



International Tax

## United States Tax Alert

February 11, 2016

### Temporary and Proposed Regulations Issued Addressing Allocation of Creditable Foreign Tax Expenditures by a Partnership to its Partners

#### Contacts

Chris Trump  
ctrump@deloitte.com

Mark Graham  
mgraham@deloitte.com

Mark Opper  
markopper@deloitte.com

Jim Calzaretta  
jcalzaretta@deloitte.com

On February 4, 2016, the Treasury Department (“Treasury”) and the IRS published temporary regulations ([T.D. 9748](#), “the Temporary Regulations”) modifying the rules applicable to the allocation by a partnership of creditable foreign tax expenditures (CFTEs) that are paid or accrued by the partnership or the partnership’s wholly owned disregarded entity. These regulations are effective immediately. On the same day, the Treasury and the IRS published proposed regulations ([REG-100861-15](#)) containing the same text as the Temporary Regulations and requested comment.

The Temporary regulations will affect partnerships that pay or accrue creditable foreign tax expenditures and their partners. Taxpayers are more likely to be affected by the Temporary Regulations if, in addition to paying or accruing foreign tax costs, they: (i) have partners with section 743 adjustments, (ii) make guaranteed payments or special allocations of gross income, or (iii) make disregarded payments between branches that affect the economic returns to the partners differently.

#### Background

Generally, allocations of CFTEs do not have substantial economic effect and must be allocated in accordance with the partners’ interests in the partnership. However, Treas. Reg. §1.704-1(b)(4)(viii) provides a safe harbor under which CFTE allocations are deemed to be in accordance with the partners’ interests in the partnership.

Under the current regulations, in order to apply the safe harbor, a partnership must:

- (i) determine the partnership’s “CFTE categories”;
- (ii) determine the partnership’s net income in each CFTE category;
- (iii) allocate the partnership’s CFTEs to each category; and
- (iv) allocate the CFTEs in proportion to the distributive shares of income in the

CFTE category.

Treas. Reg. §1.704-1(b)(4)(viii)(c)(2) requires a partnership to assign its income to activities and provides for the grouping of a partnership's activities into one or more CFTE categories based, generally, on whether net income from the activities is allocated to partners in the same sharing ratios.

## The Temporary Regulations

The Temporary Regulations modify the existing safe harbor rule under Treas. Reg. §1.704-1(b)(4)(viii) regarding when a partnership's allocation of CFTEs should be respected for U.S. federal income tax purposes.

In general, and as described more fully below, the Temporary Regulations make, among others, the following modifications:

- Include provisions requiring the tracing of gross basis withholding taxes to the income on which such tax was imposed;
- Provide that a transferee partner's section 743(b) adjustment should not be taken into account in allocating CFTEs;

Address the treatment of guaranteed payments, gross income allocations, and other preferential allocations.

### **Disregarded inter-branch payments**

Under the current regulations, only items of gross income recognized for U.S. income tax purposes are taken into account to determine net income attributable to any activity of a branch.

The Temporary Regulations include examples illustrating that inter-branch payments (disregarded for U.S. federal income tax purposes) do not move gross income from one "activity" to another, and by extension are generally not taken into account in determining the net income in a CFTE category. However, the Temporary Regulations do not modify the current provisions, which provide that if a partnership elects to allocate income attributable to a disregarded inter-branch payment differently from the allocation of other items attributable to the activity of the branch, the special allocation may result in the subdivision of the branch's activity into "divisible parts." The subdivision of an activity into divisible parts generally splits an activity into different CFTE categories and allows a partnership to trace CFTEs to the disregarded payment that was subject to local country tax.

### **Withholding taxes**

The Temporary Regulations contain two new examples ([Example 36](#) and [Example 37](#)) that provide guidance on the allocation of foreign withholding taxes under the CFTE safe harbor. The examples illustrate situations in which gross-basis withholding taxes are imposed on disregarded inter-branch payments and generally require that the gross basis withholding tax be traced to the income on which that tax was imposed.

### **Effect of section 743 adjustments**

Certain transfers of partnership interests result in a "section 743(b) adjustment," which is an adjustment to the basis of partnership property with respect to the

transferee partner. Adjustments under section 743(b) generally arise upon a transfer of an interest (i) in a partnership having a section 754 election in effect or (ii) in a partnership with a “substantial built-in loss” (under section 743(d)) in its property. Adjustments to the basis of partnership property under section 743(b) are made only with respect to the transferee partner, and are therefore not shared by all partners.

The Temporary Regulations provide that, for purposes of computing a partnership’s net income in a CFTE category, the partnership determines its items without regard to any section 743(b) adjustments that its partners may have to the basis of property of the partnership.

### **Guaranteed payments, gross income allocations, and other preferential allocations**

The current regulations contain special rules that adjust net income in a CFTE category for certain preferred allocations and guaranteed payments based on the treatment of those items under foreign tax law. For example, where a guaranteed payment is deductible for U.S. tax purposes, but not foreign tax purposes (“non-deductible guaranteed payment”), the net income in the CFTE category is increased to ensure a more appropriate matching of CFTEs and the income to which they relate. Under the current regulations, net income in a CFTE category from which a non-deductible guaranteed payment is made will be increased by the amount of the guaranteed payment; and that amount will be treated as an allocation to the recipient of the guaranteed payment for purposes of determining the partners’ shares of income in the CFTE category.

The Temporary Regulations amend this rule so that it applies solely for purposes of testing allocations of CFTEs attributable to the foreign jurisdiction that does not allow a deduction for the guaranteed payment. However, for purposes of testing allocations of CFTEs attributable to a foreign jurisdiction that does allow a deduction for the guaranteed payment, a partnership’s net income in a CFTE category is not increased by the amount of the guaranteed payment. This could arise, for example, when partnership income in the same CFTE category is subject to net-basis tax in country X as well as withholding tax imposed by country Y and where country X, but not country Y, treats the partnership’s guaranteed payment as deductible. In these situations, the CFTEs attributable to country X tax and country Y tax are analyzed separately. (See [Example 25](#)). Similar rules apply to gross income and other preferential allocations.

### **Non-substantive clarifications and changes**

The Temporary Regulations make a number of non-substantive clarifications to the current regulations and change some existing terminology. For instance, the phrase “CFTE category share of income” is adopted in place of the former references to “distributive share of income.”

The Temporary Regulations also reorganize the current regulations to some extent and provide an introductory paragraph at Temp. Treas. Reg. §1.704-1T(b)(4)(viii)(c)(3)(i) that describes the steps for computing a partnership’s net income in a CFTE category.

### **Effective Date**

The provisions of the Temporary Regulations generally are effective for partnership taxable years that begin on or after January 1, 2016, and end after February 4, 2016. For certain partnerships whose agreements were entered into

prior to February 14, 2012 that fall within the scope of these rules, the Temporary Regulations modify the availability of a transition rule that was in effect following a prior amendment to these regulations in 2011.

---

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as “Deloitte Global”) does not provide services to clients. Please see <http://www.deloitte.com/about> for a more detailed description of DTTL and its member firms. Certain services are not available to attest clients under the rules and regulations of public accounting.

Deloitte provides audit, consulting, financial advisory, risk management, tax and related services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries and territories, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte’s more than 225,000 professionals are committed to making an impact that matters.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the “Deloitte Network”) is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2016. For information, contact Deloitte Touche Tohmatsu Limited.