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New IRS Foreign Tax Credit Regulations: Allocating Expenses, Assigning Foreign Taxes to Income Groups, GILTI, NOLs

THURSDAY, APRIL 16, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Emphasis:
International Tax
Tax Planning
Tax Controversy

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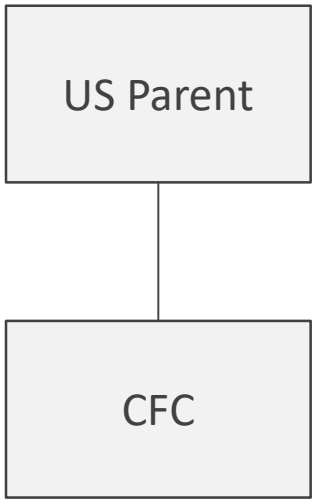
  He graduated from Harvard College and Yale Law School, where he was an Articles Editor of the Yale Law Journal. He focuses his practice on U.S. international corporate taxation, M&A taxation and tax controversies.

Section 960 Regulations

Indirect credit under § 960 regulations

- Credit is available for tax paid by CFC
- Current-year tax only; no more pooling
- Applies to subpart F and GILTI only; no deemed paid tax for § 956 inclusion
- "Inclusion percentage" for taxes with respect to tested income
- Further 20% haircut for taxes related to tested income

$100 Income
$80 Subpart F Income
or GILTI + $20 § 78 Gross-up
$20/$16 Indirect Credit
(Sub F)/(GILTI)



$100 Income
<20> Foreign Tax
$80 Net Income

Allocating foreign income and tax

- Begin with the lowest-tier CFC in the chain
- Assign income (other than § 959(b) PTEP distributions) to § 904(d) categories and income groups within those categories
- Allocate deductions to those groups, and allocate the functional currency amount of current-year taxes
- Compute current-year taxes deemed paid
- Separate PTEP E&P into PTEP account
- Repeat this process for each CFC up the chain
- E&P calculations are in functional currency; deemed paid taxes are in US dollars

Grouping of CFC income and taxes

- CFC divides its income and current year taxes into several groupings for credit purposes:
- Subpart F income groups consisting of each item of income that is a separate item under Reg. § 1.954-1(c)(1)(iii)
- The Tested Income group (i.e., GILTI)
- The Residual Income group
- Deductions at the CFC level are allocated and apportioned among the groups using IRC Section 861 principles.
- Indirect credits may be claimed for current year taxes only, and only from the first two groups. Taxes attributable to the residual category are never creditable. *See* Reg. § 1.960-1(e).
- No creditable tax from group if loss in that group.

Grouping of CFC income and taxes

- Separate subpart F income groups:
  - Dividends, interest, rents, royalties and annuities
  - Gain from certain property transactions
  - Gain from commodities transactions
  - Foreign currency gain
  - Income equivalent to interest
  - Passive FPHC income is further subdivided into groups described in Reg. § 1.904-4(c)(3)-(5)
  - Separate groups for foreign base company sales income, services income, shipping income, or oil related income, and full inclusion foreign base company income

Calculating creditable tax

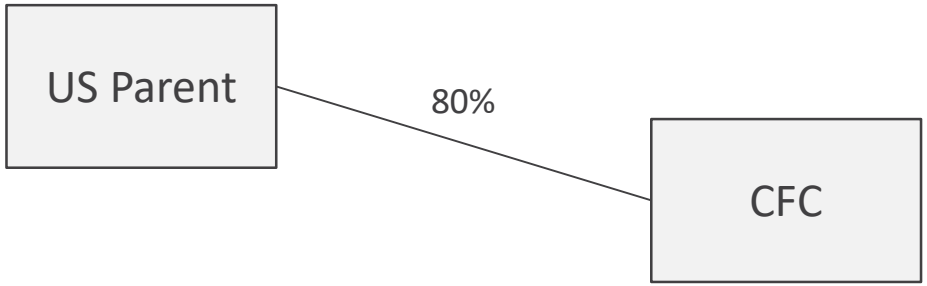
- For each CFC, the shareholder's indirect credit from a Subpart F income group is generally equal to the amount of the shareholder's inclusion as a fraction of all income in that group.
- As under pre-2018 law, the application of the current-year E&P limitation will reduce both the numerator and denominator of the credit fraction.
- For the tested income group, the shareholder includes a fraction of the CFC's taxes attributable to tested income equal to the shareholder's inclusion percentage, which is the shareholder's GILTI inclusion amount divided by the aggregate amount of the shareholder's pro rata share of the tested income of each tested income CFC in which it is a United States shareholder.

Reg. § 1.960-1(d)(2)(E), Example 1

		CFC (Country X) Note - Country X has no Income Tax			
Subpart F Income Groups:					
	Portfolio Dividend	Portfolio Interest	Passive Royalty	FBC Services	FBC Sales
Income	$100K	$1.5M	$70K	$450K	$50K
Taxes	$15K (Third Country Withholding Tax)	$0	$0	$0	$0
Income Groups	$100K	$1.57M		$450K	$50K

- Dividend income is separate from other items in 954(c)(1)(A) because subject to high withholding tax. *See* Reg. § 1.904-4(c).

Reg. § 1.960-2(b)(5), Example



CFC Income Categories			
	Passive Dividend Income	Passive Commodities Income	Foreign Base Company Services Income
Income	$1mm	$2.4mm	$1.8mm
Taxes	$50,000	$240,000	$450,000
ETR	5%	10%	25%

- US Parent includes 80% of the subpart F income and 80% of the taxes in each group.

Alternative example with losses

CFC Income Categories			
	Passive Dividend Income	Passive Commodities Income	Foreign Base Company Services Income
Income	$1mm	<$500,000>	$1.8mm
Taxes	$50,000	$100,000	$450,000
ETR	5%	N/A	25%

- Assume US Parent owns 100% of CFC. US Parent's passive basket subpart F inclusion is limited to $500,000 because of the E&P limitation, but entire $50,000 of taxes in passive dividend income group are creditable. *See* Reg. § 1.960-2(b)(3)(iii).
- The $100,000 of taxes in the passive commodities income group are not creditable because income in the group is negative.

PTEP groups

- A separate annual PTEP account for each § 904 category (assigned at the level of the United States shareholder) is established with respect to previously taxed earnings and profits to which GILTI or Subpart F inclusions are attributable.
    - Thus, there can be a GILTI category or treaty category.
- Within each account, PTEP is assigned to ten (not 16) groups:
- Reclassified section 965(a) PTEP
- Reclassified section 965(b) PTEP
- General section 959(c)(1) PTEP
- Reclassified section 951A PTEP
- Reclassified section 245A(d) PTEP
- Section 965(a) PTEP
- Section 965(b) PTEP
- Section 951A PTEP
- Section 245A(d) PTEP
- Section 951(a)(1)(A) PTEP

PTEP groups

- Each PTEP group and related foreign income taxes must be maintained in annual layers.
- As PTEP is distributed up the chain and withholding taxes are incurred, the E&P remains in the same PTEP group and annual layer in the hands of the recipient as it was in the hands of the distributing corporation.
- For example, if during 2020, CFC2 makes a distribution of 2018 PTEP to CFC1, the PTEP and any taxes will be assigned to CFC1's 2018 PTEP account layer.
- § 986(c) currency gain or loss with respect to a distribution of PTEP is assigned to the same basket as the E&P from which the distribution is made.

Prop. Reg. § 1.860-20

Prop. Reg. § 1.861-20: Basics

- Prop. Reg. § 1.861-20 sets forth rules for allocating and apportioning foreign income taxes
- Applies for taxable years beginning after December 31, 2019
- Contains many provisions currently addressed in Reg. § 1.904-6
- Is very important given the large number of categories under the new § 960 regulations
- Prop. Reg. § 1.861-20 is proposed to apply except as modified by an operative section, such as Regs. §§ 1.704-1(b)(4)(viii)(d)(1), 1.904-6, 1.960-1(d)(3)(ii), and 1.965-5(b)(2)

Prop. Reg. § 1.861-20: Basics

- First, assign items of foreign gross income to the groupings
- Second, allocate and apportion foreign law deductions to that income
- Finally, assign the foreign tax to the groupings in accordance with foreign law

Prop. Reg. § 1.861-20: Corresponding items

- Key concept: "Corresponding item"
  - Item of U.S. gross income or loss arising from the same transaction or realization event from which the item of foreign gross income arises
  - Must be realized, recognized, or taken into account in the same U.S. taxable year that the foreign tax was paid or accrued
  - Cannot be exempt, excluded, or eliminated from U.S. gross income
  - Need not be the same amount as the item of foreign gross income

Prop. Reg. § 1.861-20: General rules

- Generally, if there is a corresponding item and it is a gain, the item of foreign gross income is assigned to the group to which the corresponding item is assigned
- Generally, if there is a corresponding item and it is a loss or zero, the item of foreign gross income is assigned to the group to which it would have been assigned if the transaction had given rise to a gain rather than a US loss or zero
- If there is no corresponding item because of a tax year difference, the item of foreign income is assigned to the grouping to which the corresponding U.S. item would be assigned if the event giving rise to the foreign gross income resulted in the recognition of gross income or loss under Federal income tax law in that U.S. taxable year

Prop. Reg. § 1.861-20: General rules

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- If there is no corresponding item because of a tax year difference, the item of foreign income is assigned to the grouping to which the corresponding U.S. item would be assigned if the event giving rise to the foreign gross income resulted in the recognition of gross income or loss in that U.S. taxable year
- If income is excluded from U.S. tax, allocate as if it were not, unless the income appears on the base difference list

Base differences

Prop. Reg. § 1.860-20(d)(2)(ii)(B) provides an exclusive list of base differences (assigned to category described in § 904(d)(2)(H)(i)):

- Death benefits described in § 101
- Gifts and inheritances described in § 102
- Contributions to capital described in § 118
- The receipt of money or other property in exchange for stock described in § 1032 (including by reason of a transfer described in § 351)
- The receipt of money or other property in exchange for a partnership interest described in § 721
- The portion of a corporate distribution described in § 301(c)(2)
- A distribution to a partner described in § 733

Special rules

- To the extent foreign law treats a greater portion of a distribution as a dividend than U.S. law does, the excess is allocated as a base difference amount (up to the U.S. return of capital amount) and then as capital gain
- The foreign capital gain amount is assigned to the group applicable to the U.S. capital gain amount (up to the U.S. capital gain amount), then as a base difference amount (up to the U.S. return of capital amount) and then, proportionately, to the groups to which the foreign dividend amount was allocated
- Items of foreign income included by a shareholder under a foreign subpart F regime are assigned to a group by reference to the income that produced the foreign subpart F inclusion

Disregarded payments

- Disregarded payment made by a disregarded entity or other foreign branch is generally assigned to statutory and residual groupings based on the income of the branch, which is deemed to have arisen in the groupings in the same ratio as the tax book value of the branch's assets (subject to an anti-abuse rule)
    - This rule is modified for purposes of § 904
- Disregarded payment made by a foreign branch owner is assigned to the residual grouping
    - This disallows credit for taxes imposed on a payment by a branch owner to its branch
    - This rule also is modified for purposes of § 904

Prop. Reg. § 1.860-20(g), Example 2

- US entity sells CFC stock to a third party for $800x
- Country A imposes $80x tax
- US taxes transaction as dividend under § 1248
- Reg. §§ 1.904-4(d) and 1.904-5(c)(4) classify the U.S. income as general category
- The $800x of foreign income is classified as general category, in line with the corresponding U.S. item despite the fact that for foreign law purposes it is gain from the sale of stock, which would be passive
- The $80x foreign tax is placed in the same category as the income

Prop. Reg. § 1.860-20(g), Example 5

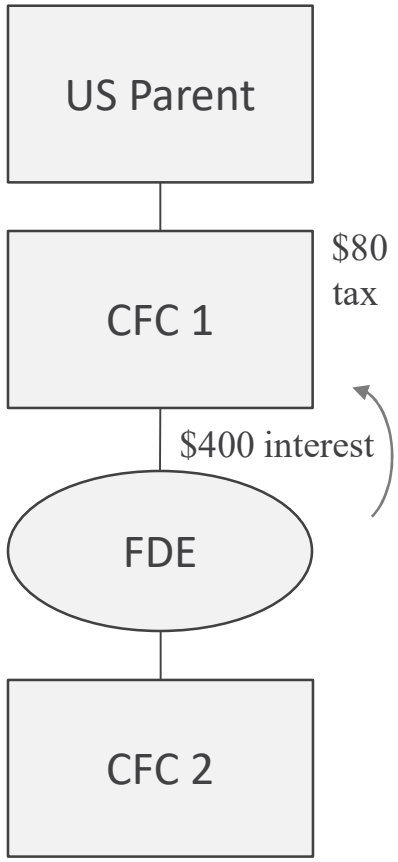
	Dividend	Tax on Dividend	Return of Basis	Capital Gain	Tax on Capital Gain
Foreign law	$100x	$20x	$160x	$40x	$4x
U.S.	$150x		$100x	$50x	

- Because foreign dividend < U.S. dividend, all is allocated to same group as U.S. dividend, as is all tax on dividend
- Because foreign capital gain < U.S. capital gain, all is allocated to same group as U.S. capital gain, as is all tax on capital gain

Prop. Reg. § 1.860-20(g), Example 9

Tax Book Value of FDE Assets (including CFC 2 stock)	
General category	Passive category
$750	$250

- $400 interest is allocated in proportion to the tax book value of FDE's assets
- General: $400 x $750/($750 + $250) = $300
- Passive: $400 x $250/($750 + $250) = $100
- Tax is allocated in same proportions
- General: $60
- Passive: $20



Redeterminations under § 905(c)

Proposed § 905(c) regulations: Overview

- Temporary regulations were published in 2007 but have been revised and re-proposed to reflect changes from the Tax Cuts and Jobs Act.
- The proposed regulations cover:
    - Redeterminations of deemed paid taxes
    - Procedural rules for notifying the IRS of a redetermination
    - A transition rule

Redetermination regulation basics

- Any foreign tax redetermination requires an adjustment in the year to which the redetermination relates (rather than the year a refund is received)
- The adjustment includes
    - Amount of foreign taxes deemed paid
    - § 78 gross-up
    - E&P
    - Subpart F inclusion and GILTI inclusion
- Eventually fewer adjustments to intervening years because of current-year nature of the new FTC regime
- Mess for redeterminations that relate to pre-TCJA years

Redetermination triggers

- Redetermination occurs if
  - Accrued tax remains unpaid after two years
  - Foreign tax is refunded in whole or in part
  - Foreign tax liability increases
  - These triggers apply if they affect US tax liability (e.g., eligibility for the high-tax kick-out), even if they make no change in the amount of foreign tax credit claimed

Redetermination triggers, successors

- Redetermination occurs if
  - Accrued tax remains unpaid after two years
  - Foreign tax is refunded in whole or in part
  - Foreign tax liability increases
  - These triggers apply if they affect US tax liability (e.g., eligibility for the high-tax kick-out), even if they make no change in the amount of foreign tax credit claimed
- If refund is received or an additional payment is made by a successor entity, redetermination is made as if tax was reduced or increased for the predecessor in the year to which the refund or additional payment of tax relates

Reporting requirement

- Generally, file amended return
  - Form 1116 or 1118 if U.S. liability changes, and file explanatory statement
  - Due by due date for return for the year in which the redetermination occurred (if increased liability)
  - Otherwise, limitations period for refund applies
  - Generally one return for each redetermination, except that redeterminations in successive years can be combined on a single return
  - Taxpayers under audit by Large Business and International division for redetermination year can notify exam team instead of filing amended return

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- Taxpayers under audit by Large Business and International for redetermination year can notify exam team instead of filing amended return

Information required

- Identification details
- Dates and amounts of taxes, exchange rates
- Info sufficient to determine any change to characterization of any distribution, income inclusion, deferred tax under § 1291
- Info needed for interest calculations
- Dates and amounts of refunds, and relevant exchange rates
- For foreign taxes unpaid after 2 years, amount of tax in foreign currency, exchange rate used to calculate credit or PTEP
- If increase in U.S. tax liability is not totally covered by carryback or carryforward of FTCs, info required by § 904 regs
- In the case of a passthrough, info about beneficial owners

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- In the case of a passthrough, info about beneficial owners

Transition rule

- Redeterminations with respect to pre-TCJA require adjusting taxable income, E&P, E&P pool, and foreign tax pool
- Redetermination of U.S. tax liability info for each United States shareholder for year to which the taxes relate and subsequent years and any years to which unused foreign taxes were carried forward or back
- Treasury and the IRS requested comments on whether a single adjustment in the last pre-TCJA taxable year would be a better approach

Effective dates

- Final § 960 regulations generally are effective for taxable years that begin after December 31, 2017, and end on or after December 4, 2018.
- Many of the proposed foreign tax credit regulations published on December 17, 2019, are proposed to apply to taxable years "ending on or after" that date.
- They therefore will influence how calendar year taxpayers file their 2019 returns.

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Foreign Tax Credit Final and Proposed Regulations Issued December 2019

Melody Horton
Shareholder
International Tax Practice Services Leader
April 16, 2020

Final and Proposed FTC Regulations

The final regulations (T.D. 9882) and the proposed regulations (Reg-105495-190) largely retain the provisions of the 2018 proposed regulations (with revisions) and provide further guidance for the Tax Cuts and Jobs Act (TCJA).

Final and Proposed FTC Regulations

Broad Application to many provisions:

- *Final Regulations*
- Sections 861, 901, 904, 905, 954, 960, 965 and 986
- *Proposed Regulations*
- *Sections 704, 861, 904, 905, 954, 960, 965, 1502, 6227, and 6889*

Section 904 Limitation

Foreign Tax Credit Limitation =

$$\frac{\text{Foreign Source Income in the Category}}{\text{Worldwide taxable income}}$$

X

U.S. tax before foreign tax credit

Allocation and Apportionment of Expenses for 904(a)

The final regulations require deductions to be allocated and apportioned to the Section 951A category.

Allocation and Apportionment of Expenses

Treatment of exempt income and exempt assets:

- ***Exempt Income*** is based on the amount of the Section 250 deduction allowed to the U.S. shareholder (FDII, GILTI and Section 78 dividend).

- ***Exempt Asset*** the equivalent portion of the domestic corporation's assets generating FDII, or the stock of the CFC giving rise to GILTI inclusion.

Exempt Income/Asset for GILTI

This exempt treatment will generally reduce the allocation and apportionment of deductions to GILTI income, particularly interest expense allocations.

FDII Exempt Asset Determination

Gross FDDEI and not FDII reflects the gross income Section 250 deduction is exempting.

Exempt Asset Calculation:

Exempt assets are calculated based on the ratio of the Section 250 deduction relating to FDII to the taxpayers FDDEI instead of FDII.

FDII Exempt Asset Determination

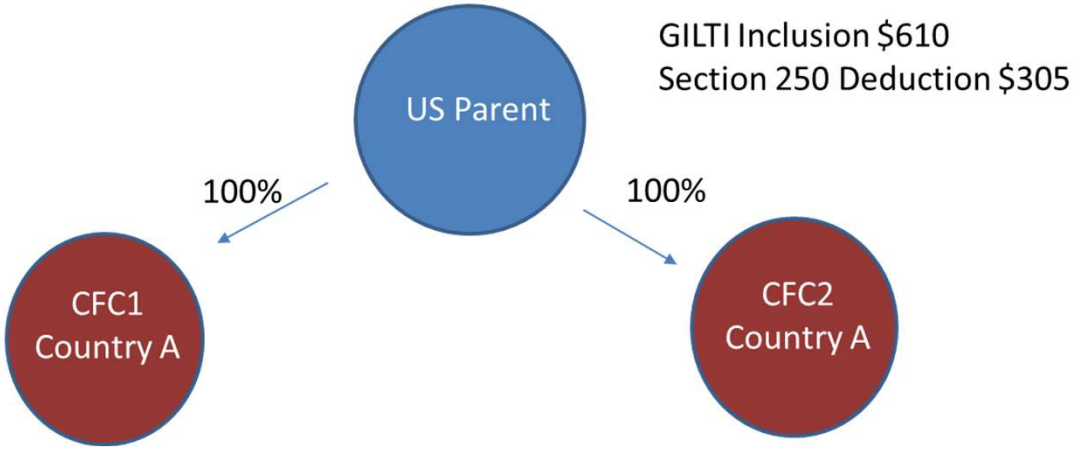
This has the impact of significantly reducing the portion of assets that are exempt by reason of FDII.

Exempt Asset – Stock of CFC

Consistent with the proposed regulations:

Section 959 Earnings and profits do not result in any portion of CFC stock treated as an exempt asset.

Example Exempt Income/Assets



Stock Tax Book Value $10,000
Section 951A Category $6,100
General Category $3,900

Stock Tax Book Value $9,000
Section 951A Category $4,880
General Category $4,120

Example Exempt Income/Assets

Facts:

- USP is a domestic corporation directly owns CFC1 and CFC2
- Tax Book value of CFC1 and CFC2 is $10,000X and $9,000X respectively
- $6,100X of CFC1 stock is Section 951A category and $3,900 is general category
- $4,800 of CFC2 stock is Section 951A category and $4,120 is general category
- USP's GILTI inclusion is $610X
- USP's Section 250 deduction is $305X

Example Exempt Income/Assets

Analysis:

- $305X of USP's gross income attributable to GILTI is exempt
- GILTI inclusion stock of CFC1 is $6,100 and CFC2 is $4,880
- Exempt asset CFC1 and CFC2 is the inclusion stock X 50%
- Stock of CFC1 for apportionment is $3,050 of non-exempt Section 951A category and $3,900 of general category
- Stock of CFC2 for apportionment is $2,440X of non-exempt Section 951A category and $4,120X of general category stock

Allocation and Apportionment of Interest Expense : Specified Partnership Loans (“SPL”)

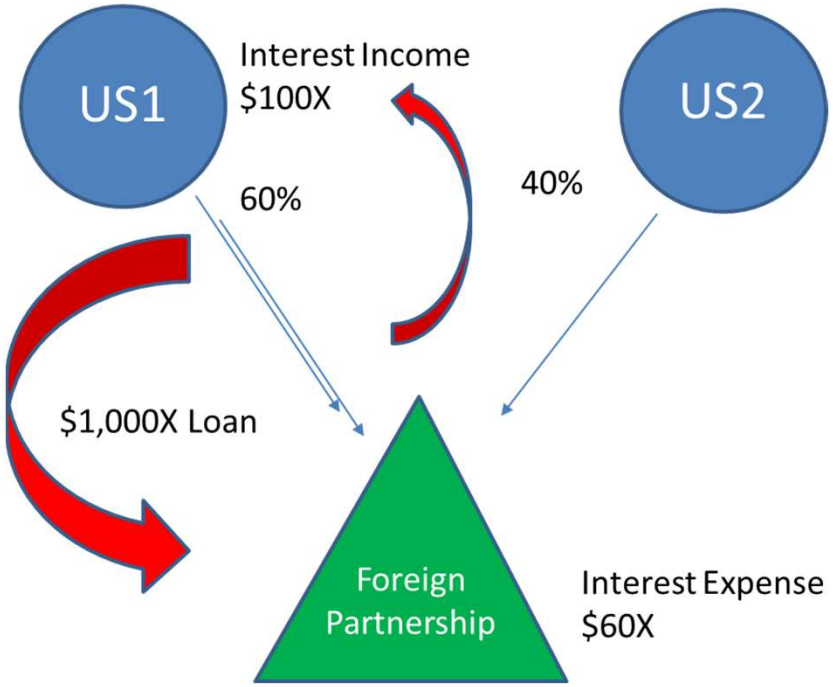
Loans to a partnership by a U.S. person that owns an interest in the partnership

- Lender matches the source and separate category of the interest income and expense by assigning the interest income to the same statutory and residual groupings from which the interest expense is deducted
- Lender disregards a portion of the loan receivable for the purpose of allocating any other interest expense of the U.S. person
- Appropriate adjustments are made to the value and characterization of the U.S. shareholder’s stock of the CFC to reflect the disregarded loan
- 2019 proposed regulations are similar for upstream loans
- To coordinate with the proposed regulations, all references in the final regulations are changed to downstream partnership loans (“DPL”)

Example §1.861-9(e)(8)(vii) Example 1

Distributive share of interest expense $60X

Apportioned $45X US source
$15X Foreign source



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Example §1.861-9(e)(8)(vii) Example 1

Facts:

- US1 Domestic Corporation owns 60% of PRS a foreign partnership not engaged in a US trade or business
- The remaining 40% of PRS is directly owned by US2, an unrelated domestic corporation. All have a calendar tax year.
- In year 1 US1 loans $1,000X to PRS
- In year 1 US1 has $100X of interest income
- PRS has $100X interest expense with respect to the loan.
- US1's distributive share of the interest expense is $60X.
- Under paragraph (e)(2) of this section $45X of US1's distributed share is apportioned to US source income and $15X is apportioned to foreign source income.
- Under paragraph (h)(4)(i) the total loan value between US1 and PRS is $1,000X

Example §1.861-9(e)(8)(vii) Example 1

Analysis:

- US1 to PRS loan is a DPL and US1 is a DPL lender.
- Matching income amount is $60X, lesser of DPL interest income included by US1 ($100X) and the distributive share of interest expense ($60X).
- US1 assigned $45X to US source and $15X to foreign source foreign branch category income.
- The source and separate category of the remaining $40X is determined under the generally applicable rules.
- The disregarded portion of the downstream loan partnership loan is $600X ($1,000 X $60X/$100X).

Change in Method for Allocating and Apportioning R&E

- Taxpayer may change between the sales and gross income methods for allocating and apportioning research and experimental expenditures.
- Change may be made up to the last tax year the begins before January 1, 2020.
- The election is significant due to the proposed changed to the R&E apportionment rules.

Allocation and Apportionment of R&E

Proposed regulations impact the allocation and apportionment of R&E to Section 951A

- Section 174 deductions and Section 59(e) amortization are allocated to all "gross intangible income" related to the relevant SIC code category
- This includes direct sales and royalties, but not dividends or Subpart F/GILTI inclusions

Allocation and Apportionment of R&E

Proposed regulations eliminate the optional gross income method

R&E in excess of amounts exclusively apportioned to the place the R&E is performed is apportioned among the statutory and residual groupings within the class of gross intangible income on the basis of relative gross receipts from sales and services within each group

Allocation and Apportionment of Stewardship Expense

Proposed Regulations:

Definitely related and allocable to dividends and inclusions received or accrued under:

§78, §951, § 951A, §1291, §1293, §1296

Apportioned between statutory groupings and residual grouping based on the relative values of the stock in each grouping following the classification rules in the interest allocation in apportionment rules.

Allocation and Apportionment of Interest Expense

For an asset in connection with interest expense on a loan is capitalized, deferred, or disallowed, the value of the asset is reduced by the principal of the debt.

Proposed regulations define when an asset is connected, *when used to purchase the asset the causes the capitalization, deferral or disallowance*.

Allocation and Apportionment of Interest Expense

Example §1.861-12(f)

Facts:

- X is a domestic corporation uses tax book value of apportionment
- X has $1,000X debt and incurs $100X interest expense
- X uses $800X of the debt to produce tangible property
- X capitalizes $80X interest expense under §263A
- X deducts $20X interest expense

Allocation and Apportionment of Interest Expense

Example §1.861-12(f)

Analysis:

- Interest is capitalized ($800X) by reason of the use of debt proceeds to produce tangible property
- For purposes of apportioning the $20X interest expense, the adjusted basis of the tangible property is reduced by $800X.

Allocation and Apportionment of Damages and Settlements

Product Liability – related and allocable to the class of gross income produced by the specific sales of the products or services

Incident to the Production – related and allocable to the class of gross income ordinarily produced by the assets

Claims by Investors – negligence, fraud or malfeasance, related and allocable to all income of the corporation

Allocation and Apportionment of Insurance Company Expenses

- §818(f)(1) provides deductions for life insurance reserves and certain other expenses cannot definitely be allocated to a class of gross income
- Apportioned ratably to U.S. source and foreign source
- Proposed regulations address allocating expenses in a life-nonlife consolidated group
- Proposed regulations adopt a separate entity method

Allocation and Apportionment of Foreign Income Taxes

Proposed regulations aim to increase the certainty on matching foreign taxes with income

- First assign the item of gross income under foreign law on which a foreign tax is imposed to a grouping
- Allocate and apportion deductions under foreign law to the income
- Allocate and apportion the foreign tax among the grouping

Allocation and Apportionment of Foreign Taxes

- Foreign gross income is assigned a grouping based on Federal income tax law
- “Corresponding U.S. items“ arise in the same transaction or events
- No corresponding U.S. item (i.e. nonrecognition event under U.S. tax law) assigned as if recognition
- Base differences, Entity mismatch, etc.

Allocation and Apportionment of Interest Expense of a CFC

Modified Gross Income Method

- Gross tested income (net of interest expense) from lower-tier CFCs tiers up to higher-tier corporations
- Otherwise the interest expense of a CFC without gross tested income (i.e., a holding company) would not be allocated and apportioned to gross tested income, and would not create a tested loss

Example §1.861-13(c)(3) Example 3

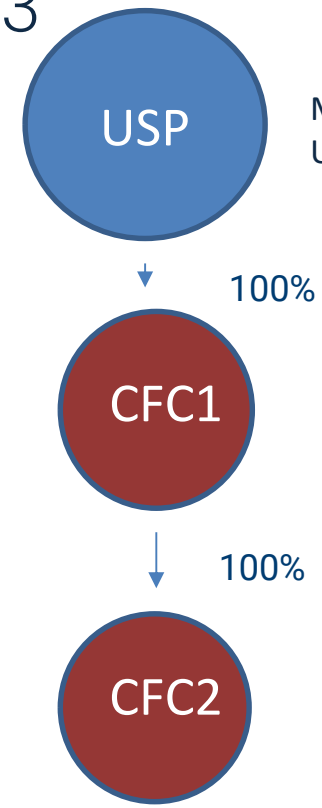
Modified Gross Income Method

CFC1

- *$1,500 of foreign source gross tested income*
- *$500X foreign source Subpart F income passive category*
- *Interest expense $1,000X*

CFC2

- *$3,000X of foreign source gross tested income in general category*
- *$2,000X of foreign source gross Subpart F in general category*
- *$1,000X of specified foreign source general category income*
- *Interest expense of $3,000X*



Modified Gross Income
USP's inclusion 100%

Tax Book Value CFC1
$100,000X

Example §1.861-13(c)(3) Example 3

Facts:

- USP, a domestic corporation, directly owns all of the stock of a controlled foreign corporation, CFC1.
- The tax book value of CFC1's stock is $100,000x.
- CFC1 owns all of the stock of CFC2, a controlled foreign corporation.
- USP uses the modified gross income method described in § 1.861-12(c)(3)(iii) to characterize the stock in CFC1.
- USP's inclusion percentage is 100%.

Example §1.861-13(c)(3) Example 3

Facts:

- CFC1 earns $1,500x of foreign source gross tested income within the general category and $500x of foreign source gross Subpart F income within the passive category.
- CFC1 incurs $1,000x of interest expense.
- CFC2 earns $3,000x of foreign source gross tested income within the general category, $2,000x of foreign source gross Subpart F income within the general category, and $1,000x of specified foreign source general category gross income.
- CFC2 incurs $3,000x of interest expense.

Example §1.861-13(c)(3) Example 3

Analysis:

Step One Determination of CFC2 gross income (net of interest expense)

- CFC2 has total gross income of $6,000x and $3,000x of interest expense .
- $1,500x ($3,000x/$6,000x × $3,000x) of interest expense is apportioned to foreign source gross tested income within the general category, $1,000x ($2,000x/$6,000x × $3,000x) of interest expense is apportioned to foreign source gross Subpart F income within the general category, and $500x ($1,000x/$6,000x × $3,000x) of interest expense is apportioned to specified foreign source general category gross income.
- CFC2 $1,500x ($3,000x – $1,500x) of foreign source gross tested income within the general category, $1,000x ($2,000x – $1,000x) of foreign source gross Subpart F income within the general category, and $500x ($1,000x – $500x) of specified foreign source general category gross income.

Example §1.861-13(c)(3) Example 3

Analysis:

Step One Determination of CFC1 gross income (net of interest expense)

- CFC1 Gross income of $4,000X (includes $1,500X and $500X from CFC2)
- CFC1's $1,000 Interest Expense is apportioned
- General $750X ($3,000X/$4,000X) X $1,000
- Subpart F $125X ($500X/$4,000X) X $1,000
- Specified Foreign Source General $125X ($500X/$4,000X) X $1,000

Example §1.861-13(c)(3) Example 3

Gross Income net of Interest expense	CFC1	CFC2	Combined
Foreign Gross Tested Income-General Category	$2,250X ($3,000X-$750X)	n/a	$2,250X
Foreign Source Subpart F – Passive Category	$375X ($500X-$125X)	n/a	$375X
Specified Foreign Source – General Category	$375X ($500X-$125X)	n/a	$375X
Foreign Source Gross Supbart F – General Category		$1,000X	$1,000X

Example §1.861-13(c)(3) Example 3

Characterize CFC 1 Stock

CFC1 Total Gross Income $4,000X

Foreign Source Gross Tested Income – General $56,250X

- ($2,250X/$4,000X/$100,000X)

Foreign Source Gross Subpart F- General $25,000X

- ($1,000X/$4,000X X $100,000X)

Specified Foreign Source – General $9,375X

- ($375X/$4,000X X $100,000X)

Foreign Source Gross Subpart F – Passive $9,375

- ($375X/$4,000x X $100,000X)

Example §1.861-13(c)(3) Example 3

Step 2

The value of the portion of the stock of CFC1 that is general category gross tested income stock is $56,250x. USP's inclusion percentage is 100%.

Accordingly, under paragraph (a)(2) of this section, all of the $56,250x of the stock of CFC1 is assigned to the section 951A category and a portion thereof may be treated as an exempt asset under § 1.861-8(d)(2)(ii)(C)(2)(ii).

Example §1.861-13(c)(3) Example 3

Step 3

No portion of the stock of CFC1 is resourced gross tested income or assigned to the resourced gross subpart F income statutory group in any treaty category. Accordingly, no portion of the stock of CFC1 is assigned to a treaty category under paragraph (a)(3) of this section

Example §1.861-13(c)(3) Example 3

Step 4

General category stock.

The total value of the portion of the stock of CFC1 that is general category stock is $34,375x, which is equal to $25,000x (the value of the portion of the stock of CFC1 assigned to the subpart F income statutory grouping within the general category income statutory grouping) plus $9,375x (the value of the portion of the stock of CFC1 assigned to the specified foreign source general category gross income statutory grouping).

Example §1.861-13(c)(3) Example 3

Step 4

2) Passive category stock. The total value of the portion of the stock of CFC1 that is passive category stock is $9,375x.

(3) U.S. source category stock. No value of the portion of the stock of CFC1 is U.S. source category stock

Example §1.861-13(c)(3) Example 3

Step 5

General category stock

The value of the stock of CFC1 assigned to the section 245A subgroup of general category stock is $9,375x, which is equal to the value of the portion assigned to the specified foreign source general category gross income statutory grouping. Under paragraph (a)(5)(v) of this section, the remainder of the general category stock of CFC1, $25,000x, is assigned to the non-section 245A subgroup of general category stock.

Example §1.861-13(c)(3) Example 3

Step 5

Passive category stock

No portion of the passive category stock of CFC1 is in the foreign source gross tested income statutory grouping or the specified foreign source passive category gross income statutory grouping. Accordingly, under paragraph (a)(5)(iii) of this section, no value of the portion of the stock of CFC1 is assigned to the section 245A subgroup. Under paragraph (a)(5)(v) of this section, the passive category stock of CFC1, $9,375x, is assigned to the non-section 245A subgroup of passive category stock.

Example §1.861-13(c)(3) Example 3

Step 5

Section 951A category stock.

Under paragraph (a)(5)(v) of this section, all of the section 951A category stock, $56,250x, is assigned to the non-section 245A subgroup of section 951A category stock.

Example §1.861-13(c)(3) Example 3

Summary for Allocation and Apportionment of Expenses

- $56,250X CFC1 Stock is Section 951A (all of which is in the non-section 245A subgroup
- $34,375X CFC1 stock is general category
  - ✓ $9,375 is in the section 245A subgroup
  - ✓ $25,000 is in the non-section 245A subgroup
- $9,375X of the stock of CFC1 is passive (all of which is in the non-section 245A subgroup

Characterization of CFC Stock

For statutory groupings of the CFC stock, the U.S. shareholder of the CFC must use the same method (asset or modified gross income method) that the CFC uses to apportion its interest expense.

Reconstruction

Allows the “reconstruction” of foreign tax credit carryovers from pre-2018 years of the branch basket (as if that category had applied in the year the taxes were paid or accrued)

Simplified Safe Harbor:

Allocates foreign taxes to the branch basket on a pro rata basis of branch tax included in the general limitation basket

Branch Basket Rules

Generally retained the proposed regulations

- Disregarded payments other than interest are generally taken into account for foreign branch category income
- Section 367(d) applies to impute payments for certain disregarded transfers of intangible property
- Special rule for certain disregarded payments
- Activities that constitute a permanent establishment is a trade or business outside the United States

Branch Basket Rules

Generally retained the proposed regulations

- Activities that constitute a permanent establishment is a trade or business outside the United States
- Attribution of income items to deemed set of books and records
- Gain from the sale of an interest in a foreign branch is not attributable to that branch
- Future guidance with respect to foreign branch category

Look-Through for Section 951A

Section 904(d)(3) cannot produce section 951A category income

Section 951A category income only includes amounts includible in gross income under Section 951A. Look through cannot give rise to Section 951A category income.

Section 951A, SLL, OFL, ODL

- The ordering rules for the allocation and recapture of Separate Limitation Losses and Overall Foreign Losses were unchanged
- The rules apply to Section 951A.
- SLL, OFL and ODL may reduce Section 951A category income.

Scope of Current Year Taxes

Current year taxes

Foreign income taxes that a CFC pays or accrues in its tax year.

Scope of Current Year Taxes

- Current year taxes are not attributable to PTEP
- Retains reduction of foreign income tax deemed paid to the extent Subpart F inclusion is reduced by qualified deficit
- Current year taxes assigned as if current Section 904 categories existed when the income was included

Subpart F Income Groups

Consistent grouping rules are required to coordinate deemed paid foreign taxes with the Subpart F high tax exception and the Section 904 high tax kickout.

Subpart F Income Groups Example

Facts:

- CFC is incorporated in Country X and used “u” as functional currency. 1u=$1x
- CFC earns outside X, dividend income of 100,000u, portfolio interest 1,500,000u and 70,000u royalty not derived in an active trade or business
- CFC earns 50,000u for sales of personal property (FBCSI)
- Country X does not tax any income
- Dividend is subject to 15% third party withholding tax, interest and royalty are not subject to withholding tax
- CFC incurs no expense

Subpart F Income Groups Example

Analysis:

- Interest, Dividend and Royalty are passive category
- Sales and Consulting are general category
- CFC has a separate subpart F group within the passive category for FPHC income subject to withholding of 15% or greater (dividend 100,000u)
- CFC has a separate subpart F group within passive category for FPHC income subject to no withholding (1,500,000u interest and 70,000u royalty)
- CFC has a separate subpart F group for FBCS income within the general category (50,000u sales)
- CFC has a separate subpart F group for FBCS income within the general category (45,000u services)

Questions

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Professional Overview
Melody has more than 11 years of experience in public accounting. She provides comprehensive planning and compliance services to clients with multi-state and international operations across a variety of industries. Melody primarily works with clients that have international operations in the manufacturing, distribution, technology, and services industries. Melody assists many international companies making inbound investment in the US with tax structuring and economic incentives. She also works with international companies to create efficient global tax strategies. She has significant experience with income tax provisions and other ASC 740 reporting matters, international reporting requirements, foreign tax credit planning, repatriation of foreign profits, treaty analysis and thin capitalization rules.

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