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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–127732–19]

RIN 1545–BP62

Guidance Under Section 954(b)(4) Regarding Income Subject to a High Rate of Foreign Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under the subpart F income and global intangible low-taxed income provisions of the Internal Revenue Code regarding the treatment of certain income that is subject to a high rate of foreign tax. This document also contains proposed regulations under the information reporting provisions for foreign corporations to facilitate the administration of certain rules in the proposed regulations. The proposed regulations would affect United States shareholders of controlled foreign corporations.

DATES: Written or electronic comments and requests for a public hearing must be received by September 21, 2020. Requests for a public hearing must be submitted as prescribed in the ''Comments and Requests for a Public Hearing'' section.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–127732–19) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.

Send hard copy submissions to: CC:PA:LPD:PR (REG–127732–19), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jorge M. Oben or Larry R. Pounders at (202) 317–6934; concerning submissions of comments or requests for a public hearing, Regina Johnson at (202) 317–5177 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 951(a)(1) of the Internal Revenue Code (the ''Code'') provides that if a foreign corporation is a controlled foreign corporation (as defined in section 957) (''CFC'') at any time during a taxable year, every person who is a United States shareholder (as defined in section 951(b) (a ''U.S. shareholder'')) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a CFC must include in gross income, for the taxable year in which or with which such taxable year of the corporation ends, the U.S. shareholder's pro rata share of the corporation's subpart F income for such year. Section 952 provides that subpart F income generally includes insurance income (as defined under section 953) and foreign base company income (as determined under section 954). Section 954(b)(4), however, provides that for purposes of sections 953 and 954(a), insurance income and foreign base company income do not include any item of income received by a CFC if a taxpayer establishes to the satisfaction of the Secretary that the income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum tax rate specified in section 11. Historically, § 1.954–1(d) has implemented section 954(b)(4) by providing an election to exclude certain high-taxed income from the computation of subpart F income (the ''subpart F high-tax exception'').

Section 951A, added to the Code by the Tax Cuts and Jobs Act, Public Law 115–97, 131 Stat. 2054, 2208 (December 22, 2017) (the ''Act''), generally requires, for taxable years of foreign corporations beginning after December 31, 2017, that each U.S. shareholder of a CFC include in gross income its global intangible low-taxed income for the taxable year (''GILTI''). Section 951A(b) defines GILTI as a U.S. shareholder's excess (if any) of net CFC tested income for a taxable year over the U.S. shareholder's net deemed tangible income return for such taxable year. Section 951A(c)(1) provides that the net CFC tested income of a U.S. shareholder is the excess of the U.S. shareholder's aggregate pro rata share of tested income over the U.S. shareholder's aggregate pro rata share of tested loss of each CFC. To determine the tested income of a CFC, section 951A(c)(2)(A)(i) first determines the ''gross tested income'' of the CFC, which is the gross income of the CFC without regard to certain items, including any gross income excluded from foreign base company income and insurance income by reason of section 954(b)(4). *See* section 951A(c)(2)(A)(i)(III). Tested income is then determined as the excess of gross tested income over the deductions properly allocable to such gross tested income under rules similar to the rules of section 954(b)(5). *See* section 951A(c)(2)(A).

On June 21, 2019, the Treasury Department and the IRS published proposed regulations (REG–101828–19) under sections 951, 951A, 954, 956, 958, and 1502 in the **Federal Register** (84 FR 29114) (the ''2019 proposed regulations''). The 2019 proposed regulations under section 951A provide an election to apply section 954(b)(4) to certain high-taxed income of a CFC to which the subpart F high-tax exception does not apply, such that it can be excluded from tested income under section 951A(c)(2)(A)(i)(III) (the ''GILTI high-tax exclusion''). Rules in the 2019 proposed regulations relating to sections 951A and 954, including the GILTI high-tax exclusion, are finalized, with modification, in the Final Rules section of this issue of the **Federal Register** (the ''final regulations''). For rules in the final regulations relating to the GILTI high-tax exclusion, see § 1.951A–2(c)(1)(iii), (c)(3), (c)(7) and (c)(8).

Terms used but not defined in this preamble have the meaning provided in these proposed regulations or the final regulations.

Explanation of Provisions

I. Conforming the Subpart F High-Tax Exception With the GILTI High-Tax Exclusion

As discussed in more detail in parts I and IV of the Summary of Comments and Explanation of Revisions in the preamble to the final regulations, comments on the 2019 proposed regulations recommended that various aspects of the GILTI high-tax exclusion be conformed with the subpart F high-tax exception to ensure that the goals of the Treasury Department and the IRS in promulgating the GILTI high-tax exclusion are not undermined. For example, comments noted that the election for the subpart F high-tax exception (other than with respect to passive foreign personal holding company income) is made on an item-by-item basis with respect to each individual CFC. In contrast, the election for the GILTI high-tax exclusion is subject to a ''consistency requirement,'' pursuant to which an election must be made with respect to all of the CFCs that are members of a CFC group (as discussed in part III of this Explanation of Provisions). Comments asserted that the consistency requirement would make the GILTI high-tax exclusion less beneficial to taxpayers, causing them in certain cases to engage in uneconomic tax planning to convert tested income into subpart F income to avail themselves of the subpart F high-tax exception, contrary to one of the stated purposes of the GILTI high-tax exclusion (to eliminate incentives to convert tested income into subpart F income).

As discussed in the preamble to the final regulations, numerous comments recommended that the application of the GILTI high-tax exclusion be conformed with the subpart F high-tax exception. The Treasury Department and the IRS agree that the GILTI high-tax exclusion and the subpart F high-tax exception should be conformed but have determined that the rules applicable to the GILTI high-tax exclusion are appropriate and better reflect the changes made as part of the Act than the existing subpart F high-tax exception. Accordingly, to prevent inappropriate tax planning and reduce complexity, these proposed regulations revise and conform the provisions of the subpart F high-tax exception with the provisions of the GILTI high-tax exclusion in the final regulations, as modified by these proposed regulations.

Another comment on the 2019 proposed regulations suggested that section 954(b)(4) should apply consistently to all of a CFC's items of gross income. In response to this comment, these proposed regulations provide for a single election under section 954(b)(4) for purposes of both subpart F income and tested income (the ''high-tax exception'').[1] This unified rule, modeled on the GILTI high-tax exclusion in the final regulations, provides for further simplification.

II. Calculation of the Effective Tax Rate on the Basis of Tested Units

A. In General

Under § 1.954–1(d), effective tax rates and the applicability of the subpart F high-tax exception are determined on the basis of net foreign base company income of a CFC.[2] Net foreign base company income generally means income described in § 1.954–1(c)(1)(iii) reduced by deductions. *See* § 1.954–1(c)(1). In general, single items of income tested for eligibility are determined by aggregating items of income of a certain type. *See* § 1.954–1(c)(iii)(A) and (B). For example, the aggregate amount of a CFC's income from dividends, interests, rents, royalties, and annuities giving rise to non-passive foreign personal holding company income constitutes a single item of income. *See* § 1.954–1(c)(1)(iii)(A)(*1*)(*i*). In contrast, under the final regulations, effective tax rates and the applicability of the GILTI high-tax exclusion are determined by aggregating gross income that would be gross tested income (but for the GILTI high-tax exclusion) within a separate category to the extent attributable to a tested unit of a CFC. *See* § 1.951A–2(c)(7)(ii)(A). For this purpose, the tentative tested income items and foreign taxes of multiple tested units of a CFC (including the CFC itself) that are tax residents of, or located in (in the case of certain branches), the same foreign country, generally are aggregated. *See* § 1.951A–2(c)(7)(iv)(C)(*1*) and (*3*). As described further in the preamble to the final regulations, applying these rules on a tested unit basis ensures that high-taxed and low-taxed items of income are not inappropriately aggregated for purposes of determining the effective rate of tax, while at the same time allowing for some level of aggregation to minimize complexity. Measuring the effective rate of foreign tax on a tested unit basis is also appropriate in light of the reduction of corporate federal income tax rates by the Act; as a result of such lower rates, it is likely that CFCs will earn more high-taxed income potentially eligible for section 954(b)(4).

For the same reasons that the GILTI high-tax exclusion applies on a tested unit basis, the Treasury Department and the IRS have determined that the subpart F high-tax exception should apply on a tested unit basis. *See* proposed § 1.954–1(d)(1)(ii)(A) and (B). In addition, the Treasury Department and the IRS have determined that for purposes of determining the applicability of section 954(b)(4), it is appropriate to group general category items of income attributable to a tested unit that would otherwise be tested income, foreign base company income, or insurance income. *See* proposed § 1.954–1(d)(1)(ii)(A). By grouping these items of income, taxpayers making a high-tax exception election may be able to forego the often-complex analysis required to determine whether income would meet the definition of subpart F income. For example, taxpayers will not be required to determine whether income is foreign base company sales income versus tested income if the high-tax exception applies to the income.

The proposed regulations generally group passive foreign personal holding company income in the same manner as existing § 1.954–1(c)(1)(iii)(B). *See* proposed § 1.954–1(d)(1)(ii)(C). However, the Treasury Department and the IRS may propose conforming changes to the income grouping rules in § 1.904–4(c) as part of future guidance. Comments are requested on this topic.

Certain income and deductions attributable to equity transactions (for example, dividends or losses attributable to stock) are also separately grouped for purposes of the high-tax exception if the income is subject to preferential rates or an exemption under the tax law of the country of residence of the recipient. *See* proposed § 1.954–1(d)(1)(ii)(B) and (iv)(C). The purpose of this separate equity grouping is to separately test income or loss that is subject to foreign tax at a different rate than other general category income attributed to the tested unit and that may be susceptible to manipulation through, for example, the timing of distributions or losses.

[1] As a result, when the rules in these proposed regulations are adopted as final regulations, the rules in § 1.951A–2(c)(7) (which provide the election specific to the GILTI high-tax exclusion) will be withdrawn.

[2] Similar rules apply for insurance income. *See* § 1.954–1(d)(3)(i) and § 1.954–1(a)(6).

B. Gross Income Attributable to Tested Units Based on Applicable Financial Statement

The final regulations generally use items properly reflected on the separate set of books and records (within the meaning of § 1.989(a)–1(d)) as the starting point for determining gross income attributable to a tested unit. *See* § 1.951A–2(c)(7)(ii)(B)(*1*). Books and records are used for this purpose because they serve as a reasonable proxy for determining the amount of gross income that the foreign country of the tested unit is likely to subject to tax and, given that this approach is consistent with the approach taken in other provisions, it should promote administrability.

The proposed regulations retain this general approach but replace the reference to ''books and records'' with a more specific standard based on items of gross income attributable to the ''applicable financial statement'' of the tested unit. *See* proposed § 1.954–1(d)(1)(iii)(A). For this purpose, an applicable financial statement refers to a ''separate-entity'' (or ''separate-branch,'' if applicable) financial statement that is readily available, with the highest priority within a list of different types of financial statements. *See* proposed § 1.954–1(d)(3)(i). These financial statements include, for example, financial statements that are audited or unaudited, and that are prepared in accordance with U.S. generally accepted accounting principles (''U.S. GAAP''), international financial reporting standards (''IFRS''), or the generally accepted accounting principles of the jurisdiction in which the entity is organized or the activities are located (''local-country GAAP''). *See id.*

The Treasury Department and the IRS have determined that this new standard will provide more accurate and reliable information and will promote certainty in cases where there may be various forms of readily available financial information. This standard is also expected to promote administrability because it is consistent with approaches taken under other provisions. *See* section 451(b) and Rev. Proc. 2019–40, 2019–43 I.R.B. 982. Finally, the Treasury Department and the IRS anticipate that the type of applicable financial statement will, in many cases, be the same from year to year and therefore will result in consistency and minimize opportunities for manipulation.

C. Allocation and Apportionment of Deductions for Purposes of the High-Tax Exception

As explained in section II.B of this Explanation of Provisions, the final regulations generally use items properly reflected on the separate set of books and records as the starting point for determining gross income attributable to a tested unit. *See* § 1.951A–2(c)(7)(ii)(B)(*1*). In contrast, the final regulations do not allocate and apportion deductions to those items of gross income by reference to the items of deduction that are properly reflected on the books and records of a tested unit. Instead, the final regulations apply the general allocation and apportionment rules for purposes of determining a tentative tested income item with respect to a tentative gross tested income item, such that deductions are generally allocated and apportioned under the principles of § 1.960–1(d)(3) by treating each tentative gross tested income item as income in a separate tested income group, as that term is described in § 1.960–1(d)(2)(ii)(C). *See* § 1.951A–2(c)(7)(iii). Under those principles, certain deductions, such as interest expense, are allocated and apportioned based on a specific factor (such as assets or gross income) among the separate items of gross income of a CFC, such that deductions reflected on the books and records of a single tested unit, and generally taken into account for foreign tax purposes in computing the foreign taxable income, may not be fully taken into account for purposes of determining a tentative tested income item.

The application of this provision of the final regulations may be illustrated by the following example. Assume that a CFC owns interests in two disregarded entities the interests in which are tested units (''TU1'' and ''TU2''), an equal amount of gross income is attributable to each of TU1 and TU2, and the CFC has no other activities. TU1's income is subject to a 30 percent rate of foreign tax, and TU2's income is subject to a 15 percent rate of foreign tax. TU1 accrues deductible interest expense payable to a third party that is allocated and apportioned to the CFC's gross income using the modified gross income method of § 1.861–9T(j)(1), such that interest expense incurred by TU1 is allocated and apportioned equally between TU1 and TU2 for purposes of the GILTI high-tax exclusion. The foreign countries in which TU1 and TU2 are tax residents allow for deductions of interest expense only to the extent that resident entities in the country actually accrue such interest expenses. Therefore, the foreign country in which TU1 is tax resident allows a full deduction for the interest accrued by TU1, and TU2's country of tax residence does not allow an interest deduction for any interest accrued by TU1. Under the final regulations, the allocation of interest expense for federal income tax purposes may cause TU1's gross income to fail to qualify for the high-tax exception and may cause TU2's gross income to qualify for the high-tax exception, notwithstanding the higher tax rate in TU1's country of residence and the lower tax rate in TU2's country of residence.

The Treasury Department and the IRS have determined that the policy goal of section 954(b)(4) is to identify income of a CFC subject to a high effective rate of foreign tax and is better served by determining the effective foreign tax rate with respect to items of income attributable to a tested unit by reference to an amount of income that approximates taxable income as computed for foreign tax purposes, rather than federal income tax purposes. However, the use of U.S. (rather than foreign) tax accounting rules to determine the amount and timing of items of income, gain, deduction, and loss included in the high-tax exception computation remains appropriate to ensure that the computation is not distorted by reason of foreign tax rules that do not conform to federal income tax principles. Therefore, these proposed regulations generally determine tentative net items by allocating and apportioning deductions, determined under federal income tax principles, to items of gross income to the extent the deductions are properly reflected on the applicable financial statement of the tested unit, consistent with the manner in which gross income is attributed to a tested unit. Under this method, a tentative net item better approximates the tax base upon which foreign tax is imposed than would be the case under the allocation and apportionment rules set forth in the regulations under section 861.

The proposed regulations allocate and apportion deductions to the extent properly reflected on the applicable financial statement only for purposes of section 954(b)(4), and not for any other purpose, such as for determining U.S. taxable income of the CFC under sections 954(b)(5) and 951A(c)(2)(A)(ii), and the associated foreign tax credits under section 960. In contrast to section 954(b)(4), under which the rules in the proposed regulations are intended to approximate the foreign tax base, taxable income and items of income for purposes of sections 954(b)(5), 951A(c)(2)(A)(ii), and 960 continue to be determined using the allocation and apportionment rules set forth in the regulations under section 861. Nevertheless, the Treasury Department and the IRS are considering whether for purposes of sections 954(b)(5), 951A(c)(2)(A)(ii), and 960 it would be appropriate, in limited cases (for example to reduce administrative and compliance burdens), to allocate and apportion deductions incurred by a CFC based on the extent to which they are properly reflected on an applicable financial statement, and request comments in this regard. For example, a rule could allocate and apportion deductions (other than foreign tax expense) only to the extent of the items of gross income attributable to the tested unit, and allocate and apportion any deductions in excess of such gross income to all gross income of the CFC. In addition, applying a method based on applicable financial statements for purposes of the high-tax exception could, in certain circumstances, affect the allocation and apportionment of deductions for purposes of determining the amount of an inclusion with respect to gross income of the CFC that is not eligible for the high-tax exception. One approach under consideration is to provide that deductions allocated and apportioned to an item of gross income based on an applicable financial statement for purposes of calculating a tentative net item under the high-tax exception cannot be allocated and apportioned to a different item of gross income that does not qualify for the high-tax exception for purposes of calculating the inclusion under section 951(a) or section 951A. This approach would be a limited change to the traditional rules for allocating and apportioning deductions and would address concerns that, if deductions were not allocated and apportioned using a consistent method when the high-tax exception has been elected, they could be viewed as effectively being ''double counted'' by both reducing the tentative net item for purposes of determining whether an item of gross income is eligible for the high-tax exception and also reduce the amount of a U.S. shareholder's inclusions under sections 951(a)(1) and 951A(a) with respect to a different item of gross income. Comments are requested on this issue.

D. Undefined or Negative Foreign Tax Rates

In certain cases, the effective foreign tax rate at which taxes are imposed on a tentative net item may result in an undefined value or a negative effective foreign tax rate. This may occur, for example, if foreign taxes are allocated and apportioned to the corresponding item of gross income, and the tentative net item (plus the foreign taxes) is negative because the amount of deductions allocated and apportioned to the gross income exceeds the amount of gross income (plus the foreign taxes). The proposed regulations provide that the effective rate of foreign tax with respect to a tentative net item that results in an undefined value or a negative effective foreign tax rate will be deemed to be high-taxed. *See* § 1.954–1(d)(4)(ii). As a result, the item of gross income, and the deductions allocated and apportioned to such gross income under the rules set forth in the regulations under section 861, are assigned to the residual grouping, and no credit is allowed for the foreign taxes allocated and apportioned to such gross income. Nevertheless, the Treasury Department and the IRS are considering whether this result is appropriate in all cases and request comments in this regard.

E. Combination of de Minimis Tested Units

As discussed in the preamble to the final regulations, a comment recommended that taxpayers be permitted to aggregate QBUs within the same CFC that have a small amount of tested income. Although the final regulations did not adopt this recommendation, the proposed regulations include a rule that, subject to an anti-abuse provision, combines tested units (on a non-elective basis) that are attributed gross income less than the lesser of one percent of the gross income of the CFC, or $250,000. *See* proposed § 1.954–1(d)(2)(iii)(A)(*2*). This de minimis combination rule applies after the application of the ''same foreign country'' combination rule in proposed § 1.954–1(d)(2)(iii)(A)(*1*) and, therefore, combines tested units that are not residents of (or located in) the same foreign country.

Comments are requested on this de minimis combination rule, including whether the rule could be better tailored to reduce administrative burden without permitting an excessive amount of blending of income subject to different foreign tax rates.

F. Anti-Abuse Rules

The Treasury Department and the IRS are concerned that taxpayers may include, or fail to include, items on an applicable financial statement or make, or fail to make, disregarded payments, to manipulate the application of the high-tax exception. As a result, the proposed regulations include an anti-abuse rule to address such cases if undertaken with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or proposed § 1.954–1(d). *See* proposed § 1.954–1(d)(3)(v).

The Treasury Department and the IRS are also concerned that taxpayers may enter into transactions with a significant purpose of manipulating the eligibility of income for the high-tax exception. This could occur, for example, if a payment or accrual by a CFC is deductible for federal income tax purposes but not for purposes of the tax laws of the foreign country of the payor. As a result, the deduction would reduce the tentative net items of the CFC but would not reduce the amount of foreign income taxes paid or accrued with respect to the tentative net item, which would have the effect of increasing the foreign effective tax rate imposed on the item. Accordingly, the proposed regulations include an anti-abuse rule to address transactions or structures involving certain instruments (''applicable instruments'') or reverse hybrid entities that are undertaken with a significant purpose of manipulating whether an item of income qualifies for the high-tax exception. *See* proposed § 1.954–1(d)(7). The Treasury Department and the IRS continue to study other transactions and structures that may be used to inappropriately manipulate the application of the high-tax exception, including transactions and structures with hybrid entities, and may expand the application of the anti-abuse rule in the final regulations such that it is not limited to specific types of transactions or structures.

III. Mechanics of the Election

A. In General

As described in part I of this Explanation of Provisions, under current § 1.954–1(d), the election for the subpart F high-tax exception is made separately with respect to each CFC, unlike the GILTI high-tax exclusion election, which must be made with respect to all of the CFCs that are members of a CFC group. As discussed in the preamble to the final regulations, the consistency requirement contained in the GILTI high-tax exclusion rules is necessary to prevent inappropriate cross-crediting with respect to high-taxed income under section 904. As a result of the changes made by the Act, a consistency requirement is also appropriate for the subpart F high-tax exception. The benefit of a CFC-specific election before the Act was to defer U.S.

tax with respect to high-tax income items. After the Act, as described further in the preamble to the final regulations, the ability to exclude some high-taxed income from subpart F, while claiming foreign tax credits with respect to other high-taxed income, can produce inappropriate results under section 904. As a result, the Treasury Department and the IRS have determined that a single high-tax exception election applicable to all income of all CFCs that are members of a CFC group better reflects the purposes of sections 904 and 954(b)(4) than a CFC-by-CFC election. Accordingly, the proposed regulations include a single unified election that applies for purposes of both subpart F and GILTI, incorporating a consistency requirement parallel to that in § 1.951A–2(c)(7)(viii)(A)(*1*) and (c)(7)(viii)(E). *See* proposed § 1.954–1(d)(6)(v).

B. Contemporaneous Documentation

Neither current § 1.954–1(d) nor the final regulations specify the documentation necessary for a U.S. shareholder to substantiate either the calculation of an amount excluded by reason of an election under section 954(b)(4) or that the requirements under current § 1.954–1(d) or the final regulations were met. However, to facilitate the administration of the rules regarding these elections, the Treasury Department and the IRS have determined that U.S. shareholders must maintain specific contemporaneous documentation to substantiate their high-tax exception computations. Accordingly, the proposed regulations include a contemporaneous documentation requirement. *See* proposed § 1.954–1(d)(6)(i)(D) and (d)(6)(vii). In addition, the proposed regulations add this information to the list of information that must be included on Form 5471 (''Information Return of U.S. Persons With Respect to Certain Foreign Corporations''). *See* proposed § 1.6038–2(f)(19).

IV. Other Changes to § 1.954–1

A. Coordination Rules

1. Earnings and Profits Limitation

Section 1.954–1(d)(4)(ii) provides that the amount of income that is a net item of income (an input in determining whether the subpart F high-tax exception applies) is determined after the application of the earnings and profits limitation provided under section 952(c)(1). Section 952(c)(1)(A) generally limits the amount of subpart F income of a CFC to the CFC's earnings and profits for the taxable year. In addition, section 952(c)(2) provides that if the subpart F income of a CFC is reduced by reason of the earnings and profits limitation under section 952(c)(1)(A), any excess of the earnings and profits of the CFC for any subsequent taxable year over the CFC's subpart F income for such taxable year is recharacterized as subpart F income under rules similar to the rules under section 904(f)(5).

The Treasury Department and the IRS have determined that this coordination rule can lead to inappropriate results. When the section 952(c)(1) limitation applies, the effective rate at which taxes are imposed under § 1.954–1(d)(2) would be calculated on a smaller net item of income than if the net item of income were determined before the limitation, but the amount of foreign income taxes with respect to the net item would be unchanged. *See* § 1.954–1(d)(4)(iii). This could have the effect of causing a net item of income to qualify for the subpart F high-tax exception even though the item, without regard to the limitation, would not have so qualified. In addition, amounts subject to recharacterization as subpart F income in a subsequent taxable year under section 952(c)(2) may not qualify for the subpart F high-tax exception even if the net item of income to which the recapture amount relates did so qualify. *See* § 1.954–1(a)(7). As a result, the proposed regulations provide that the high-tax exception applies without regard to the limitation in section 952(c)(1). *See* proposed § 1.954–1(a)(2)(i) and (5). The proposed regulations also follow current § 1.951–1(a)(7), which provides that the subpart F income of a CFC is increased by earnings and profits of the CFC that are recharacterized under section 952(c)(2) and § 1.952–1(f)(2)(ii) after determining the items of income of the CFC that qualify for the high-tax exception. *See* proposed § 1.954–1(a)(5).

2. Full Inclusion Rule

The current regulations generally provide that, except as provided in section 953, adjusted gross foreign base company income consists of all gross income of the CFC other than gross insurance income (and amounts described in section 952(b)), and adjusted gross insurance income consists of all gross insurance income (other than amounts described in section 952(b)), if the sum of the gross foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income (the ''full inclusion rule''). *See* § 1.954–1(a)(3) and (b)(1)(ii). Thus, under the current regulations the full inclusion rule generally applies before the application of the subpart F high-tax exception (which occurs when adjusted net foreign base company income is determined). Under a special coordination rule, however, full inclusion foreign base company income is excluded from subpart F income if more than 90 percent of the adjusted gross foreign base company income and adjusted gross insurance company income of a CFC (determined without regard to the full inclusion rule) is attributable to net amounts excluded from subpart F income under the subpart F high-tax exception. *See* § 1.954–1(d)(6).

The Treasury Department and the IRS have determined that these rules could be simplified if the determination of whether income is foreign base company income occurs before the application of the full inclusion rule. Current § 1.954–1, for example, requires taxpayers to determine whether income is foreign base company income or insurance income before applying the full inclusion rule or the high tax exception. *See* § 1.954–1(a)(2) through (a)(5), and (a)(6). Applying the high-tax exception first will eliminate the need to perform this factual analysis in many cases. Therefore, the proposed regulations provide that the high-tax exception applies before the full inclusion rule and, consequently, the special coordination rule in § 1.954–1(d)(6) is eliminated. *See* proposed § 1.954–1(a)(2)(i). In addition, the proposed regulations make conforming revisions to the coordination rule for full inclusion income and the high-tax election in the regulations under section 951A. Consequently, the proposed regulations delete § 1.951A–2(c)(4)(iii)(C) and (iv)(C) (Example 3).

B. Elections on Amended Returns

Current § 1.954–1(d)(5) generally provides that a controlling U.S. shareholder (as defined in § 1.964–1(c)(5)) may make (or revoke) a subpart F high-tax election by attaching a statement to its amended income tax return and that this election is binding on all U.S. shareholders of the CFC. In conforming the provisions of the subpart F high-tax exception with the provisions of the GILTI high-tax exclusion in the final regulations (as modified by these proposed regulations), the Treasury Department and the IRS have determined that it is also necessary to revise the rules regarding elections on amended returns. The final regulations require that amended returns for all U.S. shareholders of the CFC for the CFC inclusion year must be filed within a single 6-month period within 24 months of the unextended due date of the original income tax return of the controlling domestic shareholder's inclusion year with or within which the relevant CFC inclusion year ends. *See* § 1.951A–2(c)(7)(viii)(A)(*1*)(*iii*). As stated in the preamble to the final regulations, the Treasury Department and the IRS determined that the requirement that all amended returns be filed by the end of this period is necessary to administer the GILTI high-tax exclusion and to allow the IRS to timely evaluate refund claims or make additional assessments.

For this reason, the proposed regulations also provide that the high-tax election may be made (or revoked) on an amended federal income tax return only if all U.S. shareholders of the CFC file amended returns (unless an original federal income tax returns has not yet been filed, in which case the original return may be filed consistently with the election (or revocation)) for the year (and for any other tax year in which their U.S. tax liabilities would be increased by reason of that election (or revocation)), within a single 6-month period within 24 months of the unextended due date of the original federal income tax return of the controlling domestic shareholder's inclusion year. *See* proposed § 1.954–1(d)(6)(i)(B)(*2*). The proposed regulations provide that in the case of a U.S. shareholder that is a partnership, the election may be made (or revoked) with an amended Form 1065 or an administrative adjustment request, as applicable. Further, the proposed regulations provide that if a partnership files an administrative adjustment request, a partner that is a U.S. shareholder in the CFC is treated as having complied with these requirements (with respect to the portion of the interest held through the partnership) if the partner and the partnership timely comply with their obligations under section 6227. *See* proposed § 1.954–1(d)(6)(i)(C).

The Treasury Department and the IRS are aware that changes in circumstances occurring after the 24-month period may cause a taxpayer to benefit from making (or revoking) the election, for example, if there is a foreign tax redetermination with respect to one or more CFCs. The Treasury Department and the IRS request comments on rules that would permit a taxpayer to make (or revoke) an election after the 24-month period in cases where the taxpayer can establish that the election (or revocation) will not result in time-barred tax deficiencies.

V. Application of Section 952(c)(2) to Transactions Described in Section 381(a)

Section 952(c)(2) generally provides that if subpart F income of a CFC for a taxable year was reduced by reason of the current earnings and profits limitation in section 952(c)(1)(A), any excess of the earnings and profits of such CFC for any subsequent taxable year over the subpart F income of such foreign corporation for such taxable year is recharacterized as subpart F income under rules similar to the rules of section 904(f)(5). Section 1.904(f)–2(d)(6) generally provides, in part, that in the case of a distribution or transfer described in section 381(a), an overall foreign loss account of the distributing or transferor corporation is treated as an overall foreign loss account of the acquiring or transferee corporation as of the close of the date of the distribution or transfer.

The Treasury Department and the IRS have determined that, because of some lack of certainty whether recapture accounts carry over in transactions to which section 381(a) applies, it is appropriate to provide clarification. Therefore, the proposed regulations clarify that recapture accounts carry over to the acquiring corporation (including foreign corporations that are not CFCs) in a distribution or transfer described in section 381(a). *See* proposed § 1.952–1(f)(4). The Treasury Department and the IRS believe that this clarification is consistent with general successor principles as may be applied under current law in certain successor transactions such as transactions described in section 381(a).

VI. Applicability Dates

The proposed regulations under § 1.951A–2, 1.952–1(e), and § 1.954–1 are proposed to apply to taxable years of CFCs beginning after the date the Treasury decision adopting these rules as final regulations is filed with the **Federal Register**, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

The proposed regulations under § 1.952–1(f)(4) are proposed to apply to taxable years of a foreign corporation ending on or after July 20, 2020. *See* section 7805(b)(1)(B). As a result of this applicability date, proposed § 1.952–1(f)(4) would apply with respect to recapture accounts of an acquiring corporation for taxable years of the corporation ending on or after July 20, 2020, even if the distribution or transfer described in section 381(a) occurred in a taxable year ending before July 20, 2020.

Special Analyses

I. Regulatory Planning and Review—Economic Analysis

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. Order 13771 designation for any final rule resulting from these proposed regulations will be informed by comments received. The preliminary Executive Order 13771 designation for this proposed rule is regulatory.

The Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) has designated these regulations as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs (OIRA) has designated the final rulemaking as significant under section 1(c) of the Memorandum of Agreement. Accordingly, OMB has reviewed the final regulations.

A. Background

A foreign corporation with significant U.S. ownership may be classified as a controlled foreign corporation ("CFC"). Under section 951(a)(1)(A), each United States shareholder is required to include in gross income its pro rata share of the CFC's subpart F income. Subpart F income consists of the sum of a CFC's foreign base company income (as defined in section 954(a)) and insurance income (as defined in section 953(a)) and certain income described in section 952(a)(3) through (5). Section 954(b)(4), however, provides an exclusion of high-taxed items of income from foreign base company income and insurance income (the "subpart F high-tax exception"). The subpart F high-tax exception is generally governed by regulations originally issued in 1988 and significantly updated in 1995 ("current subpart F HTE regulations").

As part of the Tax Cuts and Jobs Act, Congress enacted section 951A, which subjects certain income earned by a CFC to U.S. tax on a current basis at the United States shareholder level as global intangible low-taxed income (''GILTI''). Under section 951A(c)(2)(A)(i)(III), taxpayers may apply the high-tax exception of section 954(b)(4) in order to exclude certain high-taxed income from taxation under section 951A (the ''GILTI high-tax exclusion''). The final regulations (''final GILTI HTE regulations,'' referred to elsewhere in this Preamble as the final regulations) released at this same time as these proposed regulations provide provisions for the implementation of the GILTI high-tax exclusion.

B. Need for Regulations

The current subpart F high-tax exception regulations and the final GILTI HTE regulations each contain guidance regarding statutory exclusions for high-taxed income that would otherwise be included in subpart F or tested income but these rules do not conform to each other. The proposed regulations are needed to conform the subpart F high-tax exception to the GILTI high-tax exclusion and to provide for a single election to exclude high-taxed income under section 954(b)(4).

C. Overview of Regulations

The proposed regulations provide for a single election under section 954(b)(4) for purposes of both subpart F and GILTI, modeled on the final GILTI HTE regulations. Consistent with the final GILTI HTE regulations, the proposed regulations include the requirement that an election is generally made with respect to all CFCs that are members of a CFC group (instead of an election made on a CFC-by-CFC basis) and provide that the determination of whether income is high-taxed is made on a tested unit-by-tested unit basis. The proposed regulations would also simplify the determination of high-taxed income and often eliminate the fact intensive analysis by grouping certain income that would otherwise qualify as subpart F income together with income that would otherwise qualify as tested income for the purpose of determining the effective foreign tax rate. In addition, the proposed regulations would modify the method for allocating and apportioning deductions to items of gross income for the purposes of the high-tax exception.

D. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated federal income tax-related behavior in the absence of these regulations.

2. Summary of Economic Effects

The proposed regulations conform the subpart F high-tax exception and GILTI high-tax exclusion by providing a single election for the purposes of both such exclusions, based on the final GILTI HTE regulations. This guidance thus reduces compliance costs and generally treats income earned across different forms of international business activity more equitably than under the no-action baseline. Based on these reasons, the Treasury Department and the IRS project that the proposed regulations will improve U.S. economic performance.

The Treasury Department and the IRS project that the proposed regulations, if finalized, would have annual economic effects greater than $100 million ($2020). This determination is based on the fact that many of the taxpayers potentially affected by these proposed regulations are large multinational enterprises. Because of their substantial size, even modest changes in the treatment of their foreign-source income, relative to the no-action baseline, can lead to changes in patterns of economic activity that amount to at least $100 million per year.

The Treasury Department and the IRS have not undertaken more precise estimates of the economic effects of the proposed regulations. We do not have readily available data or models that predict with reasonable precision the business decisions that taxpayers would make under the proposed regulations, such as the amount and location of their foreign business activities and the extent to which this foreign business activity may substitute for or complement domestic business activity, versus alternative regulatory approaches, including the no-action baseline.

In the absence of quantitative estimates, the Treasury Department and the IRS have undertaken a qualitative analysis of the economic effects of the proposed regulations relative to the no-action baseline and alternative regulatory approaches.

The Treasury Department and the IRS solicit comments on the economic analysis of the proposed regulations and particularly solicit data, models, or other evidence that may be used to enhance the rigor with which the final regulations are developed.

3. Economic Analysis of Specific Provisions

a. Single Exception for all High-Taxed Income

The current subpart F high-tax exception regulations and the final GILTI HTE regulations each contain guidance regarding statutory exceptions for high-taxed income that would otherwise potentially be included in U.S. taxable income through a subpart F inclusion or a GILTI inclusion. These rules do not conform to each other. In addition, there currently are two elections under section 954(b)(4) with respect to distinct categories of income that are made separately. The proposed regulations provide for a single election under section 954(b)(4) of a unified high-tax exception.

Under the current subpart F high-tax exception regulations, taxpayers may elect to exclude high-taxed income from foreign base company income and insurance income on an item-by-item basis with respect to each individual CFC. Thus, taxpayers may select individual CFCs for which they elect to exclude high-taxed income from subpart F, while not making the election for other related CFCs. In contrast, the final GILTI HTE regulations contain a ''consistency requirement'' such that the election into the GILTI high-tax exclusion must be made for all related CFCs and with respect to all high-taxed income of those CFCs.

Comments preceding the final GILTI HTE regulations noted that the lack of conformity between the two high-tax exceptions, and particularly the ability of taxpayers to exclude items of high-taxed income from subpart F on a selective basis under the current subpart F high-tax exception regulations, may provide taxpayers with an incentive to structure activities such that certain foreign income would qualify as foreign base company income or insurance income, rather than tested income, in the absence of an election under section 954(b)(4).

To better understand this incentive and why it may be problematic, consider the following example. Under the current regulations, by structuring in a way that some of its high-taxed foreign income is treated as foreign base company sales income (a category of foreign base company income) and electing the subpart F high-tax exception for only certain CFCs, a taxpayer may selectively exclude only a portion of its high-taxed CFC income from U.S. taxation under sections 951 and 951A. The taxpayer can then use foreign tax credits from the high-taxed income that is not excluded against its low-taxed foreign income. However, the taxpayer's foreign tax credit limitation will not fully take into account the expenses attributable to investments giving rise to high-taxed income, since expenses allocable to excluded high-taxed income will be disregarded under section 904(b)(4). Consequently, the foreign tax limitation may be higher on a relative basis than it would have been if all high-taxed foreign income and all expenses attributable to such income were taken into account, and tax credits from non-excluded high-taxed income may more generously reduce U.S. tax liability on the taxpayer's low-taxed income.

In contrast, under the single high-tax exception provided by these proposed regulations, the election into the high-tax exception must be made for all CFCs that are members of a CFC group. A taxpayer that wishes to use high-taxed income to cross-credit against low-taxed income would need to include all its foreign income and allocable expenses in the foreign tax credit limitation calculation. Thus, the foreign tax credit limitation will take into account all expenses attributable to foreign income and the tax credits from high-taxed foreign income will be appropriately limited. Therefore, the proposed regulations will decrease taxpayers' incentives to inefficiently structure their foreign business activities relative to the current regulations, since such structuring would no longer be advantageous to taxpayers for purposes of the high-tax exception.

The Treasury Department and the IRS project that such structuring of foreign business activities to reclassify foreign income would be undertaken for tax-driven rather than market-driven reasons and would not provide any general economic benefit relative to the single exclusion provided in the proposed regulations. Thus, the no-action baseline may lead to higher compliance costs and less efficient patterns of business activity relative to proposed regulations with a unified high-tax exception and a consistency requirement.

The Treasury Department and the IRS recognize that relative to the no-action baseline, the proposed regulations may increase U.S. tax on some foreign income earned by U.S. shareholders of CFCs since they may reduce tax planning opportunities for U.S. taxpayers. Thus, the proposed regulations may, on the margin, decrease foreign investment by some U.S. taxpayers compared to the baseline.

The Treasury Department and the IRS have not undertaken estimation of the reduction in compliance costs or the changes in the pattern of business activity under the proposed regulations, relative to the no-action baseline. We do not have readily available data or models to estimate with any reasonable precision: (i) The number and attributes of the taxpayers that will elect the unified high-tax exception under the proposed regulations or that would elect the subpart F and GILTI high-tax exceptions under the no-action baseline; (ii) the range of effective tax rates on foreign investment that taxpayers are likely to have under the proposed regulations versus the no-action baseline; and (iii) the business activities that taxpayers would undertake as a result of these effective tax rates under the proposed regulations versus the no-action baseline.

b. Grouping Various Categories of Income Into a Single Category

Under the current subpart F high-tax exception regulations, effective foreign tax rates are determined separately for a number of different income categories. Thus, taxpayers need to classify their income items into these categories when electing into the subpart F high-tax exception. In addition, under the final GILTI HTE regulations, taxpayers must determine whether income would otherwise qualify as tested income when electing into the GILTI high-tax exclusion. In both of these cases, to classify their income items into these various categories, taxpayers may need to undertake complex factual analyses. To simplify for taxpayers the determination of which income is subject to a high rate of foreign tax, the proposed regulations modify the categories into which income is grouped for the purpose of determining effective foreign tax rates for the unified high-tax exception.

Under the proposed regulations, several categories of income that would otherwise qualify as subpart F income or tested income are grouped into a single category for the purpose of determining if income is high-taxed and qualifies for the high-tax exception. This grouping of income types will, in many circumstances, eliminate the need for taxpayers to determine exactly which category an income item would belong to in the absence of an election relative to the current regulations. For example, under the no-action baseline, the taxpayer may need to undertake a complex analysis to determine whether income is properly categorized as foreign base company services income or tested income. Under the proposed regulations, taxpayers could avoid such an analysis because the income would clearly fall into the new broader category that includes both foreign base company services income and potential tested income. This proposed approach will therefore result in substantial simplification and reduce the compliance burden for taxpayers electing into the high-tax exception relative to the no-action baseline.

The proposed approach will also decrease incentives for taxpayers to organize their operations solely for the purpose of ensuring that income will qualify for a certain category, relative to the no-action baseline. Under the current subpart F high-tax exception regulations, taxpayers may have an incentive to organize certain business activities to generate, for example, sales income rather than services income in order to raise (or lower) the effective foreign tax rates in the categories of foreign base company sales income and foreign base company services income. By manipulating the effective foreign tax rates of certain income categories, taxpayers may be able to maximize the tax saving they can achieve through the subpart F high-tax exception. However, organizing their activities to generate certain types of income may result in less efficient patterns of business activity relative to a regulatory approach with less specific income categories. Under the proposed regulations, because items of income will be grouped into broader categories for the purpose of determining high-taxed income, the incentive for taxpayers to generate specific types of income will be diminished relative to the no-action baseline.

Due to the absence of readily available data or models, the Treasury Department and the IRS have not estimated the difference in compliance costs or tax administration costs between the proposed regulations and the no-action baseline. We also have not estimated the difference in business activities that taxpayers might undertake between the proposed regulations and the no-action baseline.

c. Allocation and Apportionment of Deductions for Purposes of the High-Tax Exception

The Tax Cuts and Jobs Act is silent over how deductions should be allocated and apportioned to the gross income for purposes of the high-tax exception. The allocation of these deductions can have an impact on a tested unit's effective foreign tax rate for the purposes of the high-tax exception.

Under the final GILTI HTE regulations, certain deductions are allocated and apportioned among separate items of gross income of a CFC, even if the deductions are reflected on the books and records of only one of the CFC's tested units and are likely only taken into account for the computation of foreign taxable income, as calculated for foreign tax purposes, in the jurisdiction of that tested unit. Thus, the allocation and apportionment of deductions to items of gross income may differ from how those deductions are treated by foreign jurisdictions in calculating foreign tax. For example, suppose that a CFC has an expense that for foreign jurisdictions' tax purposes is granted a full deduction against foreign taxable income in the jurisdiction of a single tested unit and is not granted deductions in any other jurisdictions where the CFC operates for the purposes of computing taxable income in these jurisdictions. Under the final GILTI HTE regulations, this deduction may nevertheless be allocated and apportioned against the gross income of multiple tested units of a CFC, some of which may not be tax resident in the same jurisdiction where the deduction is allowed for foreign tax purposes. This difference between federal and foreign tax treatment may result in some income qualifying (or not qualifying) for the high-tax exception even when the statutory rate of foreign tax is low (or high). In addition, the difference between federal tax treatment and how taxpayers record deductions in their books and records may add to taxpayers' compliance burden and may complicate tax administration relative to alternative regulatory approaches.

To address these issues, the proposed regulations adopt an approach based on the books and records kept by the taxpayer. In particular, the proposed regulations generally provide that, for the purposes of the high-tax exception, deductions will be allocated and apportioned to items of gross income by reference to the items of deduction that are properly reflected on the books and records of a tested unit. This approach will align the method for allocating deductions to tested units with the method for attributing items of gross income to tested units, which also follows a books-and-records approach under the final GILTI HTE regulations.

Using the books-and-records approach for both gross income and deductions, tested units' income will also more closely approximate taxable income as computed by foreign jurisdictions for foreign tax purposes than it does under the final GILTI HTE regulations. The approach thus serves as a more accurate and more administrable method for determining the effective foreign tax rate paid tax than the no-action baseline.

Due to the absence of readily available data or models, the Treasury Department and the IRS have not estimated the difference in compliance costs or tax administration costs between the proposed regulations and the no-action baseline. We also have not estimated the difference in business activities that taxpayers might undertake between the proposed regulations and the no-action baseline.

4. Profile of Affected Taxpayers

The proposed regulations potentially affect those taxpayers that have at least one CFC with at least one tested unit (including, potentially, the CFC itself) that has high-taxed income. Taxpayers with CFCs that have only low-taxed income are not eligible to elect the high-tax exception and hence are unaffected by the proposed regulations.

The Treasury Department and the IRS estimate that there are approximately 4,000 business entities (corporations, S corporations, and partnerships) with at least one CFC that pays an effective foreign tax rate above 18.9 percent, the current high-tax statutory threshold. The Treasury Department and the IRS further estimate that, for the partnerships with at least one CFC that pays an effective foreign tax rate greater than 18.9 percent, there are approximately 1,500 partners that have a large enough share to potentially qualify as a 10 percent U.S. shareholder of the CFC.[3] The 4,000 business entities and the 1,500 partners provide an estimate of the number of taxpayers that could potentially be affected by guidance governing the election into the high-tax exception. The figure is approximate because the tax rate at the CFC-level will not necessarily correspond to the tax rate at the tested unit-level if there are multiple tested units within a CFC.

The Treasury Department and the IRS do not have readily available data to determine how many of these taxpayers would elect the high-tax exception as provided in these proposed regulations. Under the proposed regulations, a taxpayer that has both high-taxed and low-taxed tested units will need to evaluate the benefit of eliminating any tax under section 951 and section 951A with respect to high-taxed income against the costs of forgoing the use of foreign tax credits and, with respect to section 951A, the use of tangible assets in the computation of qualified business asset investment (QBAI).

Tabulations from the IRS Statistics of Income 2014 Form 5471 file[4] further indicate that approximately 85 percent of earnings and profits are reported by CFCs incorporated in jurisdictions where the average effective foreign tax rate is less than or equal to 18.9 percent. The data indicate several examples of jurisdictions where CFCs have average effective foreign tax rates above 18.9 percent, such as France, Italy, and Japan. However, information is not readily available to determine how many tested units are part of the same CFC and what the effective foreign tax rates are with respect to such tested units. Taxpayers potentially more likely to elect the high-tax exception are those taxpayers with CFCs that only operate in high-tax jurisdictions. Data on the number or types of CFCs that operate only in high-tax jurisdictions are not readily available.

II. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520) (''Paperwork Reduction Act'') requires that a federal agency obtain the approval of the OMB before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit.

A. Overview of Collections of Information in the Proposed Regulations

The proposed regulations include new collection of information requirements in proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*), § 1.954–1(d)(6)(vii)(A), and § 1.6038–2(f)(19).

The collection of information in proposed § 1.954–1(d)(6)(i)(A)(*1*) requires a statement that a controlling domestic shareholder of a CFC must file with an original or amended income tax return to elect to apply the high-tax exception in section 954(b)(4) with respect to a controlled foreign corporation. The collection of information in proposed § 1.954–1(d)(6)(i)(A)(*2*) requires a notice that the controlling domestic shareholder must provide to other domestic shareholders who own stock of the foreign corporation to notify them of the election. The collection of information in proposed § 1.954–1(d)(6)(vii)(A) requires each U.S. shareholder of a CFC

[3] Data are from IRS's Research, Applied Analytics, and Statistics division based on E-file data available in the Compliance Data Warehouse for tax years 2015 and 2016. The counts include Category 4 and Category 5 IRS Form 5471 filers. Category 4 filers are U.S. persons who had control of a foreign corporation during the annual accounting period of the foreign corporation. Category 5 filers are U.S. shareholders who own stock in a foreign corporation that is a CFC and who owned that stock on the last day in the tax year of the foreign corporation in that year in which it was a CFC. For full definitions, see *https://www.irs.gov/pub/irs-pdf/i5471.pdf.*

[4] The IRS Statistics of Income Tax Stats report on Controlled Foreign Corporations can be accessed here: *https://www.irs.gov/statistics/soi-tax-stats-controlled-foreign-corporations.*

that makes a high-tax election under section 954(b)(4) and § 1.954–1(d)(6) to maintain certain documentation. The collection of information in proposed § 1.6038–2(f)(19) requires a U.S. shareholder of a CFC that makes a high-tax election under section 954(b)(4) and § 1.954–1(d)(6) to include certain information in the Form 5471 (or successor form).

As shown in Table 1, the Treasury Department and the IRS estimate that the number of persons potentially subject to the collections of information in proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*), § 1.954–1(d)(6)(vii)(A), and § 1.6038–2(f)(19) is between 25,000 and 35,000. The estimate in Table 1 is based on the number of taxpayers that filed an income tax return that included a Form 5471, ''Information Return of U.S. Persons With Respect to Certain Foreign Corporations.'' The collections of information in proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*), § 1.954–1(d)(6)(vii)(A), and § 1.6038–2(f)(19) can only apply to taxpayers that are U.S. shareholders (as defined in section 951(b)) and U.S. shareholders are required to file a Form 5471.

TABLE 1—TABLE OF TAX FORMS IMPACTED

Tax forms impacted		
Collection of information	Number of respondents (estimated)	Forms to which the information may be attached
Proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*), § 1.954–1(d)(6)(vii)(A), and § 1.6038–2(f)(19).	25,000–35,000	Form 990 series, Form 1120 series, Form 1040 series, Form 1041 series, and Form 1065 series.

Source: MeF, DCS, and IRS's Compliance Data Warehouse.

B. Reporting of Burden Related to Proposed § 1.954–1(d)(6)(i)(A)(1) and (2) and § 1.6038–2(f)(19)

The collection of information contained in proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*) and § 1.6038–2(f)(19) will be reflected in the Form 14029, Paperwork Reduction Act Submission, that the Treasury Department and the IRS will submit to OMB for income tax returns in the Form 990 series, Forms 1120, Forms 1040, Forms 1041, and Forms 1065. In particular, the reporting burden associated with the information collection in proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*) and § 1.6038–2(f)(19) will be included in the burden estimates for OMB control numbers 1545–0123, 1545–0074, 1545–0092, and 1545–0047. OMB control number 1545–0123 represents a total estimated burden time for all forms and schedules for corporations of 3.344 billion hours and total estimated monetized costs of $61.558 billion ($2019). OMB control number 1545–0074 represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.717 billion hours and total estimated monetized costs of $33.267 billion ($2019). OMB control number 1545–0092 represents a total estimated burden time, including all other related forms and schedules for trusts and estates, of 307,844,800 hours and total estimated monetized costs of $9.950 billion ($2016). OMB control number 1545–0047 represents a total estimated burden time, including all other related forms and schedules for tax-exempt organizations, of 52.450 million hours and total estimated monetized costs of $1,496,500,000 ($2020). Table 2 summarizes the status of the Paperwork Reduction Act submissions of the Treasury Department and the IRS related to forms in the Form 990 series, Forms 1120, Forms 1040, Forms 1041, and Forms 1065.

The overall burden estimates provided by the Treasury Department and the IRS to OMB in the Paperwork Reduction Act submissions for OMB control numbers 1545–0123, 1545–0074, 1545–0092, and 1545–0047 are aggregate amounts related to the U.S. Business Income Tax Return, the U.S. Individual Income Tax Return, and the U.S. Income Tax Return for Estates and Trusts, along with any associated forms. The burdens included in these Paperwork Reduction Act submissions, however, do not account for any burdens imposed by proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*) and § 1.6038–2(f)(19). The Treasury Department and the IRS have not identified the estimated burdens for the collections of information in proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*) and § 1.6038–2(f)(19) because there are no burden estimates specific to proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*) and § 1.6038–2(f)(19) currently available. The burden estimates in the Paperwork Reduction Act submissions that the Treasury Department and the IRS will submit to the OMB will in the future include, but not isolate, the estimated burden related to the tax forms that will be revised for the collection of information in proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*) and § 1.6038–2(f)(19).

The Treasury Department and the IRS have included the burdens related to the Paperwork Reduction Act submissions for OMB control numbers 1545–0123, 1545–0074, 1545–0092, and 1545–0047 in the Paperwork Reduction Act analysis for other regulations issued by the Treasury Department and the IRS related to the taxation of cross-border income. The Treasury Department and the IRS encourage users of this information to take measures to avoid overestimating the burden that the collections of information in proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*) and § 1.6038–2(f)(19), together with other international tax provisions, impose. Moreover, the Treasury Department and the IRS also note that the Treasury Department and the IRS estimate Paperwork Reduction Act burdens on a taxpayer-type basis rather than a provision-specific basis because an estimate based on the taxpayer-type most accurately reflects taxpayers' interactions with the forms.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. Any proposed revisions to these forms that reflect the information collections contained in proposed § 1.954–1(d)(6)(i)(A)(*1*) and (*2*) and § 1.6038–2(f)(19) will be made available for public comment at *https://apps.irs.gov/app/picklist/list/draftTaxForms.html* and will not be finalized until after these forms have been approved by OMB under the Paperwork Reduction Act.

TABLE 2—SUMMARY OF INFORMATION COLLECTION REQUEST SUBMISSIONS RELATED TO FORM 990 SERIES, FORMS 1120, FORMS 1040, FORMS 1041, AND FORMS 1065

Form	Type of filer	OMB No.(s)	Status
Forms 990	Tax exempt entities (NEW Model)	1545–0047	Approved by OIRA 2/12/2020 until 2/28/2021.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201912-1545-014.*		
Form 1040	Individual (NEW Model)	1545–0074	Approved by OIRA 1/30/2020 until 1/31/2021.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021.*		
Form 1041	Trusts and estates	1545–0092	Approved by OIRA 5/08/2019 until 5/31/2022.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014.*		
Form 1065 and 1120	Business (NEW Model)	1545–0123	Approved by OIRA 1/30/2020 until 1/31/2021.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001.*		

C. Reporting of Burden Related to Proposed § 1.954–1(d)(6)(vii)(A)

The collections of information contained in proposed § 1.954–1(d)(6)(vii)(A) will not be conducted using a new or existing IRS form.

The collections of information contained in § 1.954–1(d)(6)(vii)(A) have been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act. Commenters are strongly encouraged to submit public comments electronically. Comments and recommendations for the proposed information collection should be sent to *www.reginfo.gov/public/do/PRAMain,* with electronic copies emailed to the IRS at *omb.unit@irs.gov* (indicate REG–127732–19 on the subject line). Find this particular information collection by selecting ''Currently under Review—Open for Public Comments'' and then by using the search function. Comments can also be mailed to OMB, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies mailed to the IRS, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collections of information should be received by September 21, 2020.

The likely respondents are U.S. shareholders of CFCs.

Estimated total annual reporting burden: 300,000 hours.

Estimated average annual burden per respondent: 10 hours.

Estimated number of respondents: 30,000.

Estimated frequency of responses: Annually.

III. Regulatory Flexibility Act

When an agency issues a rulemaking proposal, the Regulatory Flexibility Act (RFA) requires the agency to ''prepare and make available for public comment an initial regulatory flexibility analysis (IRFA)'' which will ''describe the impact of the proposed rule on small entities.'' 5 U.S.C. 603(a). Section 605 of the RFA allows an agency to certify a rule, in lieu of preparing an IRFA, if the proposed rulemaking is not expected to have a significant economic impact on a substantial number of small entities.

These proposed regulations directly affect small entities that are a U.S. shareholder of a CFC and elect to apply the exception for high-tax income in section 954(b)(4) and proposed § 1.954–1(d)(6)(i). A U.S. shareholder is a U.S. person that owns, directly, indirectly, or constructively, 10 percent or more of the vote or value of a foreign corporation. A foreign corporation is a CFC if U.S. shareholders own directly, indirectly, or constructively, more than 50 percent of the vote or value of the foreign corporation. Therefore, the proposed regulations apply only to U.S. persons that operate a foreign business in corporate form, and only if the foreign corporation is a CFC.

The Small Business Administration establishes small business size standards (13 CFR part 121) by annual receipts or number of employees. There are several industries that may be identified as small even through their annual receipts are above $25 million or because of the number of employees. The Treasury Department and the IRS do not have data indicating the number of small entities that will be significantly impacted by the proposed regulations. Nevertheless, for the reasons described below, the Treasury Department and the IRS do not believe that the regulations will have a significant economic impact on small entities. The proposed regulations are elective, and small entities will likely not avail of the election unless the net benefits in terms of tax liability and any consequent compliance costs are positive. Thus, the Treasury Department and the IRS hereby certify that the proposed regulations are not expected to have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. The Treasury Department and the IRS also request comments from the public on the certifications in this Part III.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1532) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. These proposed regulations do not include any federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. These proposed regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Requests for Public Hearing

Before the proposed amendments are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. See also part II.A. of the Explanation of Provisions (requesting comments related to the income grouping rules in § 1.904–4(c)), part II.C. of the Explanation of Provisions (requesting comments related to the allocation and apportionment of deductions incurred by a CFC for purposes of sections 954(b)(5), 951A(c)(2)(A)(ii), and 960 based on the extent to which they are properly reflected on an applicable financial statement), part II.D. of the Explanation of Provisions (requesting comments related to any case in which undefined or negative foreign tax rates should not be deemed high-taxed), part II.E. of the Explanation of Provisions (requesting comments related to combination of de minimis tested units to reduce administrative burden without permitting an excessive amount of blending of income subject to different foreign tax rates), and part IV.B. of the Explanation of Provisions (requesting comments related to rules that would permit a taxpayer to make (or revoke) an election after the 24-month period in cases where the taxpayer can establish that the election (or revocation) will not result in time-barred tax deficiencies). Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at *www.regulations.gov* or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020–4, 2020–17 IRB 1, provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Because the Treasury Department and the IRS intend to make revisions to the rules concerning high-taxed income in § 1.904–4(c) to conform them with the rules in these proposed regulations, comments are requested concerning any issues that should be taken into consideration in connection with such revisions.

Comments are requested on transition rules with respect to the application of existing § 1.954–1(d), which does not contain a consistency requirement, and the final regulations in circumstances in which a U.S. shareholder's CFCs have different taxable years.

Comments are also requested on the attribution of items to a tested unit based on an applicable financial statement in certain cases in which a CFC holds directly or indirectly more than one interest in an entity. For example, assume a CFC directly owns DEX, a disregarded entity that is a tax resident in Country X, and DEY, a disregarded entity that is a tax resident in Country Y. DEX and DEY together own all the interests in DEZ, a disregarded entity organized in Country Z that is viewed as fiscally transparent under the laws of all countries. Comments are requested on how items that are properly reflected on the applicable financial statement of DEZ, and taken into account by CFC, should be attributed to CFC's interests in DEX and DEY, each of which is a tested unit.

Drafting Information

The principal authors of these regulations are Jorge M. Oben and Larry R. Pounders of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by revising the entry for § 1.954–1 to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Section 1.954–1 also issued under 26 U.S.C. 964(c), 6001 and 6038(a)(1).

* * * * *

§ 1.951A–2 [Amended]

■ **Par. 2.** Section 1.951A–2:

■ 1. As amended in a final rule published elsewhere in this issue of the **Federal Register**, effective September 21, 2020, is amended by revising paragraph (c)(1)(iii), removing the paragraph (c)(3)(i) subject heading, redesignating paragraph (c)(3)(i) as paragraph (c)(3), and removing paragraph (c)(3)(ii);

■ 2. Is amended by removing paragraphs (c)(4)(iii)(C) and (c)(4)(iv)(C); and

■ 3. As amended in a final rule published elsewhere in this issue of the **Federal Register**, effective September 21, 2020, is amended by removing paragraphs (c)(7) and (8).

The revisions read as follows:

§ 1.951A–2 Tested income and tested loss.

* * * * *

(c) * * *

(1) * * *

(iii) Gross income described in section 951A(c)(2)(A)(i)(III) that is excluded from the foreign base company income (as defined in section 954) or insurance income (as defined in section 953) of the corporation by reason of the exception described in section 954(b)(4) and § 1.954–1(d)(1) pursuant to an election under § 1.954–1(d)(6),

* * * * *

■ **Par. 3.** Section 1.951A–7, as amended in a final rule published elsewhere in this issue of the **Federal Register**, effective September 21, 2020, is amended by revising paragraph (b) to read as follows:

§ 1.951A–7 Applicability dates.

* * * * *

(b) *High-tax exception.* Section 1.951A–2(c)(1)(iii) applies to taxable years of foreign corporations beginning after [the date that final regulations are filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. For the application of § 1.951A–2(c)(1)(iii) to taxable years of controlled foreign corporations beginning on or after September 21, 2020, and before [the date final regulations are filed with the **Federal Register**] and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, see § 1.951A–2(c)(1)(iii), as in effect on September 21, 2020.

■ **Par. 4.** Section 1.952–1 is amended by:

■ 1. Revising paragraph (e)(4);

■ 2. Redesignating paragraphs (f)(4) and (5) as paragraphs (f)(5) and (6), respectively;

■ 3. Adding a new paragraph (f)(4);

■ 4. In newly redesignated paragraph (f)(5), designating Examples (1) through

(4) as paragraphs (f)(5)(i) through (iv), respectively;

■ 5. In newly designated paragraphs (f)(5)(i) through (iv), redesignating the paragraphs in the first column as the paragraphs in the second column in the following table:

Old paragraphs	New paragraphs
(f)(5)(i)(i) through (iii)	(f)(5)(i)(A) through (C).
(f)(5)(ii)(i) through (iii)	(f)(5)(ii)(A) through (C).
(f)(5)(iii)(i) through (iii)	(f)(5)(iii)(A) through (C).
(f)(5)(iv)(i) through (iii)	(f)(5)(iv)(A) through (C).

■ 6. Revising newly designated paragraph (f)(6).

The revisions and addition read as follows:

§ 1.952–1 Subpart F income defined.

* * * * *

(e) * * *

(4) *Coordination with sections 953 and 954.* The rules of this paragraph (e) apply after the determination of net foreign base company income, as provided in § 1.954–1(a)(5). This paragraph (e)(4) applies to taxable years of controlled foreign corporations beginning after [the date that final regulations are filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. For taxable years before those described in the preceding sentence, see § 1.952–1(e)(4), as contained in 26 CFR part 1 revised as of April 1, 2020.

* * * * *

(f) * * *

(4) *Carryover of recapture accounts in transactions to which section 381(a) applies.* In the case of a distribution or transfer described in section 381(a), any recapture accounts (as described in paragraph (f)(2)(i) of this section) of the distributor or transferor corporation are treated as recapture accounts of the acquiring corporation as of the close of the date of the distribution or transfer. If the acquiring corporation has recapture accounts in the same separate category (as defined in § 1.904–5(a)(4)(v) and § 1.954–1(c)(1)(iii)(1) or (2)), the recapture accounts of the distributor or transferor corporation are added to the recapture accounts of the acquiring corporation in such category; if not, the acquiring corporation adopts the recapture accounts of the distributor or transferor corporation in such category.

* * * * *

(6) *Effective date*—(i) *Paragraphs (e) and (f).* Except as provided in paragraphs (e)(4) and (f)(6)(ii) of this section, paragraph (e) of this section and this paragraph (f) apply to taxable years of a controlled foreign corporation beginning after March 3, 1997.

(ii) *Paragraph (f)(4).* Paragraph (f)(4) of this section applies to taxable years of a corporation ending on or after July 20, 2020 (even if the distribution or transfer described in section 381(a) occurred in a taxable year ending before July 20, 2020).

* * * * *

■ **Par. 5.** Section 1.954–1:

■ 1. Is amended by revising paragraphs (a)(2) and (3);

■ 2. Is amended in paragraph (a)(4) by removing the language "term," removing the language "means the" and adding the language "of a controlled foreign corporation is" in its place, removing the language "a" after the language "adjusted gross foreign base company income of" and adding "the" in its place;

■ 3. Is amended by revising paragraphs (a)(5) and (6);

■ 4. Is amended in paragraph (a)(7) by adding in the first sentence the language "and § 1.952–1(f)(2)(ii) of" after the language "under section 952(c)" and revising the last sentence;

■ 5. Is amended in paragraph (b)(1)(ii) by removing the second sentence; and

■ 6. As amended in a final rule published elsewhere in this issue of the **Federal Register**, effective September 21, 2020, is amended by: Revising paragraphs (d) and (h)(3).

The revisions read as follows:

§ 1.954–1 Foreign base company income.

(a) * * *

(2) *Gross foreign base company income*—(i) *In general.* The *gross foreign base company income* of a controlled foreign corporation, determined after the application of section 952(b) and § 1.952–1(b)(2), and after the application of the high-tax exception under section 954(b)(4) and paragraph (d) of this section, consists of the categories of gross income of the controlled foreign corporation described in paragraphs (a)(2)(i)(A) through (C) of this section.

(A) Foreign personal holding company income, as defined in section 954(c).

(B) Foreign base company sales income, as defined in section 954(d).

(C) Foreign base company services income, as defined in section 954(e).

(ii) *Foreign base company income for purposes of section 954(b).* The term foreign base company income as used in section 954(b) refers to gross foreign base company income.

(3) *Adjusted gross foreign base company income.* The *adjusted gross foreign base company income* of a controlled foreign corporation is the gross foreign base company income of the controlled foreign corporation as adjusted by the de minimis rule in section 954(b)(3)(A) and paragraph (b)(1)(i) of this section, and the full inclusion rule in section 954(b)(3)(B) and paragraph (b)(1)(ii) of this section.

* * * * *

(5) *Adjusted net foreign base company income.* The *adjusted net foreign base company income* of a controlled foreign corporation is the net foreign base company income of the controlled foreign corporation, reduced by the earnings and profits limitation of section 952(c)(1) and § 1.952–1(c), and increased by earnings and profits that are recharacterized as foreign base company income under section 952(c)(2) and § 1.952–1(f)(2)(ii). Unless otherwise provided (for example, in paragraph (a)(2)(ii) of this section), the term foreign base company income as used in the Internal Revenue Code and elsewhere in the Income Tax Regulations means adjusted net foreign base company income.

(6) *Insurance income.* The *gross insurance income* of a controlled foreign corporation is all the gross income of the controlled foreign corporation, determined after the application of section 952(b) and § 1.952–1(b)(2), and after the application of the high-tax exception under section 954(b)(4) and paragraph (d) of this section, that is taken into account to determine the insurance income of the controlled foreign corporation under section 953. The *adjusted gross insurance income* of a controlled foreign corporation is the gross insurance income of the controlled foreign corporation as adjusted by the de minimis rule in section 954(b)(3)(A) and paragraph (b)(1)(i) of this section, and the full inclusion rule in section 954(b)(3)(B) and paragraph (b)(1)(ii) of this section. The *net insurance income*

of a controlled foreign corporation is the adjusted gross insurance income of the controlled foreign corporation reduced under section 953 so as to take into account deductions (including taxes) properly allocable or apportionable to such income. The *adjusted net insurance income* of a controlled foreign corporation is the net insurance income of the controlled foreign corporation reduced by the earnings and profits limitation of section 952(c)(1) and § 1.952–1(c), and increased by earnings and profits that are recharacterized as insurance income under section 952(c)(2) and § 1.952–1(f)(2)(ii). The term insurance income as used in subpart F of the Internal Revenue Code and in the regulations under that subpart means adjusted net insurance income, unless otherwise provided.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* The earnings and profits described in this paragraph (a)(7) are not subject to the de minimis rule in section 954(b)(3)(A) and paragraph (b)(1)(i) of this section, the full inclusion rule in section 954(b)(3)(B) and paragraph (b)(1)(ii) of this section, or the high-tax exception of section 954(b)(4) and paragraph (d) of this section.

* * * * *

(d) *High-tax exception*—(1) *Application*—(i) *In general.* An item of gross income of a controlled foreign corporation for a CFC inclusion year qualifies for the high-tax exception under section 954(b)(4) and this paragraph (d)(1) only if—

(A) An election made under section 954(b)(4) and paragraph (d)(6) of this section is effective with respect to the controlled foreign corporation for the CFC inclusion year; and

(B) The tentative net item with respect to the item of gross income was subject to an effective rate of foreign tax, as determined under paragraph (d)(4) of this section, that is greater than 90 percent of the maximum rate of tax specified in section 11 for the CFC inclusion year. See paragraphs (d)(9)(iii)(A)(*2*)(*vi*) (Example 1) and (d)(9)(iii)(B)(*2*)(*vi*) (Example 2) of this section for illustrations of the application of the rules set forth in this paragraph (d)(1)(i)(B).

(ii) *Item of gross income.* For purposes of this paragraph (d), an item of gross income means an item described in paragraph (d)(1)(ii)(A), (B), or (C) of this section. See paragraphs (d)(9)(iii)(A)(*2*)(*i*) (Example 1) and (d)(9)(iii)(B)(*2*)(*i*) (Example 2) of this section for illustrations of the application of the rule set forth in this paragraph (d)(1)(ii).

(A) *General gross item.* A general gross item is the aggregate amount of all gross income, determined under federal income tax principles but without regard to items described in section 952(c)(2) and § 1.952–1(f)(2)(ii), that is attributable to a single tested unit (as provided in paragraph (d)(1)(iii) of this section) of the controlled foreign corporation in the CFC inclusion year and that is—

(*1*) In a single separate category (as defined in § 1.904–5(a)(4)(v));

(*2*) Not described in paragraph (d)(1)(ii)(B) of this section;

(*3*) Not passive foreign personal holding company income; and

(*4*) Of a type that would be treated as gross tested income, gross foreign base company income (as defined in paragraph (a)(2) of this section), or gross insurance income (as defined in paragraph (a)(6) of this section) (in all cases, determined without regard to the high-tax exception described in section 954(b)(4) and paragraph (d)(1) of this section).

(B) *Equity gross item.* An equity gross item is the sum of gross income described in paragraph (d)(1)(ii)(A) of this section, determined without regard to paragraph (d)(1)(ii)(A)(*2*) of this section, that is also described in either paragraph (d)(1)(ii)(B)(*1*) or (*2*) of this section.

(*1*) *Income or gain arising from stock.* Gross income described in this paragraph (d)(1)(ii)(B)(*1*) consists of dividends, income or gain recognized from dispositions of stock, and any similar items arising from stock that are taken into account by the tested unit, the entity an interest in which is the tested unit, or the branch the portion of the activities of which is the tested unit, as applicable, and subject to an exclusion, exemption, or other similar relief (such as a preferential tax rate) under the tax law of the country of tax residence of the tested unit or the entity, or the country in which the branch is located. For purposes of the preceding sentence, other similar relief does not include a deduction or credit against the tax imposed under such tax law for tax paid to another foreign country with respect to income attributable to the branch. Gross income described in this paragraph (d)(1)(ii)(B)(*1*) does not include gain recognized from dispositions of stock if the stock would be dealer property (as defined in § 1.954–2(a)(4)(v)).

(*2*) *Income or gain arising from interests in pass-through entities.* Gross income described in this paragraph (d)(1)(ii)(B)(*2*) is income or gain recognized on the disposition of, or a distribution with respect to, an interest in a pass-through entity (including an interest in a disregarded entity) that is attributable to the tested unit, the entity an interest in which is the tested unit, or the branch the portion of the activities of which is the tested unit, as applicable, and subject to an exclusion, exemption, or other similar relief (such as a preferential tax rate) under the tax law of the country of tax residence of the tested unit or the entity, or the country in which the branch is located. For purposes of the preceding sentence, other similar relief does not include a deduction or credit against the tax imposed under such tax law for tax paid to another foreign country with respect to income attributable to the branch.

(C) *Passive gross item.* A passive gross item is the sum of the gross income described in paragraph (d)(1)(ii)(A) of this section (without regard to the exclusion of passive foreign personal holding company income under paragraph (d)(1)(ii)(A)(*3*) of this section) that constitutes a single item of passive foreign personal holding company income described in paragraph (c)(1)(iii)(B) of this section.

(iii) *Gross income attributable to a tested unit*—(A) *Items properly reflected on an applicable financial statement.* Gross income of a controlled foreign corporation is attributable to a tested unit of the controlled foreign corporation to the extent it is properly reflected, as modified under paragraph (d)(1)(iii)(B) of this section, on the applicable financial statement of the tested unit. All gross income of a controlled foreign corporation is attributable to a tested unit (but no portion of the gross income is attributable to more than one tested unit) of the controlled foreign corporation. See paragraphs (d)(9)(iii)(C)(*2*)(*ii*) and (d)(9)(iii)(C)(*5*) (Example 3) of this section for illustrations of the application of the rule set forth in this paragraph (d)(1)(iii)(A).

(B) *Adjustments to reflect disregarded payments.* The principles of § 1.904–4(f)(2)(vi) apply to adjust gross income of the tested unit, to the extent thereof, to reflect disregarded payments. For purposes of this paragraph (d)(1)(iii)(B), the principles of § 1.904–4(f)(2)(vi) are applied taking into account the rules in paragraphs (d)(1)(iii)(B)(*1*) through (*5*) of this section. See paragraphs (d)(9)(iii)(A) (Example 1) and (d)(9)(iii)(B) (Example 2) of this section for examples that illustrate the application of the adjustments set forth in this paragraph (d)(1)(iii)(B).

(*1*) The controlled foreign corporation is treated as the foreign branch owner and any other tested units of the controlled foreign corporation are treated as foreign branches.

(*2*) The principles of § 1.904–4(f)(2)(vi)(A) apply in the case of disregarded payments between a foreign branch and another foreign branch without regard to whether either foreign branch makes a disregarded payment to, or receives a disregarded payment from, the foreign branch owner.

(*3*) The exclusion for payments described in § 1.904–4(f)(2)(vi)(C)(*1*) (''disregarded interest'') does not apply to the extent of the amount of a disregarded payment that is deductible in the country of tax residence (or location, in the case of a branch) of the tested unit that is the payor.

(*4*) In the case of an amount of disregarded interest described in paragraph (d)(1)(iii)(B)(*3*) of this section, the rules in § 1.904–4(f)(2)(vi)(B) for determining how a disregarded payment is allocated to gross income of a foreign branch or foreign branch owner are applied by treating the disregarded payment as allocated and apportioned ratably to all of the gross income attributable to the tested unit that is making the disregarded payment. However, if a tested unit is both a payor and payee of an amount of disregarded interest described in paragraph (d)(1)(iii)(B)(*3*) of this section, the payments made are first allocable to the gross income allocated to it as a result of the receipt of amounts of disregarded interest described in paragraph (d)(1)(iii)(B)(*3*) of this section, to the extent thereof. If a tested unit makes and receives payments described in paragraph (d)(1)(iii)(B)(*3*) of this section to and from the same tested unit, the payments are netted so that paragraph (d)(1)(iii)(B)(*3*) of this section and the principles of § 1.904–4(f)(2)(vi) apply only to the net amount of such payments between the two tested units. If the payment described in paragraph (d)(1)(iii)(B)(*3*) of this section would (if regarded) be directly allocated under the principles of § 1.861–10T(b) or (c) if such payment were regarded for federal income tax purposes, then notwithstanding any other rule in this paragraph (d)(1)(iii)(B)(*4*), a disregarded payment is allocated to gross income of a tested unit under the principles of § 1.904–4(f)(2)(vi)(B) by applying the principles of § 1.861–10T.

(*5*) In the case of multiple disregarded payments, in lieu of the rules in § 1.904–4(f)(2)(vi)(F), disregarded payments are taken into account under paragraph (d)(1)(iii)(B) of this section under the rules provided in paragraphs (d)(1)(iii)(B)(*5*)(*i*) through (*iii*) of this section.

(*i*) Adjustments are first made with respect to disregarded payments received by a payee tested unit that are not themselves attributable to disregarded payments received by the payor tested unit. Second, adjustments are made with respect to disregarded payments made by the payee tested unit that are attributable to the income of that tested unit, adjusted as described in the preceding sentence. Third, adjustments are made with respect to amounts of disregarded interest received and paid, as described in paragraph (d)(1)(iii)(B)(*4*) of this section. Fourth, adjustments are made with respect to any other disregarded payments made or received.

(*ii*) Adjustments with respect to disregarded payments made are first made with respect to disregarded payments that would be definitely related to a single class of gross income under the principles of § 1.861–8; second, adjustments are made with respect to disregarded payments that would be definitely related to multiple classes of gross income under the principles of § 1.861–8, but that are not definitely related to all gross income of the tested unit; third, adjustments are made with respect to disregarded payments that would be definitely related to all gross income under the principles of § 1.861–8, other than payments described in paragraph (d)(1)(iii)(B)(*3*) of this section; and fourth, adjustments are made with respect to payments described in paragraph (d)(1)(iii)(B)(*3*) of this section and disregarded payments that would not be definitely related to any gross income under the principles of § 1.861–8.

(*iii*) Adjustments can be made only to the extent there is sufficient gross income (in the relevant income group) of the tested unit making the payment, taking into account the adjustments that increase gross income as provided in this paragraph (d)(1)(iii)(B)(*5*).

(iv) *Tentative net item*—(A) *In general.* Except as provided in paragraphs (d)(1)(iv)(B) and (C) of this section, a tentative net item with respect to an item of gross income described in paragraph (d)(1)(ii) of this section is determined by allocating and apportioning deductions for the CFC inclusion year (not including any items described in § 1.951A–2(c)(5) or (c)(6)) to the item of gross income under the principles of § 1.960–1(d)(3) by treating each single item of gross income described in paragraph (d)(1)(ii) of this section as gross income in a separate income group described in § 1.960–1(d)(2)(ii) and by treating all other income as assigned to a residual income group. A deduction for current year taxes (as defined in § 1.960–1(b)(4)) imposed solely by reason of a disregarded payment that gives rise to an adjustment under paragraph (d)(1)(iii)(B) of this section, however, is allocated and apportioned under the principles of § 1.904–6(b)(2) in lieu of the rules under § 1.861–20(d)(3)(ii). See paragraph (d)(9)(iii)(A)(*2*)(*ii*) (Example 1) and (d)(9)(iii)(B)(*2*)(*iii*) (Example 2) of this section for illustrations of the application of the rule set forth in this paragraph (d)(1)(iv)(A).

(B) *Booking rule for deductions other than current year tax expense.* Deductions (other than deductions for current year taxes) are attributable to a tested unit to the extent they are properly reflected on the applicable financial statement of the tested unit under the principles of paragraph (d)(1)(iii)(A) of this section. In applying the principles of § 1.960–1(d)(3) under paragraph (d)(1)(iv)(A) of this section, deductions (other than deductions for current year taxes) attributable to a tested unit are allocated and apportioned on the basis of the income and activities to which the expense relates, but are applied only to reduce the items of gross income described in paragraph (d)(1)(ii) of this section attributable to the same tested unit (including gross income that is attributed to the tested unit by reason of disregarded payments, and regardless of whether the tested unit has gross income in the relevant income group during the CFC inclusion year). In applying §§ 1.861–9 and 1.861–9T pursuant to § 1.960–1(d)(3), solely for purposes of paragraph (d)(1)(iv)(A) of this section interest deductions attributable to a tested unit are allocated and apportioned only on the basis of the assets (or gross income, in the case of a taxpayer that has elected the modified gross income method) of that tested unit. No interest deductions attributable to the tested unit are allocated and apportioned to the assets or gross income of another tested unit, or of a corporation, owned by the controlled foreign corporation indirectly through the tested unit. See paragraph (d)(9)(iii)(B)(*2*)(*ii*) (Example 2) of this section for illustrations of the application of the rule set forth in this paragraph (d)(1)(iv)(B).

(C) *Deduction or loss with respect to equity.* Notwithstanding paragraph (d)(1)(iv)(A) of this section, if a tested unit takes into account a loss or deduction (including a deduction for foreign income taxes) with respect to a transaction involving stock or an interest in a pass-through entity, and income or gain with respect to the stock or interest is or would have been described in paragraph (d)(1)(ii)(B)(*1*) or (*2*) of this section, then for purposes of allocating and apportioning deductions under paragraph (d)(1)(iv)(A) of this section, the deduction or loss is allocated and apportioned solely to the item of gross income described in paragraph (d)(1)(ii)(B)(*1*) or (*2*) of this section, as applicable, with respect to such tested unit, regardless of whether there is any gross income included in such item during the CFC inclusion year.

(D) *Effect of potential and actual changes in taxes paid or accrued.* Except as otherwise provided in this paragraph (d)(1)(iv)(D), the amount of current year taxes paid or accrued with respect to an item of gross income (as described in paragraph (d)(1)(ii) of this section) does not take into account any potential reduction in foreign income taxes that may occur by reason of a future distribution to shareholders of all or part of such income. However, to the extent the foreign income taxes paid or accrued by the controlled foreign corporation are reasonably certain to be returned to a shareholder by the foreign country imposing such taxes, directly or indirectly, through any means (including, but not limited to, a refund, credit, payment, discharge of an obligation, or any other method) on a subsequent distribution to such shareholder, the foreign income taxes are not treated as paid or accrued for purposes of paragraphs (d)(1)(iv) or (d)(5) of this section. In addition, foreign income taxes that have not been paid or accrued because they are contingent on a future distribution of earnings (or other similar transaction, such as a loan to a shareholder) are not taken into account for purposes of paragraph (d)(1)(iv) or (d)(5) of this section. If, pursuant to section 905(c) and § 1.905–3, a redetermination of U.S. tax liability is required to account for the effect of a foreign tax redetermination (as defined in § 1.905–3(a)), paragraph (d)(1)(iv) and (d)(5) of this section are applied in the adjusted year taking into account the adjusted amount of the redetermined foreign tax.

(v) *Portfolio interest and treatment of certain income under foreign tax credit rules.* Portfolio interest, as described in section 881(c), does not qualify for the high-tax exception under section 954(b)(4) and this paragraph (d). For rules concerning the treatment for foreign tax credit purposes of distributions of passive income excluded from foreign base company income, insurance income or tested income under section 954(b)(4) and this paragraph (d), see section 904(d)(3)(E) and § 1.904–4(c)(7)(iii).

(2) *Tested unit rules*—(i) *In general.* Subject to the combination rule in paragraph (d)(2)(iii) of this section, the term *tested unit* means any corporation, interest, or branch described in paragraphs (d)(2)(i)(A) through (C) of this section. See paragraph (d)(9)(iii)(C) of this section for an example that illustrates the application of the tested unit rules set forth in this paragraph (d)(2).

(A) A controlled foreign corporation (as defined in section 957(a)).

(B) An interest held directly or indirectly by a controlled foreign corporation in a pass-through entity that is—

(*1*) A tax resident (as described in § 1.267A–5(a)(23)(i)) of any foreign country; or

(*2*) Not treated as fiscally transparent (as determined under the principles of § 1.267A–5(a)(8)) for purposes of the tax law of the foreign country of which the controlled foreign corporation is a tax resident or, in the case of an interest in a pass-through entity held by a controlled foreign corporation indirectly through one or more other tested units, for purposes of the tax law of the foreign country of which the tested unit that directly (or indirectly through the fewest number of transparent interests) owns the interest is a tax resident.

(C) A branch (as described in § 1.267A–5(a)(2)) the activities of which are carried on directly or indirectly (through one or more pass-through entities) by a controlled foreign corporation. However, in the case of a branch that does not give rise to a taxable presence under the tax law of the foreign country where the branch is located, the branch is a tested unit only if, under the tax law of the foreign country of which the controlled foreign corporation is a tax resident (or, if applicable, under the tax law of a foreign country of which the tested unit that directly (or indirectly, through the fewest number of transparent interests) carries on the activities of the branch is a tax resident), an exclusion, exemption, or other similar relief (such as a preferential rate) applies with respect to income attributable to the branch. For purposes of this paragraph (d)(2)(i)(C), similar relief does not include a deduction or credit against the tax imposed under such tax law for tax paid to another foreign country with respect to income attributable to the branch. If a controlled foreign corporation carries on directly or indirectly less than all of the activities of a branch (for example, if the activities are carried on indirectly through an interest in a partnership), then the rules in this paragraph (d)(2)(i)(C) apply separately with respect to the portion (or portions, if carried on indirectly through more than one chain of pass-through entities) of the activities carried on by the controlled foreign corporation. See paragraphs (d)(9)(iii)(C)(*3*) and (d)(9)(iii)(C)(*4*) (Example 3) of this section for illustrations of the application of the rules set forth in this paragraph (d)(2)(i)(C).

(ii) *Items attributable to only one tested unit.* For purposes of paragraph (d) of this section, if an item is attributable to more than one tested unit in a tier of tested units, the item is considered attributable only to the lowest-tier tested unit. Thus, for example, if a controlled foreign corporation directly owns a branch tested unit described in paragraph (d)(2)(i)(C) of this section, and an item of gross income is (under the rules of paragraph (d)(1)(iii) of this section) attributable to both the branch tested unit and the controlled foreign corporation tested unit, then the item is considered attributable only to the branch tested unit.

(iii) *Combination rule*—(A) *In general.* Except as provided in paragraph (d)(2)(iii)(B) of this section, tested units of a controlled foreign corporation (including the controlled foreign corporation tested unit) that meet the requirements in paragraph (d)(2)(iii)(A)(*1*) of this section are treated as a single tested unit, and tested units that meet the requirements of paragraph (d)(2)(iii)(A)(*2*) of this section (after taking into account the application of paragraph (d)(2)(iii)(A)(*1*) of this section) are also treated as a single tested unit.

(*1*) *Subject to tax in same foreign country.* The tested units are tax residents of, or located in (in the case of a tested unit that is branch, or a portion of the activities of a branch, that gives rise to a taxable presence under the tax law of a foreign country), the same foreign country. For purposes of this paragraph (d)(2)(iii)(A)(*1*), in the case of a tested unit that is an interest in a pass-through entity or a portion of the activities of a branch, a reference to the tax residency or location of the tested unit means the tax residency of the entity the interest in which is the tested unit or the location of the branch, as applicable. See paragraphs (d)(9)(iii)(C)(*2*)(*i*) and (d)(9)(iii)(C)(*5*) (Example 3) for illustrations of the application of the rule set forth in this paragraph (d)(2)(iii)(A)(*1*).

(*2*) *De minimis gross income.* The gross income attributable to the tested unit (determined under paragraph (d)(1)(iii) of this section and translated into U.S. dollars, if necessary, at the appropriate exchange rate under section 989(b)(3)) is less than the lesser of one percent of gross income of the controlled foreign corporation, or $250,000. Appropriate adjustments are made for purposes of applying this paragraph (d)(2)(iii)(A)(*2*) if assets, including assets of or interests in a tested unit or a transparent entity, are transferred, including by issuance, contribution or distribution, if a significant purpose of the transfer is to qualify for the rule in this paragraph (d)(2)(iii), or if the rule is otherwise availed of with a significant purpose of avoiding the purposes of section 951, 951A, or 954(b)(4). A purpose may be a significant purpose even though it is outweighed by other purposes (taken together or separately). See paragraph (d)(9)(iii)(D) (Example 4) of this section for an example that illustrates the application of the rule set forth in this paragraph (d)(2)(iii)(A)(*2*).

(B) *Exception for nontaxed branches.* The rule in paragraph (d)(2)(iii)(A) of this section does not apply to a tested unit that is described in paragraph (d)(2)(i)(C) of this section if the branch described in paragraph (d)(2)(i)(C) of this section does not give rise to a taxable presence under the tax law of the foreign country where the branch is located. See paragraph (d)(9)(iii)(C)(*4*) (Example 4) of this section for an illustration of the application of the rule set forth in this paragraph (d)(2)(iii)(B).

(C) *Effect of combination rule.* If, pursuant to paragraph (d)(2)(iii)(A) of this section, tested units are treated as a single tested unit, then, solely for purposes of paragraph (d) of this section, items of gross income attributable to such tested units, and items of deduction and foreign taxes allocated and apportioned to such gross income, are aggregated for purposes of determining the combined tested unit's tentative net items, and foreign income taxes paid or accrued with respect to such tentative net items.

(3) *Applicable financial statement rules*—(i) *In general.* For purposes of this paragraph (d), the term *applicable financial statement* means a statement or information described in paragraphs (d)(3)(i)(A) through (H) of this section. A statement or information described in one of these paragraphs qualifies as an applicable financial statement only if the statement or information described in all preceding paragraphs is not readily available. For example, the statement or information described in paragraph (d)(3)(i)(C) of this section qualifies as an applicable financial statement only if the statement or information described in paragraphs (d)(3)(i)(A) and (B) of this section is not readily available. For purposes of paragraphs (d)(3)(i)(A) through (H) of this section, the term ''separate-entity'' includes the term ''separate-branch,'' as applicable. For purposes of paragraph (d) of this section, in the case of a tested unit or a transparent interest that is an interest in a pass-through entity or a portion of the activities of a branch, a reference to the applicable financial statement of the tested unit or the transparent interest means the applicable financial statement of the entity or the branch, as applicable.

(A) An audited separate-entity financial statement that is prepared in accordance with U.S. generally accepted accounting principles (''U.S. GAAP'').

(B) An audited separate-entity financial statement that is prepared on the basis of international financial reporting standards (''IFRS'').

(C) An audited separate-entity financial statement that is prepared on the basis of the generally accepted accounting principles of the jurisdiction in which the entity is organized or the activities are located (''local-country GAAP'').

(D) An unaudited separate-entity financial statement that is prepared in accordance with U.S. GAAP.

(E) An unaudited separate-entity financial statement that is prepared on the basis of IFRS.

(F) An unaudited separate-entity financial statement that is prepared on the basis of local-country GAAP.

(G) Separate-entity records used for tax reporting.

(H) Separate-entity records used for internal management controls or regulatory or other similar purposes.

(ii) *Failure to prepare an applicable financial statement.* If an applicable financial statement is not prepared for a tested unit or a transparent interest, the items of gross income, deduction, disregarded payments, and any other items required to apply paragraph (d) of this section that would be properly reflected on an applicable financial statement of the tested unit or transparent interest must be determined. Such items are treated as properly reflected on the applicable financial statement of the tested unit or transparent interest for purposes of applying paragraph (d) of this section.

(iii) *Transparent interests.* If a tested unit of a controlled foreign corporation or an entity an interest in which is a tested unit of a controlled foreign corporation holds a transparent interest, either directly or indirectly through one or more other transparent interests, then, for purposes of paragraph (d) of this section (and subject to the rule of paragraph (d)(2)(iii) of this section), items of the controlled foreign corporation properly reflected on the applicable financial statement of the transparent interest are treated as being properly reflected on the applicable financial statement of the tested unit, as modified under paragraph (d)(1)(iii)(B) of this section. See paragraph (d)(9)(iii)(C)(*6*) (Example 3) of this section for an illustration of the application of the rule set forth in this paragraph (d)(3)(iii).

(iv) *Items not taken into account for financial accounting purposes.* For purposes of this paragraph (d), an item in a CFC inclusion year that is not taken into account in such year for financial accounting purposes, and therefore not property reflected on an applicable financial statement of a tested unit or a transparent interest, is treated as properly reflected on such applicable financial statement to the extent it would have been so reflected if the item were taken into account for financial accounting purposes in such CFC inclusion year.

(v) *Adjustments to items reflected on the applicable financial statement*—(A) *In general.* Appropriate adjustments are made if an item is included or not included on an applicable financial statement, or if a disregarded payment described in paragraph (d)(1)(iii)(B) of this section is made or not made, with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or paragraph (d) of this section. Adjustments pursuant to this paragraph (d)(3)(v) include attributing all or a portion of the item to one or more tested units or transparent interests in a manner that reflects the substance of the transaction, or segregating all or a portion of the item and treating it as attributable to a separate item of gross income described in paragraph (d)(1)(ii) of this section. The combination rule of paragraph (d)(2)(iii)(A)(*1*) of this section does not apply to an item that is segregated and treated as a separate item of gross income under this paragraph (d)(3)(v). See also § 1.904–4(f)(2)(vi)(E) for rules relating to the determination of the amount of disregarded payments taken into account under paragraph (d)(1)(iii)(B) of this section.

(B) *Factually unrelated items*—(*1*) *Gross income.* Without limiting the scope of a significant avoidance purpose as described in paragraph (d)(3)(v)(A) of this section, gross income generally is treated as included on an applicable financial statement with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or paragraph (d) of this section if it is factually unrelated to the other activities of the relevant entity or branch and is subject to tax at a materially different effective rate of foreign tax than the other activities of the tested unit (or entity, an interest in which is a tested unit) to which the item would otherwise be attributable, or is subject to a withholding tax imposed by a foreign country other than the country of residence of the tested unit. For purposes of this paragraph (d)(3)(v)(B)(*1*), an effective rate of foreign tax is materially different than the effective rate of foreign tax on other activities if it differs by at least 10 percentage points.

(*2*) *Deductions.* Without limiting the scope of a significant avoidance purpose as described in paragraph (d)(3)(v)(A) of this section, a deduction generally is treated as included on an applicable financial statement with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or paragraph (d) of this section if it is not incurred in connection with funding, or in the ordinary course of, the preexisting activities of the relevant entity or branch and is not deductible, in whole or in part, in the country of residence or location of the tested unit (or entity, an interest in which is a tested unit) to which the item would otherwise be attributable.

(4) *Effective rate at which foreign taxes are imposed*—(i) *In general.* For a CFC inclusion year of a controlled foreign corporation, the effective rate of foreign tax with respect to the tentative net items of the controlled foreign corporation is determined separately for each such item. The effective foreign tax rate at which taxes are imposed on a tentative net item is—

(A) The U.S. dollar amount of foreign income taxes paid or accrued with respect to the tentative net item under paragraph (d)(5) of this section; divided by

(B) The U.S. dollar amount of the tentative net item, increased by the amount of foreign income taxes described in paragraph (d)(4)(i)(A) of this section.

(ii) *Undefined value or negative effective foreign tax rate.* If the amount described in paragraph (d)(4)(i)(A) of this section is positive and the amount described in paragraph (d)(4)(i)(B) of this section is zero or negative, the effective rate of foreign tax with respect to the tentative net item is deemed to be greater than 90 percent of the rate that would apply if the income were subject to the maximum rate of tax specified in section 11.

(5) *Foreign income taxes paid or accrued with respect to a tentative net item.* For a CFC inclusion year, the amount of foreign income taxes paid or accrued by a controlled foreign corporation with respect to a tentative net item (as described in paragraph (d)(1)(iv) of this section) for purposes of section 954(b)(4) and this paragraph (d) is the amount of the controlled foreign corporation's current year taxes (as defined in § 1.960–1(b)(4)) that are allocated and apportioned to the related item of gross income under the rules of paragraph (d)(1)(iv) of this section. See paragraphs (d)(9)(iii)(A)(*2*)(*iv*) (Example 1) and (d)(9)(iii)(B)(*2*)(*v*) (Example 2) of this section for illustrations of the application of this paragraph (d)(5).

(6) *Rules regarding the high-tax election*—(i) *Manner*—(A) *In general.* An election is made under this paragraph (d)(6) by the controlling domestic shareholders (as defined in paragraph (d)(8)(iii of this section) with respect to a controlled foreign corporation for a CFC inclusion year (a *high-tax election*) in accordance with the rules provided in forms or instructions and by—

(*1*) Filing the statement required under paragraph (d)(6)(vi)(A) of this section with a timely filed original federal income tax return, or with an amended federal income tax return for the U.S. shareholder inclusion year of each controlling domestic shareholder in which or with which such CFC inclusion year ends;

(*2*) Providing any notices required under paragraph (d)(6)(vi)(B) of this section;

(*3*) Substantiating, as described in paragraph (d)(6)(vii) of this section, its determination as to whether, with respect to each item of gross income, the requirement set forth in paragraph (d)(1)(i)(B) of this section is satisfied; and

(*4*) Providing any additional information required by applicable administrative pronouncements.

(B) *Election (or revocation) made with an amended income tax return.* In the case of an election (or revocation) made with an amended federal income tax return—

(*1*) The election (or revocation) must be made on an amended federal income tax return duly filed within 24 months of the unextended due date of the original federal income tax return for the U.S. shareholder inclusion year with or within which the CFC inclusion year ends;

(*2*) Each United States shareholder of the controlled foreign corporation as of the end of the controlled foreign corporation's taxable year to which the election relates must file amended federal income tax returns (or timely original income tax returns if a return has not yet been filed) reflecting the effect of such election (or revocation) for the U.S. shareholder's inclusion year with or within which the CFC inclusion year ends as well as for any other taxable year in which the U.S. tax liability of the United States shareholder would be increased by reason of the election (or revocation) (or in the case of a partnership if any item reported by the partnership or any partnership-related item would change as a result of the election (or revocation)) within a single period no greater than six months within the 24-month period described in paragraph (d)(6)(i)(B)(*1*) of this section; and

(*3*) Each United States shareholder of the controlled foreign corporation as of the end of the controlled foreign corporation's taxable year to which the election relates must pay any tax due as a result of such adjustments within a single period no longer than six months within the 24-month period described in paragraph (d)(6)(i)(B)(*1*) of this section;

(C) *Special rules for United States shareholders that are domestic partnerships.* In the case of a United States shareholder that is a domestic partnership, paragraphs (d)(6)(i)(A) and (B) and (d)(6)(iii) of this section are applied by substituting ''Form 1065 (or successor form)'' for ''federal income tax return'' and by substituting ''amended Form 1065 (or successor form) or administrative adjustment request (as described in § 301.6227–1), as applicable,'' for ''amended federal income tax return'', each place that it appears.

(D) *Special rules for United States shareholders that hold an interest in the controlled foreign corporation through a partnership.* A United States shareholder that is a partner in a partnership that is also a United States shareholder in the controlled foreign corporation must generally file an amended return, as required under paragraph (d)(6)(i)(B)(*2*) of this section, and must generally pay any additional tax owed as required under paragraph (d)(6)(i)(B)(*3*) of this section. However, in the case of a United States shareholder that is a partner in a partnership that duly files an administrative adjustment request under paragraph (d)(6)(i)(B)(*1*) or (*2*) of this section, the partner is treated as having satisfied the requirements of paragraphs (d)(6)(i)(B)(*2*) and (*3*) of this section with respect to the interest held through that partnership if:

(*1*) The partnership files an administrative adjustment request within the time described in paragraph (d)(6)(i)(B); and,

(*2*) The partnership and the partners comply with the requirements of section 6227. See §§ 301.6227–1 through 301.6227–3 for rules relating to administrative adjustment requests.

(ii) *Scope.* A high-tax election applies with respect to each item of gross income described in paragraph (d)(1)(ii) of this section of the controlled foreign corporation for the CFC inclusion year and is binding on all United States shareholders of the controlled foreign corporation.

(iii) *Revocation.* A high-tax election may be revoked by the controlling domestic shareholders of the controlled foreign corporation in the same manner as prescribed for an election made on an amended federal income tax return as described in paragraph (d)(6)(i) of this section.

(iv) *Failure to satisfy election requirements.* A high-tax election (or revocation) is valid only if all of the requirements in paragraph (d)(6)(i)(A) of this section, including the requirement to provide notice under paragraph (d)(6)(i)(A)(*2*) of this section, are satisfied.

(v) *Rules applicable to CFC groups*—(A) *In general.* In the case of a controlled foreign corporation that is a member of a CFC group, a high-tax election is made under paragraph (d)(6)(i) of this section, or revoked under paragraph (d)(6)(iii) of this section, with respect to all controlled foreign corporations that are members of the CFC group, and the rules in paragraphs (d)(6)(i) through (iv) of this section apply by reference to the CFC group.

(B) *Determination of the CFC group*—(*1*) *Definition.* Subject to the rules in paragraphs (d)(6)(v)(B)(*2*) and (*3*) of this section, the term *CFC group* means an affiliated group as defined in section 1504(a) without regard to section 1504(b)(1) through (6), except that section 1504(a) is applied by substituting ‘‘more than 50 percent’’ for ‘‘at least 80 percent’’ each place it appears, and section 1504(a)(2)(A) is applied by substituting ‘‘or’’ for ‘‘and.’’ For purposes of this paragraph (d)(6)(v)(B), stock ownership is determined by applying the constructive ownership rules of section 318(a), other than section 318(a)(3)(A) and (B), by applying section 318(a)(4) only to options (as defined in § 1.1504–4(d)) that are reasonably certain to be exercised as described in § 1.1504–4(g), and by substituting in section 318(a)(2)(C) ‘‘5 percent’’ for ‘‘50 percent.’’

(*2*) *Member of a CFC group.* The determination of whether a controlled foreign corporation is included in a CFC group is made as of the close of the CFC inclusion year of the controlled foreign corporation that ends with or within the taxable years of the controlling domestic shareholders. One or more controlled foreign corporations are members of a CFC group if the requirements of paragraph (d)(6)(v)(B)(*1*) of this section are satisfied as of the end of the CFC inclusion year of at least one of the controlled foreign corporations, even if the requirements are not satisfied as of the end of the CFC inclusion year of all controlled foreign corporations. If the controlling domestic shareholders do not have the same taxable year, the determination of whether a controlled foreign corporation is a member of a CFC group is made with respect to the CFC inclusion year that ends with or within the taxable year of the majority of the controlling domestic shareholders (determined by voting power) or, if no such majority taxable year exists, the calendar year. See paragraph (d)(9)(iii)(E) (Example 5) of this section for an example that illustrates the application of the rule set forth in this paragraph (d)(6)(v)(B)(*2*).

(*3*) *Controlled foreign corporations included in only one CFC group.* A controlled foreign corporation cannot be a member of more than one CFC group. If a controlled foreign corporation would be a member of more than one CFC group under paragraph (d)(6)(v)(E)(*2*) of this section, then ownership of stock of the controlled foreign corporation is determined by applying paragraph (d)(6)(v)(B) of this section without regard to section 1504(a)(2)(B) or, if applicable, by reference to the ownership existing as of the end of the first CFC inclusion year of a controlled foreign corporation that would cause a CFC group to exist.

(vi) *Rules regarding the statement and the notice requirements.* The following rules apply for purposes of the statement and notice requirements in this paragraph (d)(6).

(A) *Statement required to be filed with a tax return.* The statement required by paragraph (d)(6)(i)(A)(*1*) of this section must set forth the name, country of organization, and U.S. employer identification number (if applicable) of the foreign corporation, the name, address, stock interests, and U.S. employer identification number of each controlling domestic shareholder (or, if applicable, the agent described in § 1.1502–77(a) with respect to the consolidated group of which the controlling domestic shareholder is a member) approving the action, and the names, addresses, U.S. employer identification numbers, and stock interests of all other domestic shareholders notified of the action taken. Such statement must describe the nature of the action taken on behalf of the foreign corporation and the taxable year for which made, and identify a designated shareholder who retains a jointly executed consent confirming that such action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder (or the agent described in § 1.1502–77(a), if applicable).

(B) *Notice.* On or before the filing date described in paragraph (d)(6)(i)(A)(*1*) of this section (or paragraph (d)(6)(i)(B)(*1*) of this section if filing an amended income tax return), the controlling domestic shareholders must provide written notice of the election made to all other persons known by them to be domestic shareholders who own (within the meaning of section 958(a)) stock of the foreign corporation. Such notice must set forth the name, country of organization and U.S. employer identification number (if applicable) of the foreign corporation, and the names, addresses, and stock interests of the controlling domestic shareholders. Such notice must describe the nature of the action taken on behalf of the foreign corporation and the taxable year for which made, and identify a designated shareholder who retains a jointly executed consent confirming that such action has been approved by all of the controlling domestic shareholders and containing the signature of a principal officer of each such shareholder (or the agent described in § 1.1502–77(a), if applicable).

(vii) *Substantiation requirements*—(A) *In general.* If an election under section 954(b)(4) and paragraph (d)(6) of this section is in effect for a controlled foreign corporation for a CFC inclusion year, then each United States shareholder of that controlled foreign corporation with respect to the CFC inclusion year is required to maintain sufficient documentation (as described in paragraph (d)(6)(vii)(B) of this section) to establish that the taxpayer reasonably concluded that each item of gross income of the controlled foreign corporation satisfied (or did not satisfy) the requirement set forth in paragraph (d)(1)(i)(B) of this section. The substantiating documents must be in existence as of the filing date of the income tax return described in paragraph (d)(6)(i)(A) of this section (or paragraph (d)(6)(i)(B)(*1*) of this section if filing an amended income tax return) and must be provided to the

Commissioner within 30 days of being requested by the Commissioner (unless otherwise agreed between the Commissioner and the taxpayer).

(B) *Sufficient documentation.* For purposes of paragraph (d)(6)(vii)(A) of this section, the term sufficient documentation means documentation that accurately and completely describes the computations related to the high-tax exception under section 954(b)(4) and this paragraph (d)(6) with respect to each item of gross income of the controlled foreign corporation. Sufficient documentation must include the information described in paragraphs (d)(6)(vii)(B)(*1*) through (*5*) of this section.

(*1*) A description of each of the tested units and transparent interests of the controlled foreign corporation, including a detailed explanation of any tested units that are combined either under the same-country combination rule, or the de minimis combination rule.

(*2*) A detailed list of the items of gross income and deductions attributable to each tested unit and the applicable financial statement of each tested unit and transparent interest.

(*3*) A list of disregarded payments taken into account under paragraph (d)(1)(iii)(B) of this section for purposes of determining the gross income attributable to a tested unit.

(*4*) A list of current year foreign taxes paid or accrued with respect to each item of gross income, as described in paragraph (d)(5) of this section.

(*5*) The effective tax rate calculation for each item of gross income attributable to a tested unit, as described in paragraph (d)(4)(i) of this section.

(7) *Anti-abuse rule.* Appropriate adjustments are made if an applicable instrument is issued or acquired, or a reverse hybrid is formed or availed of, with a significant purpose of avoiding the purposes of section 951, 951A, 954(b)(4), or paragraph (d) of this section. Adjustments pursuant to this paragraph (d)(7) include adjustments to foreign income taxes paid or accrued with respect to a tentative net item as determined under paragraph (d)(5) of this section, and adjustments to the tentative net item as determined under paragraph (d)(1)(iv) of this section. See paragraph (d)(9)(iii)(F) (Example 6) of this section for an example that illustrates the application of the anti-abuse rule set forth in this paragraph (d)(7).

(8) *Definitions.* The following definitions apply for purposes of this paragraph (d).

(i) *Applicable instrument.* The term *applicable instrument* means an instrument or arrangement described in paragraph (d)(8)(i)(A) or (B) of this section. For purposes of this paragraph (d)(8)(i), an instrument or arrangement includes a sale-repurchase transaction (including as described in § 1.861–2(a)(7)), or other similar transaction or series of related transactions in which legal title to property is transferred and the property (or similar property, such as securities of the same class and issue) is reacquired or expected to be reacquired.

(A) *Deductions to issuer.* An instrument or arrangement is described in this paragraph (d)(8)(i)(A) if, for federal income tax purposes, the instrument or arrangement gives rise to deductions to the issuer but, under the tax law of a foreign country, does not give rise to deductions (or gives rise to deductions that are disallowed), in whole or in part, to the issuer.

(B) *Income to holder.* An instrument or arrangement is described in this paragraph (d)(8)(i)(B) if, under the tax law of a foreign country, the instrument or arrangement gives rise to income included in the holder's income but, for federal income tax purposes, does not give rise to income to the holder.

(ii) *CFC inclusion year.* The term *CFC inclusion year* has the meaning provided in § 1.951A–1(f)(1).

(iii) *Controlling domestic shareholders.* The term *controlling domestic shareholders* of a controlled foreign corporation means the United States shareholders (as defined in section 951(b) or 953(c)) who, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote and who undertake to act on its behalf. If United States shareholders of the controlled foreign corporation do not, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of the stock of such foreign corporation entitled to vote, the controlling United States shareholders of the controlled foreign corporation are all those United States shareholders who own (within the meaning of section 958(a)) stock of such corporation.

(iv) *Disregarded entity.* The term *disregarded entity* means an entity that is disregarded as an entity separate from its owner, as described in § 301.7701–2(c)(2)(i) of this chapter.

(v) *Disregarded payment.* The term *disregarded payment* means any amount described in paragraph (d)(8)(v)(A) or (B) of this section.

(A) *Transfers to or from a disregarded entity.* An amount described in this paragraph (d)(8)(iv)(A) is any amount that is transferred to or from a disregarded entity in connection with a transaction that is disregarded for federal income tax purposes and that is properly reflected on the applicable financial statement of a tested unit or a transparent interest.

(B) *Other disregarded amounts.* An amount described in this paragraph (d)(8)(iv)(B) is any amount properly reflected on the applicable financial statement of a tested unit or transparent interest that would constitute an item of income, gain, deduction, or loss (other than an amount described in paragraph (d)(8)(iv)(A) of this section), a distribution to or contribution from the owner of the tested unit, transparent interest or entity, or a payment in exchange for property if the transaction to which the amount is attributable were regarded for federal income tax purposes.

(vi) *Indirectly.* The term *indirectly,* when used in reference to ownership, means ownership through one or more pass-through entities.

(vii) *Pass-through entity.* The term *pass-through entity* means a partnership, a disregarded entity, or any other person (whether domestic or foreign) other than a corporation to the extent that income, gain, deduction, or loss of the person is taken into account in determining the income or loss of a controlled foreign corporation that owns, directly or indirectly, interests in the person.

(viii) *Reverse hybrid.* The term *reverse hybrid* has the meaning provided in § 1.909–2(b)(1)(iv).

(ix) *Transparent interest.* The term *transparent interest* means an interest in a pass-through entity (or the activities of a branch) that is not a tested unit.

(x) *U.S. shareholder inclusion year.* The term *U.S. shareholder inclusion year* has the meaning provided in § 1.951A–1(f)(7).

(9) *Examples*—(i) *Scope.* This paragraph (d)(9) provides presumed facts and examples illustrating the application of the rules in paragraph (d) of this section.

(ii) *Presumed facts.* For purposes of the examples in paragraph (d)(9)(iii) of this section, except as otherwise stated, the following facts are presumed:

(A) USP is a domestic corporation.

(B) CFC1X and CFC2X are controlled foreign corporations organized in, and tax residents of, Country X.

(C) FDEX is a disregarded entity that is a tax resident of Country X.

(D) FDE1Y and FDE2Y are disregarded entities that are tax residents of Country Y.

(E) FPSY is an entity that is organized in, and a tax resident of, Country Y but is classified as a partnership for federal income tax purposes.

(F) CFC1X, CFC2X, and the interests in FDEX, FDE1Y, FDE2Y, and FPSY are tested units (the CFC1X tested unit, CFC2X tested unit, FDEX tested unit, FDE1Y tested unit, FDE2Y tested unit, and FPSY tested unit, respectively).

(G) CFC1X, CFC2X, FDEX, FDE1Y and FDE2Y conduct activities in the foreign country in which they are tax resident, and properly reflect items of income, gain, deduction, and loss on separate applicable financial statements.

(H) All entities have calendar taxable years (for both federal income tax purposes and for purposes of the relevant foreign country) and use the Euro (€) as their functional currency. At all relevant times €1 = $1.

(I) The maximum rate of tax specified in section 11 for the CFC inclusion year is 21 percent.

(J) Neither CFC1X nor CFC2X directly or indirectly earns income described in section 952(b), or has any items of income, gain, deduction, or loss. In addition, no tested unit of CFC1X or CFC2X makes or receives disregarded payments.

(K) No tested unit is eligible for the de minimis combination rule of paragraph (d)(2)(iii)(A)(*2*) of this section.

(L) An election made under section 954(b)(4) and paragraph (d)(6) of this section is effective with respect to CFC1X and CFC2X, as applicable, for the CFC inclusion year.

(iii) *Examples*—(A) *Example 1: Effect of disregarded interest*—(*1*) *Facts*—(*i*) *Ownership.* USP owns all of the stock of CFC1X, and CFC1X owns all of the interests of FDE1Y.

(*ii*) *Gross income and deductions (other than foreign income taxes).* In Year 1, CFC1X generates €100x of gross income from services performed for unrelated parties and properly reflects that gross income on the applicable financial statement of FDE1Y. The €100x of services income is general category income under § 1.904–4(d). In Year 1, FDE1Y accrues and pays €20x of interest to CFC1X that is deductible for Country Y tax purposes but is disregarded for federal income tax purposes. The €20x of disregarded interest income received by CFC1X from FDE1Y is properly reflected on CFC1X's applicable financial statement, and the €20x of disregarded interest expense paid from FDE1Y to CFC1X is properly reflected on FDE1Y's applicable financial statement.

(*iii*) *Foreign income taxes.* Country X imposes no tax on net income, and Country Y imposes a 25% tax on net income. For Country Y tax purposes, FDE1Y (which is not disregarded under Country Y tax law) has €80x of taxable income (€100x of services income from the unrelated parties, less a €20x deduction for the interest paid to CFC1X). Accordingly, FDE1Y incurs a Country Y income tax liability of €20x ((€100x − €20x) × 25%) with respect to Year 1, the U.S. dollar amount of which is $20x.

(*2*) *Analysis*—(*i*) *Items of gross income.* Under paragraph (d)(1)(ii) of this section, CFC1X has €100x of general category gross income that is divided into two general gross items, one item that is attributable to the CFC1X tested unit and one item that is attributable to the FDE1Y tested unit under paragraph (d)(1)(iii) of this section. Without regard to the €20x interest payment from FDE1Y to CFC1X, the gross income attributable to the CFC1X tested unit would be €0 (that is, the €20x of interest income properly reflected on the applicable financial statement of CFC1X would be reduced by €20x, the amount attributable to the payment that is disregarded for federal income tax purposes). Similarly, without regard to the €20x interest payment from FDE1Y to CFC1X, the gross income attributable to the FDE1Y tested unit would be €100x (that is, the €100x of services income properly reflected on the applicable financial statement of FDE1Y, unreduced by the €20x disregarded payment made from FDE1Y to CFC1X). However, under paragraph (d)(1)(iii)(B) of this section, the gross income attributable to each of the CFC1X tested unit and the FDE1Y tested unit is adjusted by €20x, the amount of the disregarded interest payment from FDE1Y to CFC1X that is deductible for Country Y tax purposes. Accordingly, the item of gross income attributable to the CFC1X tested unit (the ''CFC1X general gross item'') is €20x (€0 + €20x) and the item of gross income attributable to the FDE1Y tested unit (the ''FDE1Y general gross item'') is €80x (€100x − €20x), both of which are general gross items under paragraph (d)(1)(ii)(A) of this section.

(*ii*) *Foreign income tax deduction.* Under paragraph (d)(1)(iv) of this section, CFC1X's tentative net items are computed by treating the CFC1X general gross item and the FDE1Y general gross item each as in a separate income group (the ''CFC1X income group'' and the ''FDE1Y income group'') and by allocating and apportioning CFC1X's deductions for current year taxes between the income groups under the principles of § 1.960–1(d)(3) (CFC1X has no other deductions to allocate and apportion). Under paragraph (d)(1)(iv)(A) of this section, the €20x deduction for Country Y income taxes is allocated and apportioned solely to the FDE1Y income group (the ''FDE1Y group tax''). None of the Country Y taxes are allocated and apportioned to the CFC1X income group under paragraph (d)(1)(iv) of this section and the principles of § 1.904–6(b)(2), because none of the Country Y tax is imposed solely by reason of the disregarded interest payment.

(*iii*) *Tentative net items.* Under paragraph (d)(1)(iv)(A) of this section, the tentative net item with respect to the FDE1Y income group (the ''FDE1Y tentative net item'') is €60x (the FDE1Y general gross item of €80x, less the €20x deduction for the FDE1Y group tax). The tentative net item with respect to the CFC1X income group (the ''CFC1X tentative net item'') is €20x.

(*iv*) *Foreign income taxes paid or accrued with respect to a tentative net item.* Under paragraph (d)(5) of this section, the foreign income taxes paid or accrued with respect to a tentative net item is the U.S. dollar amount of the current year taxes that are allocated and apportioned to the item of gross income under the rules of paragraph (d)(1)(iv) of this section. Therefore, the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item is $20x, the U.S. dollar amount of the FDE1Y group tax. The foreign income taxes paid or accrued with respect to the CFC1X tentative net item is $0, the U.S. dollar amount of the foreign tax allocated and apportioned to the CFC1X general gross item under paragraph (d)(1)(iv) of this section.

(*v*) *Effective foreign tax rate.* The effective foreign tax rate is determined under paragraph (d)(4) of this section by dividing the U.S. dollar amount of foreign income taxes paid or accrued with respect to each respective tentative net item by the U.S. dollar amount of the tentative net item increased by the U.S. dollar amount of the relevant foreign income taxes. Therefore, the effective foreign tax rate with respect to the FDEY1 tentative net item is 25%, calculated by dividing $20x (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item under paragraph (d)(5) of this section) by $80x (the sum of $60x, the U.S. dollar amount of the FDE1Y tentative net item, and $20x, the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item). The CFC1X tentative net item is not subject to any foreign income tax, so is subject to an effective foreign tax rate of 0%, calculated as $0 (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the CFC1X tentative net item), divided by $20x (the U.S. dollar amount of the FDE1Y tentative net item).

(*vi*) *Qualification for the high-tax exception.* The FDE1Y tentative net item is subject to an effective foreign tax rate (25%) that is greater than 18.9% (90% of the 21% maximum rate of tax specified in section 11). Therefore, the requirement of paragraph (d)(1)(i)(B) of this section is satisfied, and the FDEY1 general gross item qualifies under paragraph (d)(1)(i) of this section for the high-tax exception of section 954(b)(4) and, under paragraphs (a)(2) and (a)(6) of this section, is excluded from the gross foreign base company income and gross insurance income, respectively, of CFC1X; in addition, the FDE1Y general gross item is excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and § 1.951A–2(c)(1)(iii). The CFC1X tentative net item is subject to an effective foreign tax rate of 0%. Therefore, the CFC1X tentative net item does not satisfy the requirement of paragraph (d)(1)(i)(B) of this section, and the CFC1X general gross item does not qualify under paragraph (d)(1)(i) of this section for the high-tax exception of section 954(b)(4) and, under paragraphs (a)(2) and (a)(6) of this section, is not excluded from the gross foreign base company income and gross insurance income of CFC1X; in addition, the CFC1X general gross item is not excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and § 1.951A–2(c)(1)(iii).

(B) *Example 2: Effect of disregarded payment for services*—(*1*) *Facts*—(*i*) *Ownership.* USP owns all of the stock of CFC1X. CFC1X owns all of the interests of FDE1Y. FDE1Y is a tax resident of Country Y, but is treated as fiscally transparent for Country X tax purposes, so that FDE1Y is subject to tax in Country Y and that CFC1X is subject to tax in Country X with respect to FDE1Y's activities.

(*ii*) *Gross income, deductions (other than for foreign income taxes), and disregarded payments.* In Year 1, CFC1X generates €1,000x of gross income from services to unrelated parties that would be gross tested income or gross foreign base company income without regard to paragraph (d)(1) of this section and that is properly reflected on the applicable financial statement of CFC1X. The €1,000x of gross income for services is general category income under § 1.904–4(d). In Year 1, CFC1X accrues and pays €480x of deductible expenses to unrelated parties, €280x of which is properly reflected on CFC1X's applicable financial statement and is definitely related solely to CFC1X's gross income reflected on its applicable financial statement, and €200x of which is properly reflected on FDE1Y's applicable financial statement and is definitely related solely to FDE1Y's gross income reflected on its applicable financial statement. Country X law does not provide rules for the allocation or apportionment of these deductions to particular items of gross income. In Year 1, CFC1X also accrues and pays €325x to FDE1Y for support services performed by FDE1Y in Country Y; the payment is disregarded for federal income tax purposes. The €325x of disregarded support services income received by FDE1Y from CFC1X is properly reflected on FDE1Y's applicable financial statement, and the €325x of disregarded support services expense paid from CFC1X to FDE1Y is properly reflected on CFC1X's applicable financial statement.

(*iii*) *Foreign income taxes.* Country X imposes a 10% tax on net income, and Country Y imposes a 16% tax on net income. Country X allows a deduction, but not a credit, for foreign income taxes paid or accrued to another country (such as Country Y). For Country Y tax purposes, FDE1Y (which is not disregarded under Country Y tax law) has €125x of taxable income (€325x of support services income received from CFC1X, less a €200x deduction for expenses paid to unrelated parties). Accordingly, FDE1Y incurs a Country Y income tax liability with respect to Year 1 of €20x (€125x × 16%), the U.S. dollar amount of which is $20x. For Country X tax purposes, CFC1X has €500x of taxable income (€1,000x of gross income for services, less a €480x deduction for expenses paid to unrelated parties by CFC1X and FDE1Y and a €20x deduction for Country Y taxes; Country X does not allow CFC1X a deduction for the €325x paid to FDE1Y for support services because the €325x payment is disregarded for Country X tax purposes). Accordingly, CFC1X incurs a Country X income tax liability with respect to Year 1 of €50x (€500x × 10%), the U.S. dollar amount of which is $50x.

(*2*) *Analysis*—(*i*) *Items of gross income.* Under paragraph (d)(1)(ii) of this section, CFC1X has €1,000x of general category gross income that is divided into two general gross items, one item that is attributable to the CFC1X tested unit and one item that is attributable to the FDE1Y tested unit under paragraph (d)(1)(iii) of this section. Without regard to the €325x payment for support services from CFC1X to FDE1Y, the gross income attributable to the CFC1X tested unit would be €1,000x (that is, the €1,000x of gross income from services properly reflected on the applicable financial statement of CFC1X, unreduced by the €325x payment from CFC1X to FDE1Y that is disregarded for federal income tax purposes). Similarly, without regard to the €325x payment for support services from CFC1X to FDE1Y, the gross income attributable to the FDE1Y tested unit would be €0 (that is, the €325x of services income properly reflected on the applicable financial statement of FDE1Y, reduced by the €325x disregarded payment). However, under paragraph (d)(1)(iii)(B) of this section, the gross income attributable to each of the CFCX1 tested unit and the FDE1Y tested unit is adjusted by €325x, the amount of the disregarded services payment from CFC1X to FDE1Y. Accordingly, the item of gross income attributable to the CFC1X tested unit (the ''CFC1X general gross item'') is €675x (€1,000x − €325x), and the item of gross income attributable to the FDE1Y tested unit (the ''FDE1Y general gross item'') is €325x (€0 + €325x), both of which are general gross items under paragraph (d)(1)(ii)(A) of this section.

(*ii*) *Deductions (other than for foreign income taxes).* Under paragraph (d)(1)(iv) of this section, CFC1X's tentative net items are computed by applying the principles of § 1.960–1(d)(3), treating the CFC1X general gross item and the FDE1Y general gross item each as in a separate income group (the ''CFC1X income group'' and the ''FDE1Y income group'') and by allocating and apportioning CFC1X's deductions among the income groups. Under paragraph (d)(1)(iv)(B) of this section, the €280x of deductible expenses properly reflected on the applicable financial statement of the CFC1X tested unit are allocated and apportioned to the CFC1X income group, and the €200x of deductible expenses properly reflected on the applicable financial statement of the FDE1Y tested unit are allocated and apportioned to the FDE1Y income group.

(*iii*) *Foreign income tax deduction.* CFC1X accrues foreign income tax in Year 1 of €70x (€50x imposed by Country X and €20x imposed by Country Y). Under paragraph (d)(1)(iv)(A) of this section, the €70x of foreign income tax is allocated and apportioned under the principles of § 1.960–1(d)(3)(ii) (or under the principles of § 1.904–6(b)(2) in the case of tax imposed solely by reason of a disregarded payment that gives rise to an adjustment under paragraph (d)(1)(iii)(B) of this section) to the FDE1Y income group and the CFC1X income group. The Country Y tax of

€20x is imposed solely by reason of FDE1Y's receipt of a €325x disregarded payment. As a result, the €20x of Country Y tax is allocated and apportioned to the FDE1Y income group under the principles of § 1.904–6(b)(2). If Country X had allowed a deduction for the disregarded payment from CFC1X to FDE1Y and not otherwise imposed tax on CFC1X with respect to income of FDE1Y, the foreign tax imposed by Country X would relate only to the CFC1X income group, and no portion of it would be allocated and apportioned to the FDE1Y income group because the FDE1Y income would not be included in the Country X tax base. However, because gross income subject to tax in Country X corresponds to gross income that for federal income tax purposes is attributable to both the FDE1Y income group and the CFC1X income group, the €50x of foreign income tax imposed by Country X is allocated to both the FDE1Y income group and the CFC1X income group and must be apportioned between the two income groups under § 1.861–20(e). Because Country X does not provide specific rules for the allocation or apportionment of the €500x of deductible expenses, § 1.861–20(e) applies the principles of the section 861 regulations to determine the foreign law net income subject to Country X tax for purposes of apportioning the €50x of Country X tax between the income groups. CFC1X has €1,000x of gross income and €500x of deductible expenses under the tax laws of Country X, resulting in €500x of net foreign law income. Of the €1,000x of foreign law gross income, €325x corresponds to the gross income in the FDE1Y income group, and €675x corresponds to the gross income in the CFC1X income group. Applying federal income tax principles to allocate and apportion the foreign law deductions to foreign law gross income, €220x of the €500x foreign law deductions is allocated and apportioned to the FDE1Y income group and €280x is allocated and apportioned to the CFC1X income group. Of the total €500x of net foreign law income, €105x (€325x Country X gross income corresponding to the FDE1Y income group, less €220x allocable Country X expenses) corresponds to the FDE1Y income group and €395x (€675x Country X gross income corresponding to the CFC1X income group, less €280x allocable Country X expenses) corresponds to the CFC1X income group. Therefore, €10.5x (€50x × €105x/€500x) of Country X tax is allocated and apportioned to the FDE1Y income group, and €39.5x (€50x × €395x/€500x) is allocated and apportioned to the CFC1X income group. In total, €30.5x of foreign income tax (€10.5x of Country X tax and €20x of Country Y tax) is allocated and apportioned to the FDE1Y income group (the "FDE1Y group tax") and €39.5x of foreign income tax (all of which is Country X tax) is allocated and apportioned to the CFC1X income group (the "CFC1X group tax").

(*iv*) *Tentative net items.* Under paragraphs (d)(1)(iv)(A) and (B) of this section, the tentative net item in the FDE1Y income group (the "FDE1Y tentative net item") is €94.5x (the general gross item of €325x, less the allocated and apportioned deductions of €230.5x (the sum of deductions (other than for foreign income tax) of €200x and the FDE1Y group taxes of €30.5x)). The tentative net item in the CFC1X income group (the "CFC1X tentative net item") is €355.5x (the general gross item of €675x, less the allocated and apportioned deductions of €319.5x (the sum of deductions (other than for foreign income tax) of €280x and the CFC1X group tax of €39.5x)).

(*v*) *Foreign income taxes paid or accrued with respect to a tentative net item.* Under paragraph (d)(5) of this section, the foreign income taxes paid or accrued with respect to a tentative net item is the U.S. dollar amount of the current year taxes that are allocated and apportioned to the item of gross income under the rules of paragraph (d)(1)(iv) of this section. Therefore, the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item is $30.5x, the U.S. dollar amount of the FDE1Y group tax. The foreign income tax paid or accrued with respect to the CFC1X tentative net item is $39.5x, the U.S. dollar amount of the CFC1X group tax.

(*vi*) *Effective foreign tax rate.* The effective foreign tax rate is determined under paragraph (d)(4) of this section by dividing the U.S. dollar amount of foreign income taxes with respect to each respective tentative net item by the U.S. dollar amount of the tentative net item increased by the U.S. dollar amount of the relevant foreign income taxes. Therefore, the effective foreign tax rate with respect to the FDE1Y tentative net item is 24.4%, calculated by dividing $30.5x (the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item under paragraph (d)(5)) by $125x (the sum of $94.5x, the U.S. dollar amount of the FDE1Y tentative net item, and $30.5x, the U.S. dollar amount of the foreign income taxes paid or accrued with respect to the FDE1Y tentative net item). The effective foreign tax rate with respect to the CFC1X tentative net item is 10%, calculated by dividing $39.5x (the U.S. dollar amount of the CFC1X group tax) by $395x (the sum of $355.5x, the U.S. dollar amount of the CFC1X tentative net item and $39.5x, the U.S. dollar amount of the foreign income tax paid or accrued with respect to the CFC1X tentative net item).

(*vii*) *Qualification for the high-tax exception.* The FDE1Y tentative net item is subject to an effective foreign tax rate (24.4%) that is greater than 18.9% (90% of the maximum rate of tax specified in section 11). Therefore, the requirement of paragraph (d)(1)(i)(B) of this section is satisfied, and the FDE1Y general gross item qualifies for the high-tax exception of section 954(b)(4) and, under paragraphs (a)(2) and (a)(6) of this section, is excluded from the gross foreign base company income and the gross insurance income, respectively, of CFC1X; in addition, the FDE1Y general gross item is excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and § 1.951A–2(c)(1)(iii). The CFC1X tentative net item is subject to an effective foreign tax rate (10%) that is not greater than 18.9%. Therefore, the CFC1X general gross item does not satisfy the requirement of paragraph (d)(1)(i)(B) of this section, does not qualify for the high-tax exception of section 954(b)(4) and, under paragraphs (a)(2) and (a)(6) of this section, is not excluded from the gross foreign base company income and gross insurance income of CFC1X; in addition, the CFC1X general gross item is not excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and § 1.951A–2(c)(1)(iii).

(C) *Example 3: Application of tested unit rules*—(*1*) *Facts*—(*i*) *Ownership.* USP owns all of the stock of CFC1X. CFC1X directly owns all of the interests of FDEX and FDE1Y. In addition, CFC1X directly carries on activities in Country Y that constitute a branch (as described in § 1.267A–5(a)(2)) and that give rise to a taxable presence under Country Y tax law and Country X tax law (such branch, "FBY").

(*ii*) *Items reflected on applicable financial statement.* For the CFC inclusion year, CFC1X has a €20x item of gross income (Item A), which is properly reflected on the applicable financial statement of FBY, and a €30x item of gross income (Item B), which is properly reflected on the applicable financial statement of FDEX.

(*2*) *Analysis*—(*i*) *Identifying the tested units of CFC1X.* Without regard to the combination rule of paragraph (d)(2)(iii) of this section, CFC1X, CFC1X's interest in FDEX, CFC1X's interest in FDE1Y, and FBY would each be a tested unit of CFC1X. *See* paragraph (d)(2)(i) of this section. Pursuant to the combination rule, however, the FDE1Y tested unit is combined with the FBY tested unit and treated as a single tested unit because FDE1Y is a tax resident of Country Y, the same country in which FBY is located (the ''Country Y tested unit''). *See* paragraph (d)(2)(iii)(A)(*1*) of this section. The CFC1X tested unit (without regard to any items attributable to the FDEX, FDE1Y, or FBY tested units) is also combined with the FDEX tested unit and treated as a single tested unit because CFC1X and FDEX are both tax residents of County X (the ''Country X tested unit''). *See* paragraph (d)(2)(iii)(A)(*1*) of this section.

(*ii*) *Computing the items of CFC1X.* Under paragraph (d)(1)(ii) of this section, an item of gross income is determined with respect to each of the Country Y tested unit and the Country X tested unit. To determine the item of gross income of each tested unit, the gross income that is attributable to the tested unit is determined under paragraph (d)(1)(iii) of this section. Under paragraph (d)(1)(iii)(A) of this section, only Item A is attributable to the Country Y tested unit, and only Item B is attributable to the Country X tested unit. Item A is not attributable to the Country X tested unit because it is not reflected on the applicable financial statement of the CFC1X tested unit or the FDEX tested unit, and an item of gross income is only attributable to one tested unit. *See* paragraph (d)(1)(iii)(A) of this section.

(*3*) *Alternative facts—branch does not give rise to a taxable presence in country where located*—(*i*) *Facts.* The facts are the same as in paragraph (d)(9)(iii)(C)(*1*) of this section (the original facts in this *Example 3*), except that FBY does not give rise to a taxable presence under Country Y tax law; moreover, Country X tax law does not provide an exclusion, exemption, or other similar relief with respect to income attributable to FBY.

(*ii*) *Analysis.* FBY is not a tested unit but is a transparent interest. *See* paragraphs (d)(2)(i)(C) and (d)(8)(ix) of this section. CFC1X has a tested unit in Country X that includes the CFC1X tested unit (without regard to any items related to the interest in FDEX or FDE1Y, but that includes FBY since it is a transparent interest and not a tested unit) and the interest in FDEX. *See* paragraph (d)(2)(iii) of this section. CFC1X has another tested unit in Country Y, the interest in FDE1Y.

(*4*) *Alternative facts—branch is a tested unit but is not combined*—(*i*) *Facts.* The facts are the same as in paragraph (d)(9)(iii)(C)(*1*) of this section (the original facts in this *Example 3*), except that FBY does not give rise to a taxable presence under Country Y tax law but Country X tax law provides an exclusion, exemption, or other similar relief (such as a preferential rate) with respect to income attributable to FBY.

(*ii*) *Analysis.* FBY is a tested unit. *See* paragraph (d)(2)(i)(C) of this section. CFC1X has two tested units in Country Y, the interest in FDE1Y and FBY. The interest in FDE1Y and FBY tested units are not combined because FBY does not give rise to a taxable presence under the tax law of Country Y. *See* paragraph (d)(2)(iii)(B) of this section. CFC1X also has a tested unit in Country X that includes the activities of CFC1X (without regard to any items related to the interest in FDEX, the interest in FDE1Y, or FBY) and the interest in FDEX.

(*5*) *Alternative facts—split ownership of tested unit*—(*i*) *Facts.* The facts are the same as in paragraph (d)(9)(iii)(C)(*1*) of this section (the original facts in this *Example 3*), except that USP also owns CFC2X, CFC1X does not own FDE1Y, and CFC1X and CFC2X own 60% and 40%, respectively, of the interests of FPSY.

(*ii*) *Analysis for CFC1X.* Under paragraph (d)(2)(iii)(A)(*1*) of this section, FBY and CFC1X's 60% interest in FPSY are combined and treated as a single tested unit of CFC1X (''CFC1X's Country Y tested unit''), and CFC1X's interest in FDEX and its other activities are combined and treated as a single tested unit of CFC1X (''CFC1X's Country X tested unit''). CFC1X's Country Y tested unit is attributed any item of CFC1X that is derived through its interest in FPSY to the extent the item is properly reflected on the applicable financial statement of FPSY. *See* paragraph (d)(1)(iii)(A) of this section.

(*iii*) *Analysis for CFC2X.* Under paragraphs (d)(2)(i)(A) and (d)(2)(i)(B)(*1*) of this section, CFC2X and CFC2X's 40% interest in FPSY are tested units of CFC2X. CFC2X's interest in FPSY is attributed any item of CFC2X that is derived through FPSY to the extent that it is properly reflected on the applicable financial statement of FPSY. *See* paragraph (d)(1)(iii)(A) of this section.

(*iv*) *Analysis for not combining CFC1X and CFC2X tested units.* None of the tested units of CFC1X are combined with the tested units of CFC2X under paragraph (d)(2)(iii)(A)(*1*) of this section because they are tested units of different controlled foreign corporations, and the combination rule only combines tested units of the same controlled foreign corporation.

(*6*) *Alternative facts—split ownership of transparent interest*—(*i*) *Facts.* The facts are the same as in paragraph (d)(9)(iii)(C)(*1*) of this section (the original facts in this *Example 3*), except that USP also owns CFC2X, CFC1X does not own FDE1Y, and CFC1X and CFC2X own 60% and 40%, respectively, of the interests in FPSY, but FPSY is not a tax resident of any foreign country and is fiscally transparent for Country X tax law purposes.

(*ii*) *Analysis for CFC1X.* CFC1X's interest in FPSY is not a tested unit but is a transparent interest. *See* paragraphs (d)(2)(i)(B) and (d)(8)(ix) of this section. Under paragraph (d)(3)(iii) of this section, any item of CFC1X that is derived through its interest in FPSY and is properly reflected on the applicable financial statement of FPSY is treated as properly reflected on the applicable financial statement of CFC1X.

(*iii*) *Analysis for CFC2X.* CFC2X's interest in FPSY is not a tested unit but is a transparent interest. *See* paragraphs (d)(2)(i)(B) and (d)(8)(ix) of this section. Under paragraph (d)(3)(iii) of this section, any item of CFC2X that is derived through its interest in FPSY and is properly reflected on the applicable financial statement of FPSY is treated as properly reflected on the applicable financial statement of CFC2X.

(D) *Example 4: Application of de minimis combination rule*—(*1*) *Facts*—(*i*) *Ownership.* USP owns all of the stock of CFC1X, and CFC1X directly owns all of the interests of FDEW, FDEX, FDE1Y, FDE2Y, and FDEZ. FDEW and FDEZ are disregarded entities that are tax residents of Country W and Country Z, respectively.

(*ii*) *Gross income attributable to tested units.* Without regard to the combination rule of paragraph (d)(2)(iii) of this section, CFC1X, and CFC1X's interests in each of FDEW, FDEX, FDE1Y, FDE2Y, and FDEZ, would each be a tested unit of CFC1X. For the CFC inclusion year, and without regard to the combination rule of paragraph (d)(2)(iii) of this section, the U.S. dollar amount of the gross income attributable to the tested units of CFC1X (determined under paragraph (d)(1)(iii) of this section, and without regard to the combination rule in paragraph (d)(2)(iii) of this section) is as follows:

TABLE 1 TO PARAGRAPH (d)(9)(iii)(D)(*1*)(*ii*)

Tested unit	Gross income
CFC1X	$19,500,000
FDEW	100,000
FDEX	100,000
FDE1Y	175,000

TABLE 1 TO PARAGRAPH (d)(9)(iii)(D)(*1*)(*ii*)—Continued

Tested unit	Gross income
FDE2Y	50,000
FDEZ	*75,000*
Total	*20,000,000*

(*2*) *Analysis*—(*i*) *Same country combination rule.* Pursuant to the same country combination rule in paragraph (d)(2)(iii)(A)(*1*) of this section, which applies before the de minimis combination rule in paragraph (d)(2)(iii)(A)(*2*) this section, the CFC1X tested unit (without regard to any items attributed to other tested units) is combined with CFC1X's interest in FDEX and treated as a single tested unit because CFC1X and FDEX are both tax residents of Country X (the ''Country X tested unit''). CFC1X's interests in FDE1Y and FDE2Y are also combined under the same country combination rule and treated as a single tested unit because FDE1Y and FDE2Y are both tax residents of Country Y (the ''Country Y tested unit'').

(*ii*) *De minimis combination rule.* Pursuant to the de minimis combination rule in paragraph (d)(2)(iii)(A)(*2*) of this section, CFC1X's interests in FDEW and FDEZ are combined and treated as a single tested unit because the gross income attributable to each of these tested units ($100,000 attributable to CFC1X's interest in FDEW, and $75,000 attributable to CFC1X's interest in FDEZ) is less than $200,000, which is the lesser of 1% of CFCX's total gross income ($200,000) or $250,000. The Country X tested unit and the Country Y tested unit are not combined under the de minimis combination rule because the gross income attributable to these tested units ($19,600,000 attributable to the Country X tested unit, and $225,000 attributable to the Country Y tested unit) is not less than $200,000.

(E) *Example 5: CFC group—Controlled foreign corporations with different taxable years*—(*1*) *Facts.* USP owns all of the stock of CFC1X and CFC2X. CFC2X has a taxable year ending November 30. On December 15, Year 1, USP sells all the stock of CFC2X to an unrelated party for cash.

(*2*) *Analysis.* The determination of whether CFC1X and CFC2X are in a CFC group is made as of the close of their CFC inclusion years that end with or within the taxable year ending December 31, Year 1, the taxable year of USP, the controlling domestic shareholder under paragraph (d)(8)(iii) of this section. *See* paragraph (d)(6)(v)(B)(*2*) of this section. Under paragraph (d)(6)(v)(B)(*1*) of this section, USP directly owns more than 50% of the stock of CFC1X as of December 31, Year 1, the end of CFC1X's CFC inclusion year. USP also directly owns more than 50% of the stock of CFC2X as of November 30, Year 1, the end of CFC2X's CFC inclusion year. Therefore, CFC1X and CFC2X are members of a CFC group and USP must consistently make high-tax elections, or revocations, under paragraph (d)(6) of this section with respect to CFC1X's taxable year ending December 31, Year 1, and CFC2X's taxable year ending November 30, Year 1. This is the case notwithstanding that USP does not directly own more than 50% of the stock of CFC2X as of December 31, Year 1, the end of CFC1X's CFC inclusion year. *See* paragraph (d)(6)(v)(B)(*2*) of this section.

(F) *Example 6: Application of anti-abuse rule to applicable instrument*—(*1*) *Facts*—(*i*) *Ownership.* USP owns all the stock of CFC1X. CFC1X owns all the stock of CFCY, a controlled foreign corporation organized in Country Y. Under paragraph (d)(2)(i)(A) of this section, CFCY is a tested unit.

(*ii*) *Applicable instrument.* With a significant purpose of causing an item of gross income of CFCY to qualify for the high-tax exception described in section 954(b)(4) and paragraph (d)(1) of this section, CFCY issues an instrument to CFC1X. The instrument is treated as indebtedness that gives rise to deductible interest for federal income tax purposes and under the tax law of Country X, but payments or accruals with respect to the instrument are not deductible under the tax law of Country Y. During Year 1, CFCY accrues and pays €20x with respect to the instrument held by CFC1X. For federal income tax purposes, the €20x accrual is deductible interest expense. For Country Y tax purposes, neither the payment nor accrual is deductible. For Country X tax purposes, the €20x payment is interest and included in income. CFCY has a general gross item that after taking into account the €20x interest deduction on the instrument, but before taking into account the anti-abuse rule under paragraph (d)(7) of this section, would qualify for the high-tax exception in section 954(b)(4) and paragraph (d)(1) of this section; but for the €20x interest deduction (for federal income tax purposes), the general gross item of CFCY would not qualify for the high-tax exception.

(*2*) *Analysis.* Under paragraph (d)(8)(i)(A) of this section, the instrument CFCY issues to CFC1X is an applicable instrument because it gives rise to deductions for federal income tax purposes but not, in whole or in part, under the tax law of Country Y. In addition, CFCY issues the instrument with a significant purpose of avoiding the purposes of section 951, 951A, or 954(b)(4) or paragraph (d)(1) of this section. As a result, appropriate adjustments are made pursuant to the anti-abuse rule in paragraph (d)(7) of this section. The adjustments in this case would be an increase in the amount of the tentative net item described in paragraph (d)(1)(iv) of this section by €20x, the amount of the payment on the applicable instrument that is deductible for federal income tax purposes, but not for Country Y tax purposes, such that CFCY's item of gross income does not qualify for the high-tax exception described in section 954(b)(4) and paragraph (d)(1) of this section.

* * * * *

(h) * * *

(3) *Paragraphs (a)(2) through (a)(7), (b)(1)(ii), (c)(1)(iii)(A)(3), (c)(1)(iv), and (d) of this section.* Paragraphs (c)(1)(iii)(A)(3) and (c)(1)(iv) of this section apply to taxable years of a controlled foreign corporation beginning on or after July 23, 2020, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. Paragraphs (a)(2) through (7), (b)(1)(ii), and (d) of this section apply to taxable years of controlled foreign corporations beginning on or after [the date that final regulations are filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. For the application of paragraphs (a)(2) through (7), (b)(1)(ii), and (d) (excluding paragraphs (d)(3)(i) and (d)(3)(ii)) of this section to taxable years of controlled foreign corporations beginning before [the date that final regulations are filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, see § 1.954–1, as contained in 26 CFR part 1 revised as of April 1, 2020. For the application of paragraphs (d)(3)(i) and (ii) of this section to taxable years of controlled foreign corporations beginning on or after July 23, 2020, and before [the date final regulations are filed on public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, see § 1.954–1(d)(3)(i) and (ii), as in effect on September 21, 2020.

§ 1.954–3 [Amended]

■ **Par. 6.** Section 1.954–3 is amended by removing the second sentence in paragraph (b)(3).

§§ 1.954–6, 1.954–7, and 1.954–8 [Removed]

■ **Par. 7.** Sections 1.954–6 through 1.954–8 are removed.

■ **Par. 8.** Section 1.6038–2, as amended July 15, 2020, at 85 FR43042, effective September 14, 2020, is further amended by:

■ 1. Adding reserved paragraphs (f)(16) through (18);

■ 2. Adding paragraph (f)(19);

■ 3. Adding reserved paragraph (m)(5); and

■ 4. Adding paragraph (m)(6).

The additions read as follows:

§ 1.6038–2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations.

* * * * *

(f) * * *

(16)–(18) [Reserved]

(19) *High-tax election documentation requirement.* If for the annual accounting period of a corporation a United States shareholder makes a high-tax election under section 954(b)(4) and § 1.954–1(d)(6), then Form 5471 (or successor form) must contain such information related to the high-tax election in the form and manner and to the extent prescribed by the form, instructions to the form, publication, or other guidance published in the Internal Revenue Bulletin.

* * * * *

(m) * * *

(5) [Reserved]

(6) *Special rule for paragraph (f)(19) of this section.* Paragraph (f)(19) of this section applies to taxable years of controlled foreign corporations beginning on or after [the date that final regulations are filed for public inspection], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

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