes to their last pre-2018 tax year. Such tax carrybacks are allocated to the taxpayer’s pre-2018 general income category.
  - Any other carrybacks of unused post-2017 foreign taxes to a pre-2018 taxable year are allocated to the same pre-2018 separate category as the post- 2017 separate category to which the carrybacks pertained (i.e. passive category income or a specified separate category of income).

New FTC Regulations –
Deemed Paid Foreign Taxes Under Section 960

Prop Reg. Sec. 1.960 - Deemed Paid Taxes

Provisions re: Deemed Paid Taxes	Prop. Reg.
Application of §960(c) to GILTI Inclusion Amounts	Prop. Reg. §1.960-4, §1.960-5
Computational and Grouping Rules	Prop. Reg. §1.960-1
Calculation of Deemed Paid Taxes for Subpart F Inclusions	Prop. Reg. §1.960-2(b)
Calculation of Deemed Paid Taxes for GILTI Inclusion Amounts	Prop. Reg. §1.960-2(c)
Calculation of Deemed Paid Taxes for Distributions of PTEP	Prop. Reg. §1.960-3
Section 78 Gross Up	Prop. Reg. §1.78-1

Prop. Reg. §1.960 – Deemed Paid Taxes

- Following the repeal of IRC Sec. 902, IRC Sec. 960 is now the only provision that allows a US corporate shareholder to claim a deemed paid credit with respect to taxes paid by its CFCs.
- Taxes are deemed paid by a corporate US shareholder to the extent they are "attributable to" subpart F or GILTI inclusions, or, in case of foreign taxes imposed on a distribution of "PTEP" (previously taxes earnings and profits, fka PTI) they are deemed paid by the US shareholder or upper tier CFC.
- Sec. 960 provides <u>two sets of computational rules</u>:
  1. For determining deemed paid taxes attributable to subpart F and GILTI inclusions based on current year CFC taxes, and
  2. For calculating deemed paid taxes attributable to PTI distributions based on current and prior year CFC taxes.
- These computational rules include a multi-step process for computing the deemed paid foreign taxes, beginning with the lowest tier CFC and then repeated for each CFC up the chain of ownership.
- The process involves dividing a CFC's income (other than PTEP income) into tested income, various subcategories of Subpart F income, and residual income (neither subpart F income, nor tested income).
- Only current year taxes allocated to a specific income group are deemed paid with respect to an income inclusion that is sourced from the income group (i.e. Subpart F income or GILTI), while taxes assigned to the residual group would not be deemed paid, and therefore, are lost.
- Current year taxes of a CFC, imposed on an income amount under foreign law that would be recognized under U.S. law in a different taxable year, are eligible to be deemed paid in the year in which the foreign tax accrues, and not in the earlier or later year when the related income is recognized for U.S. tax purposes.

Prop. Reg. Sec. 1.960-2(c) - Calculation of Deemed Paid Taxes for GILTI Inclusion Amounts

- The foreign income taxes deemed paid in connection with a deemed GILTI inclusion = 80% x (inclusion percentage) x (tested foreign income taxes) – applied by tested income group within each §904 category of the CFC. In other words, the deemed paid taxes bear the same proportion to total tested foreign income taxes as the 951A inclusion bears to total tested income of all CFCs in the group, and such deemed paid taxes are subject to a further 80% haircut.
- Tested foreign income taxes are taxes properly attributable to tested income of the U.S. corporate shareholder under §951A and Prop. Reg. §1.951A-1, which are defined as the shareholder's proportionate share of the current year taxes of the CFC that are allocated and apportioned to the tested income group within each §904 category of the CFC. No other foreign income taxes are considered properly attributable to tested income.

Notice 2019-1 – New Guidance on the treatment of Previously Taxed Earnings and Profits under IRC Sec. 959 and IRC Sec. 961

Notice 2019-1 – Previously Taxed Earnings and Profits

- Notice 2019-1 (Dec. 14, 2018) announces that Treasury and the IRS intend to issue Treasury Regulations under IRC Sec. 959 and IRC Sec. 961 addressing certain issues arising from the enactment of the TCJA with respect to foreign corporations with previously taxed earnings and profits ("PTEP"). The Proposed Regulations issued in 2006 will be withdrawn.
- The PTEP rules apply to distributions from CFCs to United States shareholders who were previously required to include amounts in taxable income as Sec. 951(a) subpart F income inclusions and IRC Sec. 956 income inclusions arising from investments by the CFC in United States property.
- To prevent double taxation, IRC Sec. 959 provides that distributions of PTEP are not taxed again when distributed to a United States shareholder or any other U.S. person who acquires the United States shareholder's interest (or a portion thereof) in the CFC.
- The PTEP provisions also provide ordering rules to determine which type of PTEP is deemed to be distributed from the CFC. Generally, a distribution of E&P from a CFC is treated as coming:
  - First, from PTEP previously included in income pursuant to IRC Sec. 956 (or which has been reclassified as such) ("IRC Sec. 959(c)(1) PTEP"),
  - Second, from PTEP previously included in income as subpart F income pursuant to IRC Sec. 951(a) or under IRC Sec. 1248 as deemed dividend inclusions ("IRC Sec. 959(c)(2) PTEP"), and
  - Third, from other E&P (*i.e.*, that is not PTEP)

Notice 2019-1 – Effective Dates and Forthcoming Guidance

- The PTEP provisions were not directly amended by the TCJA. But additional categories of PTEP were created by the TCJA, including due to the new deemed repatriation rules under IRC Sec. 965 and the new GILTI tax regime under IRC Sec. 951A.
- The Notice states that Treasury and the IRS intend to issue Treasury Regulations addressing:

(i) rules relating to the maintenance of PTEP in annual accounts;

(ii) rules relating to the ordering of PTEP upon distribution and reclassification; and

(iii) rules relating to the adjustment required when an income inclusion exceeds the E&P of a foreign corporation.

- It is expected that the forthcoming Treasury Regulations will apply to taxable years of United States shareholders (and successors in interest) ending after Dec. 14, 2018 and to taxable years of foreign corporations ending with or within such taxable years of United States shareholders.
- It is also expected that the final Treasury Regulations will provide transition rules for annual PTEP accounts maintained before the applicability date of the Treasury Regulations.
- Before the issuance of final Treasury Regulations, taxpayers can rely on the guidance set forth in Section 3 of the Notice.

Notice 2019-1, Sec. 3: Maintenance of PTEP Accounts

- Taxpayers must maintain PTEP in an annual account for each separate category or “basket” of income under IRC Sec. 904.
- Each group of IRC Sec. 959(c)(2) PTEP must be separately tracked since it may be subject to different rules under the following provisions:
  - IRC Sec. 960, which allows a domestic corporation to claim a deemed paid FTC for subpart F income inclusions;
  - IRC Sec. 965(g), which disallows an FTC for the portion of the mandatory income inclusion amount under IRC Sec. 965(a) that is deductible under IRC Sec. 965(c) (this deduction generally reduces the IRC Sec. 965(a) amount by a 15.5% rate equivalent percentage for assets held as cash and cash equivalents and an 8% rate equivalent percentage for all other assets);
  - IRC Sec. 245A(e)(3), which treats hybrid dividends received by a CFC from another CFC with the same United States shareholder as subpart F income for the United States shareholder; and
  - IRC Sec. 986(c), which treats foreign currency gains or losses due to exchange rate changes between the date of a deemed and actual distribution as ordinary

Notice 2019-1, Sec 3: Maintenance of PTEP Accounts

- In addition, because IRC Sec. 959(c)(2) PTEP may be reclassified as IRC Sec. 959(c)(1) PTEP when a CFC makes an IRC Sec. 956 investment in United States property, similar groups must be maintained for IRC Sec. 959(c)(1) PTEP in order to properly apply IRC Secs. 960, 965(g), 245A(e)(3), and 986(c) when earnings are reclassified.
- Sec. 3 of the Notice provides that future Treasury Regulations are expected to require an annual PTEP account be maintained for each CFC, and each annual PTEP account must be segregated into the following 16 PTEP groups in each separate IRC Sec. 904 limitation "basket":
- **IRC Sec. 959(c)(1) PTEP**
  - (1) reclassified IRC Sec. 965(a) PTEP; (2) reclassified IRC Sec. 965(b) PTEP; (3) IRC Sec. 951(a)(1)(B) PTEP; (4) reclassified IRC Sec. 951A PTEP; (5) reclassified IRC Sec. 245A(e)(2) PTEP; (6) reclassified IRC Sec. 959(e) PTEP; (7) reclassified IRC Sec. 964(e)(4) PTEP; (8) reclassified IRC Sec. 951(a)(1)(A) PTEP; and (9) IRC Sec. 956A PTEP;
- **Section 959(c)(2) PTEP**
  - (10) IRC Sec. 965(a) PTEP; (11) IRC Sec. 965(b) PTEP; (12) IRC Sec. 951A PTEP; (13) IRC Sec. 245A(e)(2) PTEP; (14) IRC Sec. 959(e) PTEP; (15) IRC Sec. 964(e)(4) PTEP; and (16) IRC Sec. 951(a)(1)9(A) PTEP.

Notice 2019-1, Sec. 3 – Maintenance of PTEP Accounts

- Once established, each PTEP account must be maintained for the year it was created until distributions have been made by the CFC reducing the account balance to zero.
- To the extent a CFC has E&P in a PTEP group with more than one IRC Sec. 904 category, any distribution out of that PTEP group is made pro rata out of the E&P of each IRC Sec. 904 category.
- Dollar basis must be tracked for each annual PTEP account, and, to the extent provided in the final Treasury Regulations, separately for each PTEP group within an annual account.
- Distributions from any PTEP group will reduce the shareholder's stock basis under IRC Sec. 961(b)(1) without regard to how that basis was originally created.
- The final Treasury Regulations are expected to provide transition rules for annual PTEP accounts maintained before the applicability date of the regulations.

Notice 2019-1, Sec. 3 – Maintenance of PTEP Accounts

- The Notice also states the final Treasury Regulations are expected to provide the following clarifications:
  - A distribution will be a distribution of PTEP only to the extent it would have otherwise been a dividend under section 316 (*i.e.*, a distribution from current or accumulated E&P).
  - A LIFO approach will apply to determine the source of distributions from annual PTEP accounts, except that PTEP attributable to income inclusions under IRC Sec. 965(a) or by reason of IRC Sec. 965(b)(4)(A), will receive priority when determining the group of PTEP from which a distribution is made.
  - Starting with IRC Sec. 959(c)(1) PTEP, distributions will be sourced first from the reclassified IRC Sec. 965(a) PTEP and then from the reclassified IRC Sec. 965(b) PTEP. After these groups are exhausted, distributions will be sourced pro rata from the remaining IRC Sec. 959(c)(1) PTEP groups under the LIFO approach (*i.e.*, starting with the most recent year's PTEP account).
  - After the balance in all IRC Sec. 959(c)(1) PTEP groups is zero, distributions are sourced from IRC Sec. 959(c)(2) PTEP (with the same rule that distributions are first sourced from IRC Sec. 965(a) PTEP, then IRC Sec. 965(b)(4)(A) PTEP, and thereafter pro rata from the remaining groups under the LIFO method.

Notice 2019-1, Sec. 3 – Maintenance of PTEP Accounts

- The amount of a United States shareholder's subpart F income inclusion is limited to the current year E&P of the CFC.
- In contrast, GILTI inclusions are not limited by current year E&P.
- The Notice states that the aggregate amount of a CFC's IRC Sec. 959(c)(3) E&P (i.e., E&P that is not PTEP), IRC Sec. 959(c)(1) PTEP and IRC Sec. 959(c)(2) PTEP generally must equal the CFC's E&P.
- Current E&P is first classified as IRC Sec. 959(c)(3) E&P that has not been previously taxed, and then gets reclassified as IRC Sec. 959(c)(1) PTEP or IRC Sec. 959(c)(2) PTEP as necessary. This reclassification may create or increase a deficit in IRC Sec. 959(c)(3) E&P. Thus, where a current-year GILTI inclusion exceeds available IRC Sec. 959(c)(3) E&P, that balance would become negative in order to allow for the creation of the appropriate PTEP while maintaining the correct total E&P.
- If a CFC has a current-year deficit in E&P, that deficit will solely reduce the foreign corporation's section 959(c)(3) E&P without affecting the amount of its section 959(c)(1) PTEP or section 959(c)(2) PTEP.

Notice 2019-1, Request for Comments

- The Notice states that Treasury and the IRS recognize the complexity of maintaining PTEP in 16 separate PTEP groups across the IRC Sec. 904 FTC limitation categories in annual accounts and they are weighing this consideration against the need for precision in applying the related foreign tax credit and foreign currency rules. They specifically requested comments on methods for simplifying the PTEP rules, including possibly consolidating certain PTEP groups or providing for multi-year PTEP accounts.
- They have also requested comments on the following issues:
  - The extent to which basis created under IRC Sec. 961(c) should be treated as basis for purposes of determining tested income in applying IRC Sec. 951A (GILTI)
  - The extent to which gain or loss, including foreign currency gain or loss, should be recognized by reason of distributions of PTEP.
  - The application of IRC Sec. 959 and IRC Sec. 961 to domestic and foreign partnerships.
  - Any other guidance that should be issued under IRC Sec. 959 and IRC Sec. 961, including the whether any provisions from the 2006 Proposed Regulations should be included in the final Treasury Regulations.
- Comments are due by February 12, 2019 and can be submitted electronically at www.regulations.gov .

Questions?