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Legal Update
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Treasury Releases Proposed Regulations on Foreign Tax Credits under New International Tax Rules

On November 28, 2018, the US Department of Treasury ("Treasury") and Internal Revenue Service ("IRS") released proposed regulations ("Proposed Regulations")[1] on the determination of foreign tax credits, providing much-awaited guidance to the many taxpayers struggling to assess the impact of provisions introduced by the Tax Cuts and Jobs Act ("TCJA").

The TCJA, enacted by Congress in December 2017,[2] made several modifications relevant to the foreign tax credit regime, including:

- Creating two new "baskets" of income, namely, the global intangible low-taxed income ("GILTI income") and the foreign branch income baskets;
- Reducing the foreign tax credit limitation to account for the new 100% dividends received deduction on certain dividends received from foreign subsidiaries;
- Repealing indirect credits for deemed-paid foreign taxes related to dividends from foreign subsidiaries;
- Modifying the rules for deemed-paid foreign taxes related to Subpart F and GILTI income inclusions; and
- Eliminating the fair market value method for interest expense apportionment.

In response to the new statutory framework, the Proposed Regulations address questions relating to (1) the allocation and apportionment of deductions to the new baskets of income and other adjustments to the calculation of the foreign tax credit limitation; (2) the new "foreign branch income" basket; (3) transition rules for the carryover and carryback of unused foreign tax credits; (4) the determination of deemed paid foreign taxes attributable to Subpart F and GILTI income; (5) the Section 78 gross up;[3] and (6) transition rules for taxpayers using the fair market value method for interest expense apportionment. In addition, the Proposed Regulations include other miscellaneous provisions not strictly related to changes introduced by the TCJA. This Legal Update provides an overview of the most noteworthy aspects of the Proposed Regulations.

The Proposed Regulations are generally applicable to taxable years beginning after December 22, 2017, and, thus, will generally apply to the 2018 taxable year of calendar-year taxpayers. The retroactivity of these regulations may prove burdensome as taxpayers rush to update their year-end calculations to reflect the new rules and take them into consideration as part of their tax provision calculations in their 2018 financial statements.

Allocation and Apportionment of Deductions

Section 904 provides the basic limitation to the use of foreign tax credits to ensure that a taxpayer cannot claim, with respect to the foreign source income in a certain category or "basket," a foreign tax credit in an amount that exceeds the US tax imposed on such taxable

income. To calculate the Section 904 limitation, the regulations require US taxpayers to allocate and apportion their expenses, losses and other deductions (notably, interest expense, R&E expense) when computing their income in each basket. The existence of different baskets of foreign source income prevents taxpayers from cross-crediting among different types of income (e.g., to prevent the shifting of passive income to a low-taxed jurisdiction so as to increase the foreign tax credit limitation).

The TCJA created a separate foreign tax credit basket for GILTI income. As soon as taxpayers began digesting the implications of the GILTI regime and its interactions with the foreign tax credit rules, questions arose regarding the overall effective tax rate to which GILTI income would be subject.

On the one hand, the legislative history of the TCJA suggested that Congress did not intend for corporations to pay any residual US tax on their GILTI income to the extent such income had been subject to a foreign tax rate of 13.125% or greater. However, taxpayers expressed concern that, under the general expense apportionment rules, the allocation of US shareholder-level deductions to the GILTI basket would result in residual US taxation even when the GILTI income is subject to foreign tax at a rate of 13.125% or greater. In this respect, deductions apportioned to GILTI income would shrink the numerator of the foreign tax credit limitation and, as a result, would reduce the amount of foreign taxes that would be allowable as a credit against GILTI income. This result would be particularly harsh considering that the TCJA applies a 20% haircut to credits claimed against GILTI income and does not allow any carryforward or carryback of excess credits in the GILTI basket. In light of these considerations, commentators recommended that Treasury exclude GILTI income from the expense allocation rules.

While Treasury did not fully exempt the GILTI basket from expense apportionment, it did provide some limited relief. Specifically, the Proposed Regulations characterize as "exempt income" the portion of the GILTI income that is offset by the Section 250 deduction and, as an "exempt asset," a corresponding percentage of the controlled foreign corporation ("CFC") stock that generates such GILTI income. Under the Proposed Regulations, exempt income and assets are not taken into account for purposes of allocating and apportioning deductible expenses, thus effectively increasing the foreign tax credit limitation in the GILTI basket. However, this limited relief will not prevent the residual US taxation on GILTI income to the extent material expenses are apportioned to the GILTI income basket; again, this will be the case even where the foreign tax rate is 13.125% or greater.

It is also worth noting that the amount of exempt income depends on the taxpayer's actual Section 250 deduction which may be reduced by the taxable income limitation under Section 250(a)(2).[4] So, effectively, in a case where the Section 250 deduction is limited, less than 50% of the GILTI income may be characterized as exempt income under the Proposed Regulations.

The Proposed Regulations provide for similar exempt treatment for FDII income that benefits from the Section 250 deduction and for the assets that give rise to such FDII income.[5]

Unlike the treatment for the Section 250 deduction, the dividends received deduction under Section 245A (i.e., the participation exemption) does not give rise to exempt income or exempt assets. Instead, the deductions properly allocable to the "Section 245A subgroup" are disregarded. This generally has the effect of increasing the denominator of the Section 904 limitation fraction, which can cause a reduction in the foreign tax credit limitations.

CFC stock will not be treated as an exempt asset solely because the US shareholder received

previously taxed income ("PTI") from that CFC. This is especially significant given the large amounts of PTI arising from the Section 965 transition tax.

The Foreign Branch Income Basket

As noted above, together with the new GILTI income basket, the TCJA also introduced a new foreign branch income basket. Section 904(d)(2)(j) defines foreign branch income as the business profits of a US person attributable to one or more qualified business units ("QBUs") in a foreign country (excluding passive income).

The Proposed Regulations clarify that foreign branch income includes income of a US person attributable to foreign branches held by the US person (i.e., not including branches held by a foreign corporation) as well as a distributive share of partnership income attributable to a foreign branch held by the partnership. A foreign branch is defined by reference to the existing definition of QBU, namely, as activities of a corporation, partnership or individual that constitute the conduct of a trade or business outside the United States and with respect to which a separate set of books and records is maintained. If a taxpayer has more than one foreign branch, all income of the different branches shall be aggregated into a single foreign branch income category.

Under the Proposed Regulations, an item of income is generally attributable to a foreign branch if it is reflected on its separate books and records. However, certain items of income will not constitute foreign branch income even if they are reflected on the branch's books and records: (i) income from US activities, (ii) income arising from stock (including gains on disposition of stock, Subpart F, GILTI and PFIC inclusions) and (iii) gain from the disposition of an interest in a pass-through entity or disregarded entity (except when the interest is held in the ordinary course of business of the foreign branch). The Proposed Regulations include an anti-abuse rule under which an item of income can be reattributed by the IRS to the foreign branch owner or to the foreign branch if a principal purpose of recording, or failing to record, the item on the books and records of the foreign branch was the avoidance of US federal income tax.

The Proposed Regulations provide that certain otherwise disregarded transactions between a foreign branch and its owner shall be taken into account for purposes of determining the amount of gross income attributable to the foreign branch income basket and the resulting adjustment to the owner's general category income. In that case, the Proposed Regulations would correspondingly allocate any foreign taxes imposed on the disregarded payments to the foreign branch income basket or the general category basket. Taxpayers will need to carefully consider these rules as disregarded foreign branch payments are a common occurrence.

If a taxpayer finds itself in an ongoing excess credit position with respect to its foreign branch income basket, certain restructurings may alleviate this situation, including moving the foreign branch operations into the United States to benefit from the FDII regime (subject to foreign tax costs resulting from the transaction), transferring the foreign branch operations to a CFC (subject to, among others, Section 367(a) consequences and overall foreign loss recapture) or converting low-tax first-tier CFCs into disregarded entities to increase the foreign branch income limitation (but forgoing the beneficial 10.5% rate of the GILTI regime).

In addition to its foreign tax credit implications, the determination of a US taxpayer's foreign branch income will also be relevant for FDII purposes since this type of income does not qualify for the preferential FDII regime.

Transition Rules for Foreign Tax Credit Carryovers and Carrybacks

The creation by the TCJA of two new foreign tax credit baskets beginning in the 2018 taxable year raised questions about the carryover and carryback of unused foreign tax credits to and from those new categories. The Proposed Regulations tackle these issues.

Carryovers of pre-2018 excess foreign tax credits can be allocated to the foreign branch income basket to the extent they would have been assigned to the foreign branch income basket if the foreign tax had been paid in 2018 or later. In turn, excess foreign tax credits in the foreign branch income basket for a post-TCJA taxable year can be carried back to a pre-TCJA taxable year and will be allocated to the general basket.[6]

No similar transition rules are needed for foreign tax credits attributable to the GILTI income basket since this basket does not allow for carryovers and carrybacks. The GILTI income category starts fresh in the 2018 taxable year.

To the extent a taxpayer carries over pre-2018 foreign tax credits to the new foreign branch income basket, the taxpayer shall also make corresponding reallocations of separate limitation and overall foreign losses.

Determination of Deemed Credits for Subpart F and GILTI Income

The Proposed Regulations include a complex set of rules for the computation of deemed foreign taxes that are "properly attributable" to Subpart F and GILTI income under Section 960. Taxes in a CFC's historic tax pool will not be available as foreign tax credits with respect to Subpart F or GILTI income. Only current year taxes can be considered "properly attributable" to Subpart F or GILTI income. In very general terms, current year taxes are allocated among the different Section 904 baskets and then among different income groups within each basket (e.g., the Subpart F income group is separated into its different items, such as foreign base company services income and foreign base company sales income).

Interestingly, the Proposed Regulations provide that no foreign taxes are attributable to a Section 956 inclusion. While this may be reasonable in most cases where the Section 956 inclusion is effectively exempt under recent proposed regulations, it would be a harsh result in certain (exceptional but plausible) cases where a US corporate shareholder may have a non-exempt Section 956 inclusion.[7] It is possible that Treasury wanted to ensure that in no case taxpayers could rely on an affirmative use of Section 956 as a foreign tax credit planning tool.

Section 78 Gross-Up

Notwithstanding certain uncertainties created by the statutory language, the Proposed Regulations clarify that the Section 78 gross-up resulting from deemed foreign taxes attributable to GILTI income is itself included in the GILTI income basket.

The Proposed Regulations also clarify that the Section 78 gross-up does not benefit from the Section 245A dividends received deduction, addressing an apparent technical glitch created by the TCJA for fiscal year taxpayers.

Transition Rules for Companies Using the Fair Market Value Method of Interest Apportionment

The TCJA no longer allows taxpayers to use the fair market value method to apportion interest expense and, instead, requires taxpayers to use the tax book or the alternative tax book value method. To alleviate the administrative burden for taxpayers that need to move away from the fair market value method, the Proposed Regulations provide that for the 2018 taxable year taxpayers that had been using the fair

market value method are allowed to determine asset values using an average of the values as of the end of the first quarter and as of year-end.[8]

MISCELLANEOUS PROVISIONS

Changes to the look-through rule

The look-through rule of Section 904(d)(3) reassigns certain payments from a CFC to its US shareholder from the passive category to the general category. Under the Proposed Regulations, these payments may be reassigned to either the new foreign branch income category or the general category (but not to the GILTI income basket).

Special rules for certain partnership loans

The preamble to the Proposed Regulations expressed a concern with certain loans made to a partnership by a US partner where there could be a distortion between the sourcing of the US partner's interest *income* (depends on whether the partnership is domestic or foreign and whether it is engaged in a US trade or business) and the allocation of the partner's distributive share of the interest *expense* (determined based on the partner's foreign source asset ratio). To prevent these mismatches, the Proposed Regulations require a lender that recognizes both interest income and interest expense in a "specified partnership loan transaction" to assign the income and expense to the same statutory and residual groupings.

The Subpart F high-tax exception

Section 954(b)(4) generally excludes from Subpart F income any income subject to foreign tax at an effective rate greater than 90% of the US rate (i.e., 18.9%). Importantly, this income excluded from Subpart F income under the high-tax exception will also not be considered "tested income" for GILTI purposes.

Under the tax laws of certain jurisdictions, a shareholder that receives a distribution from a corporation may become entitled to a refund of all or substantially all of the corporate income tax paid by the corporation on the distributed earnings. Treasury expressed concern that taxpayers with CFCs in those jurisdictions may take the position that the CFC's income should be excluded from Subpart F under the high-tax exception notwithstanding the availability of a refund of the corporate income tax to the shareholder. The Proposed Regulations address this concern providing that foreign income taxes will not be considered paid or accrued by a CFC to the extent they are reasonably certain to be returned to a shareholder upon a subsequent distribution.

Concluding Observations

In the preamble to the Proposed Regulations, Treasury went to great lengths to conclude that it did not have statutory authority to exclude GILTI from the expense allocation rules. Rather than waiting for clarity in a Technical Corrections Bill, Treasury chose to issue the Proposed Regulations to provide guidance as soon as possible. The Proposed Regulations therefore reflect the complexity inherent in the TCJA itself. Taxpayers will need to come to grips with not only the new foreign tax credit baskets but also the changes to the interest expense allocation rules, the elimination of the fair market value method, and the complex rules for the attribution of deemed paid taxes, among other considerations. Finally, the Proposed Regulations must be read in conjunction with the new rules (and proposed regulations) regarding interest expense deductibility and GILTI income. This interaction raises significant structural issues and planning opportunities.

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Endnotes

[1] The Proposed Regulations are available at https://www.irs.gov/pub/irs-drop/reg-105600-18.pdf

[2] For an overview of the TCJA and related IRS guidance implementing the same, *see* the Mayer Brown Tax Reform Roadmap, available at https://www.mayerbrown.com/experience/us-tax-reform-roadmap/

[3] Unless otherwise noted, all "Section" references are to the Internal Revenue Code of 1986, as amended.

[4] Under Section 250(a)(2), the Section 250 deduction is subject to limitation if the sum of GILTI and foreign derived intangible income ("FDII") exceeds the taxpayer's taxable income.

[5] FDII income is generally equal to the "deemed intangible income" of a US corporation that is attributable to sales of property for use outside the United States or to services provided outside the United States. Similar to the GILTI rules, the deemed intangible income is generally calculated as the excess over a deemed return on the corporation's tangible property based on an assumed 10% rate of return.

[6] Excess foreign tax credits can be carried forward ten years and carried back one year (except, as noted above, in the GILTI income basket).

[7] *See* our Legal Update covering the proposed Section 956 regulations issued on October 31, 2018, at https://www.mayerbrown.com/Proposed-Regulations-Change-Calculus-of-Section-956s-Deemed-Dividend-for-US-Corporate-Shareholders-11-02-2018/

[8] It should also be noted that, beginning in the 2021 taxable year, a US-based worldwide affiliate group may elect to allocate and apportion interest and other expenses on a worldwide basis.

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