Foreign Tax Credit Limitations Under Section 904: New IRS Regulations and Guidance for Tax Counsel

Allocations, Apportionment, Limitations Under Section 904(b)(4), Impact of GILTI, Carryover and Carryback Rules, Section 960

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Today’s faculty features:
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Neel Modha, Senior Manager, Holthouse Carlin & Van Trigt, Costa Mesa, Calif.

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Foreign Tax Credit Limitations Under Section 904: New IRS Regulations and Guidance for Tax Counsel

Neel Modha (Neel.Modha@hcvt.com)

May 14, 2019
1. US persons allowed a credit for foreign taxes paid

2. Requirements:
   a. Must be a person eligible to claim the credit; and
   b. Must be a creditable foreign tax

3. IRC and Treasury Regulations provide extensive rules and guidance on the eligibility, requirements and documentation

4. TCJA (codified December 2017) and Proposed Treasury Regulations altered the landscape for foreign tax credit purposes
Foreign Tax Credit - IRC Section 904(d)

• **Purpose** = to prevent taxpayers from crediting foreign taxes against U.S. taxes levied on U.S. source income

• **Rule**: FTC cannot exceed the lesser of two amounts:
  1. Actual foreign taxes paid or accrued; or
  2. U.S. tax on foreign source income

\[
\text{Foreign-source taxable income} \times \frac{\text{FTC Limitation}}{\text{Total taxable income}} \times \text{U.S. tax before FTC}
\]
Example #1 – FTC vs Deduction

**No Foreign Tax Credit**
- Indv (US)
- Germany
- $60 Div income
- $12 US tax 20%
- $60 E&P
- ETR = 52% (40+12)

**Foreign Tax Credit**
- Indv (US)
- Germany
- $100 Income
- $37 US tax 37%
- (37) FTC
- $0 Addtl paid to US
- ETR = 40% (40%, 3% unused FTC)

**Deduction**
- Indv (US)
- Germany
- $100 Income
- (40) Foreign tax ded
- $60
- $22.20 US tax 37%
- ETR = 62.20% (40+22.20)
1. Eligible taxpayer - the person by whom the tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposed legal liability for such tax even if another person (e.g., a withholding agent) remits such tax

2. US citizens, resident aliens
   • FTC allowed to offset US tax resulting from income taxes paid to foreign countries or US possessions

3. US corporations
   • FTC allowed to offset US tax resulting from income taxes paid to foreign countries or US possessions

4. Partnerships
   • Look-through to its partners. Creditable by regarded partners who are US persons

5. Foreign persons
   • Generally no FTC allowed
   • Exception under section 906 for foreign persons earning ECI
     ➢ Foreign source ECI
     ➢ US source ECI if local jurisdiction deems income to be sourced locally in foreign jurisdiction
1. Section 901 allows a credit for the amount of income, war profits or excess profits tax paid to any foreign country

2. Whether a foreign levy is an income tax is determined independently for each separate foreign levy.

3. Requirements – a foreign levy is an income if and only if:
   - It is a tax; and
   - The predominant character of that tax is an income tax in the US sense (also see section 903 – in lieu of tax)

4. Other foreign taxes not meeting the requirements above may be deductible but not creditable for US tax purposes

5. Subsidies are not foreign taxes eligible for section 901 credit – Treas. Reg. section 1.901-3(i)
   - Substance over form
   - Includes any benefit conferred, directly or indirectly, by a foreign country to taxpayer, related persons (as defined in section 482), to any party to the transaction, or to any party to a related transaction
   - E.g., rebate, refund, credit, deduction, payment, discharge of an obligation
**Requirement #1 - Tax**

1. A foreign levy is a tax if it requires a compulsory payment (see next slide for definition) pursuant to the authority of a foreign country to levy taxes.
2. Penalty, fine, interest, or other similar obligation is not a tax.
3. Determined under US law principles and not by principles of foreign country
   - Assertion by a foreign country that levy is creditable is not determinative
   - Foreign levy is not a tax to the extent a person subject to the levy receives (or will receive) directly or indirectly, a specific economic benefit from foreign country in exchange for the specific economic benefit.
4. Specific economic benefit
   - Defined as
     - an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country.
     - If no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population in general.
   - Examples
     - Concession to extract govt-owned petroleum is a specific economic benefit – this is not made generally available to persons
     - Right to travel or to ship freight on govt-owned airline is not a specific economic benefit – this is made generally available on substantially similar terms.
Requirement #1 – Tax (cont’d)

Compulsory Payment – Treas. Reg. section 1.901-2(e)(5)
- Indirectly defined in the treasury regulations
- Cannot exceed the amount of liability under foreign law
  ➢ Reasonable Interpretation standard
    a. Amount paid will not exceed the amount of liability if the amount paid “is
determined by the taxpayer in a manner that is consistent with a
reasonable interpretation and application of the substantive and
procedural provisions of foreign tax law (including applicable tax treaties)
in such a way as to reduce, over time, the taxpayer’s reasonably expected
liability under foreign law or tax, and if the taxpayer exhausts all effective
and practical remedies, including invocation of competent authority
procedures available under applicable tax treaties, to reduce, over time,
the taxpayer’s liability for foreign tax”
    b. Interpretation will not be reasonable if there is actual or constructive
notice (e.g., a published court decision) to the taxpayer that the
interpretation is likely to be erroneous
    c. Taxpayer may generally rely on advice obtained in good faith from
competent foreign tax advisors to whom the taxpayer has disclosed the
relevant facts

FTC – Overview – Creditable Foreign Taxes
Requirement #2 – The predominant character of that tax is an income tax in the US sense (also see section 903 – in lieu of tax)

1. The predominant character of a foreign tax is that of an income tax in the US sense if:
   • The foreign tax is likely to reach net gain the normal circumstances in which it applies
   • But only to the extent that liability is not dependent by its terms or otherwise on the availability of a credit for the tax against income tax liability to another country

2. A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged based on the basis of its predominant character, satisfies the following three tests set forth in Treas. Reg. section 1.901-2(b)(2)(i)(A)-(C):
   • Realization
   • Gross Receipts
   • Net Income

3. Liability for foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only if and to the extent that the foreign tax would not be imposed on the taxpayer but for the availability of such a credit. Treas. Reg. section 1.901-2(c)(1)
1. Several components of an individual’s tax base are not offset by foreign tax credits:
   - SECA / FICA
   - 3.8% Medicare contribution tax
   - State income taxes (varies by state)

2. Special adjustments are made to the FTC limitation for:
   - Capital gains
   - Qualified dividends
   - Foreign earned income exclusion - section 911
Credit vs Deduction - Documentation

1. How to elect to take credit versus deduction
   a. Itemize deduction (Form 1040, Schedule A)
   b. Foreign Tax Credit
      a. Corporate taxpayers – Form 1118
      b. Non-Corporate taxpayers - Form 1116 – Attach to Form 1040
      c. Annual choice

2. Claiming FTC Without Filing Form 1116 - Requirements
   a. All foreign source income is passive income;
   b. Reported on a qualified payee statement (e.g., Form 1099, Sch K-1);
   c. Total of qualified foreign taxes does not exceed a limit;
      i. Limit for tax year 2019 = $300 (or $600 if MFJ)

3. If you claim the credit directly on Form 1040 without filing Form 1116, you cannot carry back or carry forward any unused foreign tax to or from this year.
Amending Tax Return to Claim the Foreign Tax Credit

1. File Form 1040X (and Form 1116) within 10 years from the original due date of your return. The 10-year period also applies to calculate corrections of your previously claimed foreign tax credit.

2. If the foreign income taxes you claimed as a credit are refunded or otherwise reduced, you must file an amended return on Form 1040X reporting the reduced foreign tax credit. There is no time limit on this requirement.

Example: Adrian, a U.S. citizen, filed her Form 1040 for calendar year 2015 on September 16, 2016. On the return, she chose to deduct certain foreign taxes that she paid to the government of UK for a business that she operates in UK as a sole proprietor. Adrian files an amended return on Dec. 29, 2018 to claim additional mortgage interest deduction as an itemized deduction on Schedule A. When will Adrian’s ability to file an amended return to claim a foreign tax credit in lieu of a deduction originally taken?
Steps to Calculate FTC

1. Source the income

2. Basket the income
   - Post 2017: includes foreign branch and GILTI

3. Allocation and apportionment of expenses
   - Post 2017: Various changes
     - GILTI Basket Expense Allocation
     - Repeal of Fair Market Value Method for Allocation and Apportionment of Interest Expense
     - Section 904(b)(4) – Treatment of Dividends for Which Deduction is Allowed under Section 245A
     - Other
       - Assigning CFC Stock to Multiple Baskets
       - R&E Expense Allocation per 864(g)

4. Foreign Tax Credit Limitation

5. Carryovers
   - carryback 1 year, carryforward 10 years
   - No carryovers for GILTI basket
## Income Source Rules

<table>
<thead>
<tr>
<th>Type of income</th>
<th>Source rule (in general)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>Residence of payor</td>
</tr>
<tr>
<td></td>
<td>Exception for foreign corp with &gt;=25% US ECI</td>
</tr>
<tr>
<td>Interest</td>
<td>Residence of payor</td>
</tr>
<tr>
<td></td>
<td>Exception for US corp with 80% active business income from foreign sources over prior 3 years</td>
</tr>
<tr>
<td>Rent</td>
<td>Location property used</td>
</tr>
<tr>
<td>Royalties</td>
<td>Location IP is used</td>
</tr>
<tr>
<td>Gain from sale of personal property</td>
<td>Residence of seller</td>
</tr>
<tr>
<td></td>
<td>US citizen with foreign tax home is foreign source</td>
</tr>
<tr>
<td>Gain from sale of inventory</td>
<td>Location of sale</td>
</tr>
<tr>
<td></td>
<td>Special rules if inventory is manufactured</td>
</tr>
<tr>
<td>Services</td>
<td>Location where services are performed</td>
</tr>
<tr>
<td></td>
<td>Commercial traveler exception</td>
</tr>
</tbody>
</table>
Example #1
Alex receives $20,000 of interest income from domestic corporation ABC Co, and $100,000 of interest income from US corporation DEF Co. All of ABC Co’s income from inception has been US source income. For the past three years, 90% of DEF Co’s gross income has been active foreign business income. What is the source of the interest income that Alex receives for the current tax year from ABC Co and DEF Co?
Example #2

Benton receives dividends from the following corporations for the current tax year. Calculate the amount of US source income:

<table>
<thead>
<tr>
<th>Amount</th>
<th>Corporation</th>
<th>% ECI for past 3 years</th>
<th>US source income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000</td>
<td>GHI Co (domestic)</td>
<td></td>
<td>?</td>
</tr>
<tr>
<td>$2,000</td>
<td>JKL Co (foreign)</td>
<td>20%</td>
<td>?</td>
</tr>
<tr>
<td>$3,000</td>
<td>MNO Co (foreign)</td>
<td>90%</td>
<td>?</td>
</tr>
</tbody>
</table>
Basketing – Sec 904(d)
- Prevents cross crediting between baskets
- Passive
  - Interest, dividends, rent, royalties, gains
  - Defined under subpart F rules section 954(c)
- General
  - Income not in another basket
  - Usually active types of income
- Other
  - Treaty Resourcing
- Foreign Branch
- GILTI
- Look through rules – Section 904(d)(3)
  - Apply to related party CFC transactions
  - Subpart F inclusions – generally passive basket
  - Dividends – look thru to underlying E&P (10% owned)
  - Interest – generally passive basket to extent of passive category income of CFC
Three Types of Apportionment Rules

1. “Factual Relationship” Method
   - Used for deductions definitely related to a class of gross income, including all gross income. Temp. Reg. § 1.861-8T(c)(1).

2. Gross Income Method
   - Required for deductions not definitely related to any gross income. Treas. Reg. § 1.861-8(c)(3).

Apportionment – Gross Income Method

- Gross Income Method under Treas. Reg. § 1.861-8(c)(3) must be used if a deduction is not definitely related to any gross income.

\[
\text{Apportioned Amount} = \frac{\text{Gross Income in Statutory Grouping}}{\text{Total Amount of Gross Income}} \times \text{Deduction}
\]
Expense Allocation for Individuals

- Some deductions do not definitely relate to either your foreign source income or your US source income. These expenses (except for interest expense) are allocated pro rata using the gross income method.
- **Charitable contribution** are definitely related and allocable to all of taxpayer’s gross income. The deduction is ratably apportioned between statutory grouping of gross income and the residual grouping on the basis of the relative amounts of U.S. source gross income in each grouping. It cannot offset foreign source income. Effectively, it cannot impair the foreign tax credit limitation.
- **Mortgage interest** is allocated using the gross income method unless the taxpayer’s FSI (including income excluded on Form 2555) does not exceed $5,000. Then the taxpayer can allocate all mortgage expense to US source income.
- **Other interest** (investment interest, passive activity interest, interest incurred in a trade or business) is allocated using the “asset method” unless the taxpayer’s FSI (including income excluded on Form 2555) does not exceed $5,000. Then the taxpayer can allocate all other interest expense to US source income.
Allocation and Apportionment of Deductions

• GILTI Basket Expense Allocation
• Repeal of Fair Market Value Method for Allocation and Apportionment of Interest Expense
• Section 904(b)(4) – Treatment of Dividends for Which Deduction is Allowed under Section 245A
• Other
  • Assigning CFC Stock to Multiple Baskets
  • R&E Expense Allocation per 864(g)
• Per the proposed regulations, the expense allocation rules generally apply to GILTI basket income for purposes of calculating GILTI basket taxable income.

• Proposed regulations do not fully prohibit expense allocation and apportionment to GILTI. Instead, includes partial relief that may limit the amount of expenses apportioned to GILTI.
  
  • Per 864(e), GILTI income offset by the section 250 deduction will be treated as exempt – generally 50%.
  
  • Percentage of CFC stock generating GILTI income will be treated as an exempt asset – generally 50%.

• Accordingly, exempt treatment above will reduce allocation and apportionment of deductions to GILTI income basket.

\[
\text{Foreign-source taxable income} = \frac{\text{FTC Limitation}}{\text{Total taxable income}} \times \text{U.S. tax before FTC}
\]
Interest Expense - Repeal of FMV Method

Old rule – prior to TCJA

• For purposes of allocating and apportionment interest expense, taxpayer may choose any of the following three methods (Note – gross income method specifically not allowed per 864(e)(2)):
  • Tax Book Value
  • Alternative Tax Book Value
  • Fair Market Value Method

New rule per TCJA – effective tax years beginning after 12/31/17

• In addition to the disallowance of the Gross Income method, the Fair Market Value method is not allowed per new section 864(e)(2)

• Transition relief allowed
Section 245A

- Applicable to domestic corporations that are U.S. shareholders of 10% owned foreign corporations
- Allows for a deduction for foreign source portion of dividend from FC to corporate US shareholder

Section 904(b)(4)

- For U.S. shareholders described in section 245A, such shareholders’ foreign source taxable income is calculated without regard to:
  - dividend income eligible for the section 245A dividend received deduction (“DRD”), and
  - any deductions allocable/apportioned to dividend income eligible for the section 245A DRD, or stock producing such dividend income.

The proposed regulations:

- U.S. shareholder’s gross income and assets in each basket are subdivided between a section 245A subgroup and a non-section 245A subgroup.
- Expenses are allocated and apportioned treating the section 245A subgroup and a non-section 245A subgroup within each basket as a separate basket.
• GILTI basket income – Any inclusion under section 951A other than passive category income.

  • Look-through rule: passive category income to the extent the inclusion is attributable to passive category income received by CFC. Example: less than 10% owned partnership income.

  • All other section 951A income to GILTI basket.

• GILTI FTC limitation – determined on a year by year basis – no carryforwards or carrybacks.
Example #3: GILTI Basket and Passive Category Income

Facts
• USCo, a domestic corporation, owns 100% of FCo, a foreign corporation.
• FCo owns 5% of FP1 and 15% of FP2
• In 2018 USCo has a section 951A(a) inclusion from FCo equal to $100K. $25K of this amount relates to business activity conducted by FCo, $55K relates to FCo earnings from its investment in FP1 and $20K relates to FCo earnings from its investment in FP2.
• FCo does not hold FP1 in FCo’s ordinary course of business.
• FCo holds FP2 in FCo’s ordinary course of business

Conclusion
• $45K is GILTI basket income and $55K is passive category income.

Analysis:
• The GILTI inclusion amount of $100K is GILTI basket income except to the extent it is treated as passive category income.
• GILTI inclusion will be passive category income to the extent it is attributable to income received by the CFC that is passive category income – see Prop Reg 1.904-5(c)(6).
• Income earned by an LP or corporate GP from a less than 10 percent owned partnership is passive category income unless it the partnership interest is held in the partner’s ordinary course of business – see Prop Reg 1.904-4(n)(1)(ii).
• FCo holds less than 10 percent of FP1 and it does not hold FP1 in its ordinary course of business. Income from FP1 therefore is passive category income.
• Of the $100K that USCo includes under 951A(a), $45K is GILTI basket income and $55K is passive category income.
• The passive category income needs to be tested for the high tax exception.
Example #4a
Clayton Thompson is a US citizen living in Texas and has the following types of income and expenses for tax year 2017:

<table>
<thead>
<tr>
<th>Income Description</th>
<th>Income</th>
<th>Tax Withheld</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wage income from US employer (services performed in the US)</td>
<td>$150,000.00</td>
<td>$35,000.00</td>
</tr>
<tr>
<td>Partnership K-1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonqualified Dividend income from US-based corporation</td>
<td>$7,500.00</td>
<td></td>
</tr>
<tr>
<td>Interest income from US government bond</td>
<td>$10,000.00</td>
<td></td>
</tr>
<tr>
<td>Nonqualified Dividend from Dutch corporation (less than 10% owned)</td>
<td>$11,000.00</td>
<td>$1,650.00</td>
</tr>
<tr>
<td>Interest income from Dutch government bond</td>
<td>$16,000.00</td>
<td>$4,800.00</td>
</tr>
<tr>
<td>Consulting services performed in the Netherlands through a foreign DRE</td>
<td>$30,000.00</td>
<td>$9,000.00</td>
</tr>
<tr>
<td>Total</td>
<td>$224,500.00</td>
<td>$50,450.00</td>
</tr>
<tr>
<td>Mortgage Interest</td>
<td></td>
<td>$24,000.00</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td></td>
<td>$750.00</td>
</tr>
<tr>
<td>Property taxes</td>
<td></td>
<td>$7,000.00</td>
</tr>
<tr>
<td>Total itemized deductions</td>
<td></td>
<td>$31,750.00</td>
</tr>
</tbody>
</table>

1. What is the source of Clayton’s income items?
2. What are the baskets of income?
3. Calculate his foreign tax credit for 2017 and calculate any excess foreign tax credits
**Example #4b**

Clayton Thompson is a US citizen living in Texas and has the following types of income and expenses for tax year 2018:

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1. **What is the source of Clayton’s income items?**
2. **What are the baskets of income?**
3. **Calculate his foreign tax credit for 2018 and calculate any excess foreign tax credits**
Foreign Tax Credit Limitations Under Section 904: New IRS Regulations and Guidance for Tax Counsel

Stanley Barsky
stanley.barsky@eisneramper.com
• New Income Categories/Baskets
  • Section 904(d)

• Carryover and Carryback Rules
  • Section 904(c)

• Section 960
    • Generally proposed to be effective for taxable years beginning after December 22, 2017.
  • Notice 2019-1
New Baskets
New Baskets - Background

• Section 904(d) provides that the section 904 limitation on FTC applies separately with respect to certain income categories (baskets).

• In general, the baskets are intended to prevent crediting high foreign taxes imposed on one type of income against US tax imposed on a different type of income that is subject to low foreign taxes.

• Pre-2018 Law
  • From 2006 until 2017, there were generally two baskets:
    • Passive, and
    • General
      • Separate application to items resourced under a treaty
  • Prior to 2006, there were up to nine baskets.
New Baskets – Background (continued)

• Pre-2018 Law (continued):
  • General:
    • The catch-all category, everything that’s not included in the Passive basket, and
    • Financial Services Company Income.
  • Passive:
    • Generally, foreign personal holding company income (FPHCI) within the meaning of section 954(c),
    • DISC dividends and FSC distributions,
    • PFIC income under section 1293,
    • EXCEPT:
      • Export-financing interest, and
      • High-taxed income.
New Baskets - Overview

- Post-2017 Law:
  - New Baskets:
    - GILTI (section 951A), and
    - Foreign Branch Income.
  - General:
    - The catch-all category, everything that’s not included in the Passive, GILTI, or Foreign Branch Income baskets.
  - Passive:
    - Generally same as pre-2018.
  - Financial Services Company Income:
    - Proposed Regulations would allocate Financial Services Company Income to either General, GILTI, or Foreign Branch Income.
      - Query whether statutory support exists for this position?
  - Passive Exceptions:
    - Proposed Regulations would allocate Export Financing Interest and High-Taxed Income to either General, GILTI, or Foreign Branch Income.
  - Treaty Income
    - Items treated as foreign-source because of a treaty are generally taken into account separately for purposes of foreign tax credits.
New Baskets - GILTI

• New GILTI Basket:
  • Amounts included in income of a United States shareholder under section 951A, other than Passive Category Income.
  • Amounts allocable to Passive Category Income are not included.
    • Such amounts may arise from a CFC’s distributive share of passive income in which the CFC owns less than 10 percent of the value in the partnership. See Prop. Treas. Reg. section 1.904-4(n)(1)(ii).
New Baskets – Foreign Branch Income

• New Foreign Branch Income Basket:
  • Foreign Branch:
    • Defined by reference to section 989 Qualified Business Unit (QBU) rules.
      • See Treas. Reg. section 1.989(a)-1(b)(2)(ii), and -1(b)(3).
    • In general, activities constitute a QBU if:
      • The activities constitute a trade or business, and
      • A separate set of books and records is maintained with respect to the activities.
    • Activities conducted through a partnership or a trust that constitute a trade or business (or permanent establishment under an applicable treaty) are a QBU even if no separate set of books and records is maintained.
    • Activities must ordinarily include the collection of income and the payment of expenses. (Compare section 355 rules.)
New Baskets – Foreign Branch Income (continued)

- Foreign Branch Income:
  - Business profits of a United States person that are attributable to a QBU.
    - Partnership income allocable to a non-pass-through United States person can be Foreign Branch Income.
  - All income is aggregated, and is not treated separately for each QBU.
  - Foreign Branch Income is generally determined by reference to the QBU’s books and records (adjusted to the extent necessary to conform to US Federal income tax principles).
    - Excludes items arising from activities carried out in the US.
    - Excludes income arising from stock (dividends, gains, and pass-through items under sections 951(a)(1), 951A(a), and 1293(a).)
      - Gains not excluded to extent stock is inventory.
      - Query why dividends and deemed income paid on inventory stock are treated differently from gains?
    - Excludes gain realized by foreign branch owner on disposition of interest in a disregarded entity or partnership.
      - Gains not excluded to extent gain is reflected on books and records of a foreign branch and interest is held in ordinary course of foreign branch owner’s trade or business.
• Foreign Branch Income (continued):
  • Anti-abuse rule if a principal purpose of recording or failing to record an item on the books and records of a QBU is tax avoidance, or avoidance of sections 904 or 250.
    • Inclusion of item of income on books of a QBU might reduce a US corporation’s FDII deduction under section 250.
  • QBU income must be adjusted to reflect disregarded transactions between a QBU and its owner, as well as disregarded transactions between or among QBUs.
    • Otherwise deductible (if not disregarded) payment from QBU to owner may result in reduction of gross income attributable to the QBU and an increase in the General Basket. Such amounts are generally reallocated from the General basket to the Foreign Branch Income basket.
    • Certain special rules apply to disregarded transactions involving contributions, remittances and payments of interest.
  • Rules for allocating and apportioning deductions under Treas. Reg. Sections 1.861-8 through -17 apply to the Foreign Branch Income basket.
Carryover and Carryback Rules
Carryovers and Carrybacks

• Foreign tax credits are generally carried back one year, or forward 10 years. Section 904(c).

• Despite increasing the number of section 904(d) baskets from two to four, TCJA did not provide any transition rules for assigning carryforwards or carrybacks of unused foreign taxes between the old and new regimes.

• The proposed regulations recognize that double taxation may result if unused foreign taxes paid, accrued or deemed paid in a pre-2018 taxable year are not assigned to the separate category to which the taxes would have been assigned if the post-2017 separate categories had existed in the pre-2018 taxable year.

• Taxpayers may assign unused foreign taxes in a pre-2018 taxable year in the General basket to the post-2017 separate Foreign Branch Income basket to the extent they would have been assigned to that basket if the taxes had been paid or accrued in a post-2017 taxable year.
Carryovers and Carrybacks (continued)

- Any remaining unused taxes are assigned to the post-2017 taxable year to the General basket.
- The exception does not apply to deemed paid taxes, because income derived through foreign corporations is not Foreign Branch Income.
- Taxpayers must analyze the general category income in pre-2018 taxable years to determine the extent to which the income would have been allocated to the Foreign Branch Income basket.
- The exception does not apply to Passive basket items.
- Comments requested on whether final regulations should include a simplified rule to avoid difficulties in reconstructing the allocation of unused foreign taxes.
Any unused foreign taxes from a pre-2018 taxable year may not be assigned to the GILTI basket.

- The proposed regulations explain that the determination of taxable income in the GILTI basket “is intertwined with numerous other new provisions in the Code outside of section 904 that contain novel elements . . . that did not exist under prior law.”

Any Foreign Branch Income basket and General basket taxes paid or incurred in a post-2017 taxable year that are carried back to a pre-2018 taxable year are allocated to the pre-2018 General basket.

Any Passive basket and specified separate category taxes paid or incurred in a post-2017 taxable year that are carried back to a pre-2018 taxable year are allocated to the same pre-2018 separate category.
Section 960
Old Section 960 - Background

• Prior to the TCJA, section 960 provided for an indirect credit to domestic corporations for inclusions under section 951.
  • Available for inclusions from up to sixth-tier subsidiaries.
  • Generally increased the limit under section 904.
  • Sections 78 and 962 were coordinated with section 960.
  • Adopted the pre-1987 and post-1986 pools of section 902.
  • Coordinated with section 902.
Changes to section 960 generally included:

- Removal of the rules coordinating between sections 960 and 902, to reflect the repeal of section 902.
  - Coordination with section 959.
- Addition of new rules to address the new section 951A.
- Removal of the pooling rules. Instead, foreign tax credit is granted for foreign taxes that are “properly attributable” to the income included under sections 951 or 951A (generally limited to 80 percent in the case of section 951A).
- In addition, the proposed section 960 regulations attribute the current year foreign income taxes of the CFC to current year income of the CFC or a distribution of previously taxed E&P (PTEP) received by the CFC.
  - Such taxes may be deemed paid by the US shareholder or upper-tier CFC under section 960.
  - Foreign income taxes include income, war profits and excess foreign profits taxes imposed by a foreign country or a possession of the US.
  - Current year taxes are ones that are paid or accrued in the current year by the CFC, under the rules of section 461 and the “relation-back” doctrine.
    - Taxes generally accrue in the year in which the income arises.
Section 960 Computational Rules Detailed Review

- Prop. Treas. Reg. section 1.960-1(c)(1) (applied at the lowest-tier CFC first):
  - First, assign items of gross income of the CFC for the current taxable year (other than a section 959(b) distribution) to section 904 baskets and to income groups within those baskets.
    - Section 959(b) distributions are accounted for under Prop. Reg. section 1.960-3(c)(3).
  - Second, deductions (other than for current year taxes) of the CFC for the current taxable year are allocated and apportioned to reduce GI in the section 904 baskets and income groups.
    - Current year taxes allocated and apportioned to income groups and PTEP groups in the section 904 baskets are translated to USD under section 986. Prop. Reg. section 1.960-1(c)(3).
Section 960 Computational Rules Detailed Review

• Prop. Treas. Reg. section 1.960-1(c)(1) (continued):
  • Third, current year taxes deemed paid under section 960(a) and (d) by domestic corporation with respect to CFC income are computed.
    • In addition, foreign income taxes deemed paid under section 960(b)(2) with respect to receipt of a section 959(b) distribution by the CFC are computed under Prop. Reg. section 1.960-3(b).
  • Fourth, any PTEP of the CFC resulting from subpart F inclusions and GILTI inclusions with respect to the CFC’s current taxable year are separated from other E&P of the CFC and added to an annual PTEP account, and a PTEP group within the PTEP account.
    • Prop. Reg. section 1.960-3(c).
  • Fifth, steps 1 through 4 are repeated for each next higher-tier CFC.
  • Sixth, with respect to the highest-tier CFC that is directly owned by the domestic shareholder, foreign income taxes that are deemed paid under section 960(b)(1) in connection with the receipt of a section 959(a) distribution are computed under Prop. Reg. section 1.960-3(b).
Section 960 Computational Rules Detailed Review

• Step 1: Prop. Treas. Reg. section 1.960-1(d)(2):
  • First, assign items of gross income of the CFC for the current taxable year to section 904 baskets.
    • Can’t assign to the GILTI basket or the Foreign Branch basket.
    • Rules under 1.904-4, 1.904-5. Also 1.960-3(c)(1) in case of a section 959(b) distribution.
  • Second, assign to an income group (or a PTEP group under 1.960-3(c)(3)).
    • Subpart F income groups.
      • Items of foreign base company income treated as a single item of income under §1.954-1(c)(1)(iii);
      • Section 952(a)(1) insurance income;
      • Section 952(a)(3) international boycott income;
      • Section 952(a)(4) bribes and kickbacks; and
      • Section 952(a)(5 / 901(j) income.
    • Tested income groups. TIG is an income group that consist of tested income within a section 904 basket. Gross income items within each section 904 basket are aggregated and treated as gross income in a separate tested income group.
    • Residual income group. Everything else.
Section 960 Computational Rules Detailed Review

  • First, allocate and apportion to reduce gross income (or create a loss) in each section 904 basket and income group within a basket any deductions of the CFC that are definitely related to less than all of the CFC’s gross income as a class.
    • Sections 861 through 865 and 904(d) apply.
    • Special rules for current year taxes.
  • Second, related person interest expense is allocated and apportioned among the subpart F income groups within the Passive basket under the principles of section 1.904-5(c)(2) and 1.954-1(c)(1)(i).
  • Third, any remaining deductions are allocated and apportioned under the rules of sections 861 through 865 and 904(d).
    • No deductions of the CFC for the current taxable year other than a deduction for current year taxes imposed solely by receipt of a section 959(b) distribution are allocated or apportioned to reduce E&P in a PTEP group.
Section 960 Computational Rules Detailed Review

  - Current year taxes are allocated and apportioned among the section 904 baskets under the rules of §1.904-6(a)(1)(i) and (ii) on the basis of the amount of taxable income computed under foreign law in each section 904 basket that is included in the foreign tax base.
  - Current year taxes in a section 904 basket are then allocated and apportioned among the income groups within a section 904 basket under the principles of §1.904-6(a)(1)(i) and (ii). Sections 861 through 865 and 904(d) apply.
  - If the amount of previously taxed earnings and profits in a PTEP group is increased in the current taxable year of the CFC by reason of the receipt of a section 959(b) distribution, then for purposes of allocating and apportioning current year taxes that are imposed solely by reason of the receipt of the section 959(b) distribution under this paragraph (d)(3)(ii)(A), the PTEP group is treated as an income group within the section 904 basket.
    - In applying §1.904-6(a)(1)(i) and (ii) for purposes of this paragraph (d)(3)(ii)(A), the gross items of income and deduction calculated under foreign law are the items that are included in taxable income under foreign law for the foreign taxable year of the CFC that ends with or within the CFC’s current taxable year.
    - For purposes of determining foreign income taxes deemed paid under the rules in §§1.960-2 and 1.960-3, the U.S. dollar amounts of current year taxes are assigned to the section 904 baskets, income groups, and PTEP groups, if any, to which the current year taxes are allocated and apportioned.
Section 960 Computational Rules Detailed Review

  - Base and timing differences
    - Current year taxes that are attributable to a base difference described in §1.904-6(a)(1)(iv) are treated as related to income in the residual income group.
    - In general, current year taxes that are attributable to a timing difference described in §1.904-6(a)(1)(iv) are treated as related to the appropriate section 904 basket and income group to which the particular tax would be assigned if the income on which the tax is imposed were recognized under Federal income tax principles in the year in which the tax was imposed.
      - Current year taxes imposed solely by reason of the controlled foreign corporation's receipt of a section 959(b) distribution are allocated or apportioned to a PTEP group.
      - Current year taxes imposed with respect to previously taxed earnings and profits by reason of any other timing difference are allocated or apportioned, under the general rule described in paragraph (d)(3)(ii)(B)(1) of this section, to the income group to which the income that gave rise to the previously taxed earnings and profits was assigned in the inclusion year.
Section 960 Computational Rules Detailed Review

  • Base and timing differences (continued)
    • Examples:
      • A net basis tax imposed on a CFC’s receipt of a section 959(b) distribution by the corporation's country of residence is allocated or apportioned to a PTEP group.
      • Similarly, a withholding tax imposed with respect to a CFC’s receipt of a section 959(b) distribution is allocated and apportioned to a PTEP group.
      • By contrast, a withholding tax imposed on a disregarded payment from a disregarded entity to its CFC owner is treated as a timing difference and is never treated as related to a PTEP group, even if all of the CFC’s earnings are PTEP, because the tax is not imposed solely by reason of a section 959(b) distribution. Such a withholding tax, however, may be treated as related to a subpart F income group or tested income group under the general rule for timing differences.
• Step 3: Prop. Treas. Reg. section 1.960-2:
  • Section 960(a) (subpart F income):
    • For each section 904 basket, the domestic corporation is deemed to have paid foreign income taxes equal to the sum of the CFC’s foreign income taxes that are properly attributable to the items of income in the subpart F income groups to which the subpart F inclusion is attributable.
      • See §1.904-6(b)(1) for rules on assigning the foreign income tax to a section 904 category.
      • No foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B).
    • The CFC’s foreign income taxes that are properly attributable to the items of income in the subpart F income group of the CFC to which a subpart F inclusion is attributable equals the domestic corporation's proportionate share of the current year taxes of the CFC that are allocated and apportioned under §1.960-1(d)(3)(ii) to the subpart F income group.
Section 960 Computational Rules Detailed Review

• Step 3: Prop. Treas. Reg. section 1.960-2:
  • Section 960(a) (subpart F income) (continued):
    • A domestic corporation's proportionate share of the current year taxes of a CFC that are allocated and apportioned under §1.960-1(d)(3)(ii) to a subpart F income group is equal to the total U.S. dollar amount of current year taxes that are allocated and apportioned under §1.960-1(d)(3)(ii) to the subpart F income group multiplied by a fraction (not to exceed one), the numerator of which is the portion of the domestic corporation's subpart F inclusion that is attributable to the subpart F income group and the denominator of which is the total net income in the subpart F income group, both determined in the functional currency of the controlled foreign corporation.
      • If the numerator or denominator of the fraction is zero or less than zero, then the proportionate share of the current year taxes that are allocated and apportioned under §1.960-1(d)(3)(ii) to the subpart F income group is zero.
    • Neither an accumulated deficit nor any prior year deficit in the E&P of a CFC reduces its net income in a subpart F income group. Accordingly, any such deficit does not affect the denominator.
      • Any reduction to the domestic corporation's subpart F inclusion under section 952(c)(1)(B) is reflected in the numerator of the fraction.
    • If an amount of income in a subpart F income group is excluded from the subpart F income of the CFC under section 952(c)(1)(A) or (C), the denominator is reduced (but not below zero) by the amount excluded.
    • The distributive share of a U.S. shareholder partner of a U.S. shareholder partnership's subpart F inclusion with respect to the partnership CFC is a subpart F inclusion of the U.S. shareholder partner with respect to the partnership CFC.
Section 960 Computational Rules Detailed Review

• Step 3: Prop. Treas. Reg. section 1.960-2:
  • Section 960(d) (GILTI):
    • A domestic corporation is deemed to have paid an amount of foreign income taxes equal to 80 percent of the product of its inclusion percentage multiplied by the sum of all tested foreign income taxes in the tested foreign income group within each section 904 basket.
    • “Inclusion percentage” means the domestic corporation's GILTI inclusion amount divided by the aggregate amount described in section 951A(c)(1)(A) and §1.951A-1(c)(2)(i) with respect to the United States shareholder.
    • “Tested foreign income taxes” means the amount of the CFC's foreign income taxes that are properly attributable to tested income taken into account by the domestic corporation under section 951A and §1.951A-1.
Section 960 Computational Rules Detailed Review

- Step 3: Prop. Treas. Reg. section 1.960-2:
  - Section 960(d) (GILTI):
    - CFC’s foreign income taxes that are properly attributable to tested income taken into account by the domestic corporation under section 951A(a) and §1.951A-1(b) equals the domestic corporation's proportionate share of the current year taxes of the CFC that are allocated and apportioned under §1.960-1(d)(3)(ii) to the tested income group within each section 904 basket of the controlled foreign corporation.
    - “Proportionate share” is the U.S. dollar amount of current year taxes that are allocated and apportioned under §1.960-1(d)(3)(ii) to a tested income group within a section 904 basket of the CFC multiplied by a fraction (not to exceed one), the numerator of which is the portion of the tested income of the CFC in the tested income group within the section 904 category that is included in computing the domestic corporation's aggregate amount described in section 951A(c)(1)(A) and §1.951A-1(c)(2)(i), and the denominator of which is the income in the tested income group within the section 904 basket, both determined in the functional currency of the controlled foreign corporation. If the numerator or denominator of the fraction is zero or less than zero, the domestic corporation's proportionate share of the current year taxes allocated and apportioned under §1.960-1(d)(3)(ii) to the tested income group is zero.
Section 960 Computational Rules Detailed Review

- Step 4: Prop. Reg. section 1.960-3(c):
  - The regulations establish, for purposes of determining the amount of foreign income taxes deemed paid, a system of accounting for PTEP in annual accounts for each separate section 904 basket, and further segregate each annual account among ten PTEP groups.
  - A separate, annual account (annual PTEP account) must be established for the previously taxed E&P of the CFC to which inclusions under section 951(a) and GILTI inclusion amounts of United States shareholders of the CFC are attributable.
  - Each account must correspond to the inclusion year of the previously taxed E&P and to the section 904 basket to which the inclusions under section 951(a) or GILTI inclusion amounts were assigned at the level of the United States shareholders.
  - Thus, a CFC may have an annual PTEP account in the section 951A category or a treaty category (as defined in §1.861-13(b)(6)), even though income of the CFC that gave rise to the previously taxed earnings and profits cannot initially be assigned to the section 951A category or a treaty category.
Section 960 Computational Rules Detailed Review

- Step 4: Prop. Reg. section 1.960-3(c):
  - The amount in an annual PTEP account is further assigned to one or more groups of previously taxed earnings and profits (each, a PTEP group) within the account.
  - Notice 2019-1 states that there would be 16 PTEP groups. The Notice explains:
    - The Act created the need to account for new groups of PTEP because section 959(c)(2) PTEP may arise by reason of income inclusions under section 951(a)(1)(A), 245A(e)(2), 951A(f)(1), 959(e), 964(e)(4), or 965(a) or by reason of the application of section 965(b)(4)(A), and those different groups of PTEP may be subject to different rules under sections 960, 965(g), 245A(e)(3), and 986(c). Additionally, because section 959(c)(2) PTEP may be reclassified as section 959(c)(1) PTEP as a result of sections 956 and 959(a)(2), similar groups for section 959(c)(1) PTEP must be maintained in order to properly apply sections 960, 965(g), 245A(e)(3), and 986(c) when earnings are reclassified. Groups of section 959(c)(1) PTEP must also be maintained with respect to inclusions under section 951(a)(1)(B) and section 951(a)(1)(C) (before its repeal) (in such cases, not by reason of the application of section 959(a)(2) or section 959(a)(3) (before its repeal)).
    - The Treasury Department and the IRS expect that the forthcoming regulations will provide that an annual PTEP account must be maintained and each annual PTEP account must be segregated into the 16 groups described below in each section 904 category (individually, a “PTEP group” and collectively, “PTEP groups”).
    - Accordingly, after the Act, section 959(c)(1) PTEP will be comprised of PTEP groups described in (1) through (9) of the preceding paragraph, and section 959(c)(2) PTEP will be comprised of PTEP groups described in (10) through (16) of the preceding paragraph.
Step 4: Prop. Reg. section 1.960-3(c):

- With respect to a CFC that receives a section 959(b) distribution, such distribution amount is added to the annual PTEP account, and PTEP group within the annual PTEP account, that corresponds to the inclusion year and section 904 category of the annual PTEP account, and PTEP group within the annual PTEP account, from which the distributing CFC is treated as making the distribution under section 959.

- Similarly, with respect to a CFC that makes a section 959 distribution, such distribution amount reduces the annual PTEP account, and PTEP group within the annual PTEP account, that corresponds to the inclusion year and section 904 category of the annual PTEP account, and PTEP group within the annual PTEP account, from which the CFC is treated as making the distribution under section 959 and the regulations under that section. E&Pin a PTEP group are reduced by the amount of current year taxes that are allocated and apportioned to the PTEP group under §1.960-1(d)(3)(ii), and the U.S. dollar amount of the taxes are added to an account of PTEP group taxes under the rules in paragraph (d)(1) of this section.
Section 960 Computational Rules Detailed Review

• Step 4: Prop. Reg. section 1.960-3(c):
  • If an amount of previously taxed E&P that is in a section 959(c)(2) PTEP group is reclassified as previously taxed earnings and profits described in section 959(c)(1) (reclassified previously taxed earnings and profits), the section 959(c)(2) PTEP group is reduced by the functional currency amount of the reclassified previously taxed earnings and profits. This amount is added to the corresponding PTEP group described in paragraphs (c)(2)(ii) through (v) of this section (each, a reclassified PTEP group) in the same section 904 category and same annual PTEP account as the reduced section 959(c)(2) PTEP group.

• Step 5.
  • Each of steps 1 through 4 are repeated for the higher-tier CFCs.
Section 960 Computational Rules Detailed Review

• Step 6: Prop. Reg. section 1.960-3(b):
  • If a CFC makes a section 959(a) distribution with respect to a PTEP group within a section 904 category, the domestic corporation is deemed to have paid the amount of the foreign corporation's foreign income taxes that are properly attributable to the section 959(a) distribution with respect to the PTEP group and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year.
    • See §1.965-5(c)(1)(iii) for rules disallowing credits in relation to a distribution of certain previously taxed earnings and profits resulting from the application of section 965.
  • For each section 904 category, the domestic corporation is deemed to have paid foreign income taxes equal to the sum of the CFC’s foreign income taxes that are properly attributable to section 959(a) distributions with respect to all PTEP groups within the section 904 category. See § 1.904-6(b)(2) for rules on assigning the foreign income tax to a section 904 category.
Step 6: Prop. Reg. section 1.960-3(b):

- If a distributing CFC makes a distribution to a recipient CFC and the distribution is, in whole or in part, a section 959(b) distribution from a PTEP group within a section 904 category, the recipient CFC is deemed to have paid the amount of the distributing CFC’s foreign income taxes that are properly attributable to the section 959(b) distribution from the PTEP group and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year.
  - See § 1.904-6(b)(3) for rules on assigning the foreign income tax to a section 904 category.
Section 960 Computational Rules Detailed Review

• Step 6: Prop. Reg. section 1.960-3(b):
  • The amount of foreign income taxes that are properly attributable to a section 959 distribution from a PTEP group within a section 904 category equals the domestic corporation's or recipient CFC’s proportionate share of the PTEP group taxes with respect to the PTEP group within the section 904 category.
  • Proportionate share of the PTEP group taxes with respect to a PTEP group within a section 904 category is equal to the total amount of the PTEP group taxes with respect to the PTEP group multiplied by a fraction (not to exceed one), the numerator of which is the amount of the section 959 distribution from the PTEP group, and the denominator of which is the total amount of previously taxed E&P in the PTEP group, both determined in the functional currency of the CFC. If the numerator or denominator of the fraction is zero or less than zero, then the proportionate share of the PTEP group taxes with respect to the PTEP group is zero.
Section 960 Computational Rules Detailed Review

• Step 6: Prop. Reg. section 1.960-3(b):
  • In the case of a domestic partnership that is a U.S. shareholder partnership with respect to a partnership CFC, the distributive share of a U.S. shareholder partner of a U.S. shareholder partnership's section 959(a) distribution from the partnership CFC is treated as a section 959(a) distribution received by the U.S. shareholder partner from the partnership CFC.
  • PTEP Group Taxes.
    • U.S. dollar amount of foreign income taxes (translated in accordance with section 986(a)) that are paid, accrued, or deemed paid with respect to an amount in each PTEP group within an annual PTEP account.
Section 960 Computational Rules Detailed Review

• Step 6: Prop. Reg. section 1.960-3(b):
  • PTEP Group Taxes (continued).
    • The foreign income taxes that are paid, accrued, or deemed paid with respect to a PTEP group within an annual PTEP account of a controlled foreign corporation are
      The sum of:
      • The current year taxes paid or accrued by the CFC that are allocated and apportioned to the PTEP group under §1.960-1(d)(3)(ii);
      • Foreign income taxes that are deemed paid by the CFC with respect to a section 959(b) distribution received by the CFC, the amount of which is added to the PTEP group; and
      • In the case of a reclassified PTEP group of the controlled foreign corporation, reclassified PTEP group taxes that are attributable to the section 959(c)(2) PTEP group that corresponds to the reclassified PTEP group;
    Reduced by:
    • Foreign income taxes that were deemed paid by another CFC that received a section 959(b) distribution from the CFC, the amount of which is subtracted from the CFC’s PTEP group;
    • Foreign income taxes that were deemed paid a United States shareholder of the CFC that received a section 959(a) distribution from the CFC, the amount of which is subtracted from the CFC’s PTEP; and
    • In the case of a section 959(c)(2) PTEP group of the CFC, reclassified PTEP group taxes.
Section 960 Computational Rules Detailed Review

• Step 6: Prop. Reg. section 1.960-3(b):
  • PTEP Group Taxes (continued).
    • Reclassified PTEP group taxes are foreign income taxes that are initially included in PTEP group taxes with respect to a section 959(c)(2) PTEP group multiplied by a fraction, the numerator of which is the portion of the previously taxed E&P in the section 959(c)(2) PTEP group that become reclassified previously taxed E&P, and the denominator of which is the total previously taxed earnings and profits in the section 959(c)(2) PTEP group.
    • Foreign income taxes paid or accrued with respect to an annual PTEP account, and a PTEP group within such account, that was established for an inclusion year that begins before January 1, 2018, are treated as PTEP group taxes of a CFC for purposes of this section only if those foreign income taxes were—
      • Paid or accrued in a taxable year of the CFC that began before 2018;
      • Not included in a CFC’s post-1986 foreign income taxes (as defined in section 902(c)(2) as in effect on December 21, 2017) used to compute foreign taxes deemed paid under section 902 (as in effect on December 21, 2017) in any taxable year that began before January 1, 2018; and
      • Not treated as deemed paid under section 960(a)(3) (as in effect on December 21, 2017) by a domestic corporation that was a United States shareholder of the controlled foreign corporation.
Thank you
Thank You

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