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## Proposed Foreign Tax Credit Regulations Clarify Taxpayers' Ability to Claim Deemed Paid Credits

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On November 28, 2018, the Internal Revenue Service (IRS) and the US Department of the Treasury released proposed regulations (REG-105600-18) that address the calculation of a corporate US shareholder's deemed paid foreign tax credits under section 960. The proposed regulations also make clear that certain foreign income taxes paid by controlled foreign corporations (CFCs) will be "lost," and the corporate US shareholder can never claim a deemed paid credit with respect to such taxes.

Prior to the 2017 Tax Act, former sections 902 and 960(a)(1) permitted a corporate US shareholder to claim a credit for foreign taxes paid by a CFC when the related income was either distributed to the shareholder as a dividend or included in the shareholder's income under section 951(a). In both scenarios, the amount of deemed paid foreign taxes was based on multi-year "pools" of earnings and taxes, with the shareholder generally deemed to have paid the same proportion of the CFC's post-1986 foreign income taxes as the amount of the dividend or subpart F inclusion bore to such CFC's post-1986 undistributed earnings. In addition, former section 960(a)(3) generally applied the rules of former section 902 in allowing the corporate US shareholder to claim a deemed paid credit for foreign income taxes paid by a CFC on a distribution of previously taxed earnings and profits (PTEP).

The 2017 Tax Act repealed section 902, modified section 960 and generally changed the system for determining the deemed paid credit from multi-year pooling to a "properly attributable" standard. Under new sections 960(a) and (d), a corporate US shareholder can claim a deemed paid credit for foreign income taxes that are properly attributable to current year subpart F income and global intangible low taxed income (GILTI) inclusions, respectively (current year taxes). Current year taxes attributable to GILTI inclusions are further subject to a 20 percent "haircut." Under new section 960(b), a shareholder is generally deemed to have paid foreign income taxes that are properly attributable to distributions of PTEP received from a first-tier CFC (in the case of a corporate US shareholder) or from a lower-tier CFC (in the case of an upper-tier CFC shareholder) (in both cases, PTEP group taxes). Except for PTEP group taxes, only foreign income taxes paid or accrued by the CFC in a current tax year generally can be deemed paid by a US shareholder.

The proposed regulations provide rules for determining a corporate US shareholder's deemed paid credits with respect to a CFC's current year taxes and PTEP group taxes. The determination of deemed paid credits for current year taxes is first made at the lowest-tier CFC and is then repeated for each CFC on a "bottom-up" basis:

- The proposed regulations require CFCs to establish "income groups" within "section 904 categories" to which the CFC's current year taxes are allocated and apportioned. For CFCs, these section 904 categories generally consist of the general and passive categories, as income of a CFC cannot be assigned to the foreign branch category or the GILTI category.
- Within section 904 categories, the CFC first assigns gross income to subpart F income groups, the tested income group and a residual income group. Subpart F income groups include different groups for each separate item of income under Treas. Reg. § 1.954-1(c)(1)(iii) (e.g., there are separate income groups for



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foreign base company income and each single item of foreign personal holding company income). Each item of foreign personal holding company income may be assigned to four different groups based on the type of foreign taxes (withholding or not) and the foreign tax rate under Treas. Reg. § 1.904-4(c)(3)(i).

- The CFC then allocates and apportions deductions and current year taxes to income groups and PTEP groups (discussed below) under the principles set forth in corresponding proposed section 904 regulations. If a corporate US shareholder has subpart F income or GILTI inclusions with respect to the CFC's subpart F income groups or tested income group, deemed paid credits may be available for the shareholder's proportionate share of current year taxes that have been assigned to the related income group. The deemed paid taxes would be subject to the US shareholder's section 904 limitation, with the shareholder allocating deemed paid taxes to the separate category to which the related income inclusion is assigned.
- Under the proposed regulations, current year taxes that are allocated to the CFC's residual income group cannot be deemed paid by the corporate US shareholder. Further, no CFC taxes are deemed paid in connection with section 956 inclusions.

Deemed paid PTEP group taxes are also determined on a "bottom-up" basis, starting with the lowest-tier CFC:

- The proposed regulations require CFCs to establish annual PTEP "accounts" within section 904 categories. Within each account, a CFC must assign PTEP to one of 10 different "PTEP groups" based on the US shareholder's underlying income inclusion, taking into account any reclassification of PTEP resulting from section 956 inclusions. For example, if a CFC's tested income is included by a US shareholder under section 951A in 2018, the related earnings would be added to the CFC's GILTI PTEP group within the 2018 PTEP account in the section 951A category. Notice 2019-01, issued by the IRS and Treasury on December 14, 2018, describes additional regulations that Treasury intends to issue, including regulations that would expand the number of PTEP groups from 10 to 16.
- Distributions from a lower-tier CFC's PTEP group are added to the upper-tier CFC's corresponding PTEP group, with current year taxes paid by the upper-tier CFC on the distribution (such as net basis taxes and withholding taxes) assigned to that PTEP group. The PTEP group taxes that are available to be deemed paid by an upper-tier CFC or corporate US shareholder generally consist of the foreign income taxes that have been assigned to the PTEP group (both in the current year and in previous years) from which the PTEP distribution is made.
- Upon receipt of a PTEP distribution, a corporate US shareholder would allocate any deemed paid PTEP group taxes to the same separate category as the annual PTEP account and PTEP group from which the distribution was made, with such taxes subject to the shareholder's section 904 limitation. The Proposed Regulations do not apply any haircut to withholding taxes paid or deemed paid with respect to distributions of GILTI PTEP.

The proposed regulations do not address the ordering of PTEP distributions. Instead, the preamble notes that the IRS and Treasury anticipate that ordering will be addressed in forthcoming regulations under section 959. Notice 2019-01, as noted above, describes regulations that Treasury intends to issue involving the ordering of PTEP upon distribution and reclassification.

Under the Proposed Regulations, certain foreign income taxes paid by CFCs will be "lost" and unavailable to be credited by corporate US shareholders, including:

- 20 percent of taxes related to GILTI inclusions (*i.e.*, taxes that have been haircut under section 960(d))
- Taxes related to tested income that has been reduced by a tested loss from another CFC
- Taxes related to the "net deemed intangible income return" that reduces the shareholder's GILTI inclusion
- Taxes related to high-taxed subpart F income that the US shareholder has elected to exclude from subpart F income
- Taxes related to "base differences" (defined in the proposed regulations as taxes imposed on a type of item that does not constitute income under US federal income tax principles, such as gifts or life insurance proceeds)

In addition, the proposed regulations generally allocate taxes attributable to "timing differences" (defined in the proposed regulations as taxes imposed on an item of income that is not recognized for US federal income tax purposes in the current year) to the section 904 category and income group to which the related income would have been allocated if it had been recognized for US federal income tax purposes. If the shareholder does not

have subpart F income or GILTI inclusions with respect to such income group in the current year, these taxes would generally be lost, even when the corporate US shareholder recognizes the related income for US tax purposes in a later year. Given the potential for lost taxes, taxpayers should identify any material base differences or timing differences in their CFCs to determine if there will be any related US income inclusions in the current year.

The effective dates in the proposed regulations vary, depending on the provision. The regulations under section 960 are proposed to have “retroactive” effectiveness for taxable years of a foreign corporation beginning after December 31, 2017, and a taxable year of a domestic corporation that is a US shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends.

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