



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9871]

RIN 1545-BM56

Allocation of Creditable Foreign Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations with respect to a provision of the Internal Revenue Code (Code) that addresses the allocation by a partnership of foreign income taxes. These regulations are necessary to improve the operation of an existing safe harbor rule that determines whether allocations of creditable foreign tax expenditures are deemed to be in accordance with the partners' interests in the partnership. The regulations affect partnerships that pay or accrue foreign income taxes and partners in such partnerships.

DATES: Effective date: These regulations are effective on **[INSERT DATE OF**

PUBLICATION IN THE FEDERAL REGISTER].

Applicability dates: For dates of applicability, see §1.704-1(b)(1)(ii)(b)(1).

FOR FURTHER INFORMATION CONTACT: Suzanne M. Walsh, (202) 317-6936 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On February 4, 2016, a notice of proposed rulemaking by cross-reference to temporary regulations (REG-100861-15) under section 704 of the Code and temporary regulations (T.D. 9748) (2016 temporary regulations) were published in the **Federal Register** at 81 FR 5966 and 81 FR 5908, respectively.

Section 1.704-1(b)(4)(viii) provides a safe harbor under which allocations of creditable foreign tax expenditures (“CFTEs”) are deemed to be in accordance with the partners’ interests in the partnership. The 2016 temporary regulations revised the rules under this section to clarify the effect of section 743(b) adjustments on the determination of net income in a CFTE category. The 2016 temporary regulations also include special rules regarding how deductible allocations and nondeductible guaranteed payments (that is, allocations that give rise to a deduction under foreign law, and guaranteed payments that do not give rise to a deduction under foreign law) are taken into account for purposes of determining net income in a CFTE category. Finally, the 2016 temporary regulations include a clarification of the rules regarding the treatment of disregarded payments between branches of a partnership for purposes of determining income attributable to an activity included in a CFTE category.

A public hearing was not requested and none was held. However, the Department of the Treasury (“Treasury Department”) and the Internal Revenue Service (“IRS”) received a written comment in response to the notice of proposed rulemaking. After consideration of the comment, the proposed regulations under section 704 are adopted as amended by this Treasury decision. The revisions are discussed in this preamble.

Explanation of Revisions and Summary of Comments

The comment requested revising the regulations to provide that disregarded payments between CFTE categories are taken into account in computing the net income in a CFTE category. The comment argued that the placement of a disregarded payment rule in a paragraph that discusses attribution of income to an activity is potentially confusing and requested that the language be moved to the portion of the regulation that addresses the basic definition of activities and that in its place a statement be added providing that disregarded payments between CFTE categories will reduce net income in one CFTE category and increase net income in the other category.

The Treasury Department and the IRS have determined the rule is clear as originally drafted in the 2016 temporary regulations. Income in a CFTE category is determined first by assigning items of income to activities. Activities are then grouped together in a CFTE category to the extent the income attributable to activities is allocated using the same allocation percentages. Section 1.704-1(b)(4)(viii)(c)(3). Disregarded payments are not taken into account in determining income assigned to an activity. However, if a partnership makes allocations to give economic regard to the disregarded payment, it can result in more than one allocation percentage being applied to income within the same activity. Section 1.704-1(b)(4)(viii)(c)(3)(iv). This will result in the activity being subdivided and the subdivided portions being assigned to different CFTE categories. See Example 24 in §1.704-1(b)(5)(xxiv). In other words, while the 2016 temporary regulations do not literally provide that a disregarded payment “reduces” the net income in a CFTE category in that case, the 2016 temporary regulations provide for a result similar to the result suggested by the comment by

instead subdividing an activity and then assigning one sub-activity to a different CFTE category. This approach is more consistent with the fact that income items are determined based on regarded items and not disregarded items, including disregarded payments. These final regulations add a cross reference to the disregarded payment rule for assigning income to an activity in §1.704-1(b)(4)(viii)(c)(3)(iv) in the paragraph that provides the basic definition of an activity to further highlight the interaction of those two paragraphs. See §1.704-1(b)(4)(viii)(c)(2)(iii).

The 2016 temporary regulations unintentionally deleted §1.704-1(b)(4)(viii)(d)(1)(i) and (ii). Those paragraphs are restored without change by these regulations. In order to comply with new **Federal Register** formatting requirements, Examples 25, 36 and 37 in §1.704-1T(b)(5) in the 2016 temporary regulations appear without further changes in §1.704-1(b)(6)(i) through (iii) of these final regulations, Examples 1, 2, and 3, respectively.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. Therefore, a regulatory impact assessment is not required. Because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f), the proposed rule preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business and no comments were received.

Drafting Information

The principal author of these regulations is Suzanne M. Walsh of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.704-1 is amended as follows:

1. In paragraph (b)(0):

i. Add a heading for the table.

ii. Revise the entries for §1.704-1(b)(1)(ii)(b)(1), (b)(4)(viii)(c)(1) through (4), and (b)(4)(viii)(d)(1) and add an entry for §1.704-1(b)(6) at the end of the table.

2. Revise paragraph (b)(1)(ii)(b)(1).

3. Redesignate paragraphs (b)(1)(ii)(b)(3)(A) and (B) as paragraphs (b)(1)(ii)(b)(3)(i) and (ii), respectively.

4. Revise newly redesignated paragraph (b)(1)(ii)(b)(3)(ii) and paragraphs (b)(4)(viii)(a)(1), (b)(4)(viii)(c)(1), (b)(4)(viii)(c)(2)(ii) and (iii), (b)(4)(viii)(c)(3) and (4), and (b)(4)(viii)(d)(1).

5. Add paragraph (b)(6).

The revisions and additions read as follows:

§1.704-1 Partner's distributive share.

* * * * *

(b) * * *

(0) * * *

Table 1 to paragraph (b)(0)

Heading	Section

In general	1.704-1(b)(1)(ii)(b)(1)

In general	1.704-1(b)(4)(viii)(c)(1)
CFTE category	1.704-1(b)(4)(viii)(c)(2)
Net income in a CFTE category	1.704-1(b)(4)(viii)(c)(3)
CFTE category share of income	1.704-1(b)(4)(viii)(c)(4)

In general	1.704-1(b)(4)(viii)(d)(1)

Examples	1.704-1(b)(6)

(1) * * *

(ii) * * *

(b) * * *

(1) In general. Except as otherwise provided in this paragraph (b)(1)(ii)(b)(1), the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section (regarding the allocation of creditable foreign taxes) apply for partnership taxable years beginning on or after October 19, 2006. The rules that apply to allocations of creditable foreign taxes made in partnership taxable years beginning before October 19, 2006 are contained in §1.704-1T(b)(1)(ii)(b)(1) and (b)(4)(xi) as in effect before October 19, 2006 (see 26 CFR part 1 revised as of April 1, 2005). However, taxpayers may rely on the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section for partnership taxable years beginning on or after April 21, 2004. The provisions of paragraphs (b)(4)(viii)(a)(1), (b)(4)(viii)(c)(1), (b)(4)(viii)(c)(2)(ii) and (iii), (b)(4)(viii)(c)(3) and (4), (b)(4)(viii)(d)(1), and Examples 1, 2, and 3 in paragraphs (b)(6)(i), (ii), and (iii) of this section apply for partnership taxable years that both begin on or after January 1, 2016, and end after February 4, 2016. For the rules that apply to partnership taxable years beginning on or after October 19, 2006, and before January 1, 2016, and to taxable years that both begin on or after January 1, 2016, and end on or before February 4, 2016, see §1.704-1(b)(1)(ii)(b), (b)(4)(viii)(a)(1), (b)(4)(viii)(c)(1), (b)(4)(viii)(c)(2)(ii) and (iii), (b)(4)(viii)(c)(3) and (4), (b)(4)(viii)(d)(1), and (b)(5), Example 25 (as contained in 26 CFR part 1 revised as of April 1, 2015).

* * * * *

(3) * * *

(ii) Transition rule. Transition relief is provided by this paragraph (b)(1)(ii)(b)(3)(ii) to partnerships whose agreements were entered into before February 14, 2012. In such cases, if there has been no material modification to the partnership agreement on or

after February 14, 2012, then, for taxable years beginning on or after January 1, 2012, and before January 1, 2016, and for taxable years that both begin on or after January 1, 2012, and end on or before February 4, 2016, these partnerships may apply the provisions of §1.704-1(b)(4)(viii)(c)(3)(ii) and (b)(4)(viii)(d)(3) (see 26 CFR part 1 revised as of April 1, 2011). For taxable years that both begin on or after January 1, 2016, and end after February 4, 2016, these partnerships may apply the provisions of §1.704-1(b)(4)(viii)(d)(3) (see 26 CFR part 1 revised as of April 1, 2011). For purposes of this paragraph (b)(1)(ii)(b)(3), any change in ownership constitutes a material modification to the partnership agreement. The transition rule in this paragraph (b)(1)(ii)(b)(3)(ii) does not apply to any taxable year in which persons bearing a relationship to each other that is specified in section 267(b) or section 707(b) collectively have the power to amend the partnership agreement without the consent of any unrelated party (and all subsequent taxable years).

* * * * *

(4) * * *

(viii) * * *

(a) * * *

(1) The CFTE is allocated (whether or not pursuant to an express provision in the partnership agreement) to each partner and reported on the partnership return in proportion to the partners' CFTE category shares of income to which the CFTE relates; and

* * * * *

(c) Income to which CFTEs relate--(1) In general. For purposes of paragraph (b)(4)(viii)(a) of this section, CFTEs are related to net income in the partnership's CFTE category or categories to which the CFTE is allocated and apportioned in accordance with the rules of paragraph (b)(4)(viii)(d) of this section. Paragraph (b)(4)(viii)(c)(2) of this section provides rules for determining a partnership's CFTE categories. Paragraph (b)(4)(viii)(c)(3) of this section provides rules for determining the net income in each CFTE category. Paragraph (b)(4)(viii)(c)(4) of this section provides rules for determining a partner's CFTE category share of income, including rules that require adjustments to net income in a CFTE category for purposes of determining the partners' CFTE category share of income with respect to certain CFTEs. Paragraph (b)(4)(viii)(c)(5) of this section provides a special rule for allocating CFTEs when a partnership has no net income in a CFTE category.

(2) * * *

(ii) Different allocations. Different allocations of net income (or loss) generally will result from provisions of the partnership agreement providing for different sharing ratios for net income (or loss) from separate activities. Different allocations of net income (or loss) from separate activities generally will also result if any partnership item is shared in a different ratio than any other partnership item. A guaranteed payment described in paragraph (b)(4)(viii)(c)(4)(ii) of this section, gross income allocation, or other preferential allocation will result in different allocations of net income (or loss) from separate activities only if the amount of the payment or the allocation is determined by reference to income from less than all of the partnership's activities.

(iii) Activity. Whether a partnership has one or more activities, and the scope of each activity, is determined in a reasonable manner taking into account all the facts and circumstances. In evaluating whether aggregating or disaggregating income from particular business or investment operations constitutes a reasonable method of determining the scope of an activity, the principal consideration is whether the proposed determination has the effect of separating CFTEs from the related foreign income. Relevant considerations include whether the partnership conducts business in more than one geographic location or through more than one entity or branch, and whether certain types of income are exempt from foreign tax or subject to preferential foreign tax treatment. In addition, income from a divisible part of a single activity is treated as income from a separate activity if necessary to prevent separating CFTEs from the related foreign income, such as when income from divisible parts of a single activity is subject to different allocations. See, for example, paragraph (b)(4)(viii)(c)(3)(iv) of this section (special allocations related to disregarded payments can give rise to subdivision of an activity into divisible parts). A guaranteed payment, gross income allocation, or other preferential allocation of income that is determined by reference to all the income from a single activity generally will not result in the division of an activity into divisible parts. See Example 22 in paragraph (b)(5)(xxii) of this section and Example 1 in paragraph (b)(6)(i) of this section. The partnership's activities must be determined consistently from year to year absent a material change in facts and circumstances.

(3) Net income in a CFTE category--(i) In general. A partnership computes net income in a CFTE category as follows: First, the partnership determines for U.S. Federal income tax purposes all of its partnership items, including items of gross

income, gain, loss, deduction, and expense, and items allocated pursuant to section 704(c). For the purpose of this paragraph (b)(4)(viii)(c)(3)(i), the items of the partnership are determined without regard to any adjustments under section 743(b) that its partners may have to the basis of property of the partnership. However, if the partnership is a transferee partner that has a basis adjustment under section 743(b) in its capacity as a direct or indirect partner in a lower-tier partnership, the partnership does take such basis adjustment into account. Second, the partnership must assign those partnership items to its activities pursuant to paragraph (b)(4)(viii)(c)(3)(ii) of this section. Third, partnership items attributable to each activity are aggregated within the relevant CFTE category as determined under paragraph (b)(4)(viii)(c)(2) of this section in order to compute the net income in a CFTE category.

(ii) Assignment of partnership items to activities. The items of gross income attributable to an activity must be determined in a consistent manner under any reasonable method taking into account all the facts and circumstances. Except as otherwise provided in paragraph (b)(4)(viii)(c)(3)(iii) of this section, expenses, losses, or other deductions must be allocated and apportioned to gross income attributable to an activity in accordance with the rules of §§1.861-8 and 1.861-8T. Under the rules §§1.861-8 and 1.861-8T, if an expense, loss, or other deduction is allocated to gross income from more than one activity, such expense, loss, or deduction must be apportioned among each such activity using a reasonable method that reflects to a reasonably close extent the factual relationship between the deduction and the gross income from such activities. See §1.861-8T(c). For the effect of disregarded payments

in determining the amount of net income attributable to an activity, see paragraph (b)(4)(viii)(c)(3)(iv) of this section.

(iii) Interest expense and research and experimental expenditures. The partnership's interest expense and research and experimental expenditures described in section 174 may be allocated and apportioned under any reasonable method, including but not limited to the methods prescribed in §§1.861-9 through 1.861-13T (interest expense) and §1.861-17 (research and experimental expenditures).

(iv) Disregarded payments. An item of gross income is assigned to the activity that generates the item of income that is recognized for U.S. Federal income tax purposes. Consequently, disregarded payments are not taken into account in determining the amount of net income attributable to an activity, although a special allocation of income used to make a disregarded payment may result in the subdivision of an activity into divisible parts. See paragraph (b)(4)(viii)(c)(2)(iii) of this section, Example 24 in paragraph (b)(5)(xxiv) of this section, and Examples 2 and 3 in paragraphs (b)(6)(ii) and (iii), respectively, of this section (relating to inter-branch payments).

(4) CFTE category share of income--(i) In general. CFTE category share of income means the portion of the net income in a CFTE category, determined in accordance with paragraph (b)(4)(viii)(c)(3) of this section as modified by paragraphs (b)(4)(viii)(c)(4)(ii) through (iv) of this section, that is allocated to a partner. To the extent provided in paragraph (b)(4)(viii)(c)(4)(ii) of this section, a guaranteed payment is treated as an allocation to the recipient of the guaranteed payment for this purpose. If more than one partner receives positive income allocations (income in excess of

expenses) from a CFTE category, which in the aggregate exceed the total net income in the CFTE category, then such partner's CFTE category share of income equals the partner's positive income allocation from the CFTE category, divided by the aggregate positive income allocations from the CFTE category, multiplied by the net income in the CFTE category. Paragraphs (b)(4)(viii)(c)(4)(ii) through (iv) of this section require adjustments to the net income in a CFTE category for purposes of determining the partners' CFTE category share of income if one or more foreign jurisdictions impose a tax that provides for certain exclusions or deductions from the foreign taxable base. Such adjustments apply only with respect to CFTEs attributable to the taxes that allow such exclusions or deductions. Thus, net income in a CFTE category may vary for purposes of applying paragraph (b)(4)(viii)(a)(1) of this section to different CFTEs within that CFTE category.

(ii) Guaranteed payments. Except as otherwise provided in this paragraph (b)(4)(viii)(c)(4)(ii), solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(a)(1) of this section, net income in the CFTE category from which a guaranteed payment (within the meaning of section 707(c)) is made is increased by the amount of the guaranteed payment that is deductible for U.S. Federal income tax purposes, and such amount is treated as an allocation to the recipient of such guaranteed payment for purposes of determining the partners' CFTE category shares of income. If a foreign tax allows (whether in the current or in a different taxable year) a deduction from its taxable base for a guaranteed payment, then solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(a)(1) of this section to allocations of CFTEs that are attributable to that foreign tax, net income in the CFTE

category is increased only to the extent that the amount of the guaranteed payment that is deductible for U.S. Federal income tax purposes exceeds the amount allowed as a deduction for purposes of the foreign tax, and such excess is treated as an allocation to the recipient of the guaranteed payment for purposes of determining the partners' CFTE category shares of income. See Example 1 in paragraph (b)(6)(i) of this section.

(iii) Preferential allocations. To the extent that a foreign tax allows (whether in the current or in a different taxable year) a deduction from its taxable base for an allocation (or distribution of an allocated amount) to a partner, then solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(a)(1) of this section to allocations of CFTEs that are attributable to that foreign tax, the net income in the CFTE category from which the allocation is made is reduced by the amount of the allocation, and that amount is not treated as an allocation for purposes of determining the partners' CFTE category shares of income. See Example 1 in paragraph (b)(6)(i) of this section.

(iv) Foreign law exclusions due to status of partner. If a foreign tax excludes an amount from its taxable base as a result of the status of a partner, then solely for purposes of applying the safe harbor provisions of paragraph (b)(4)(viii)(a)(1) of this section to allocations of CFTEs that are attributable to that foreign tax, the net income in the relevant CFTE category is reduced by the excluded amounts that are allocable to such partners. See Example 27 in paragraph (b)(5)(xxvii) of this section.

* * * * *

(d) Allocation and apportionment of CFTEs to CFTE categories--(1) In general. CFTEs are allocated and apportioned to CFTE categories in accordance with the principles of §1.904-6. Under these principles, a CFTE is related to income in a CFTE

category if the income is included in the base upon which the foreign tax is imposed. See Examples 2 and 3 in paragraphs (b)(6)(ii) and (iii) of this section, respectively, which illustrate the application of this paragraph in the case of serial disregarded payments subject to withholding tax. In accordance with §1.904-6(a)(1)(ii) as modified by this paragraph (b)(4)(viii)(d), if the foreign tax base includes income in more than one CFTE category, the CFTEs are apportioned among the CFTE categories based on the relative amounts of taxable income computed under foreign law in each CFTE category. For purposes of this paragraph (b)(4)(viii)(d), references in §1.904-6 to a separate category or separate categories mean "CFTE category" or "CFTE categories" and the rules in §1.904-6(a)(1)(ii) are modified as follows:

(i) The related party interest expense rule in §1.904-6(a)(1)(ii) shall not apply in determining the amount of taxable income computed under foreign law in a CFTE category.

(ii) If foreign law does not provide for the direct allocation or apportionment of expenses, losses or other deductions allowed under foreign law to a CFTE category of income, then such expenses, losses or other deductions must be allocated and apportioned to gross income as determined under foreign law in a manner that is consistent with the allocation and apportionment of such items for purposes of determining the net income in the CFTE categories for U.S. tax purposes pursuant to paragraph (b)(4)(viii)(c)(3) of this section.

* * * * *

(6) Examples--(i) Example 1. (a) A contributes \$750,000 and B contributes \$250,000 to form AB, a country X eligible entity (as defined in §301.7701-3(a) of this chapter) treated as a partnership for U.S. Federal income tax purposes. AB operates business M in country X. Country X imposes a 20 percent tax on the net income from

business M, which tax is a CFTE. In 2016, AB earns \$300,000 of gross income, has deductible expenses of \$100,000, and pays or accrues \$40,000 of country X tax. Pursuant to the partnership agreement, the first \$100,000 of gross income each year is specially allocated to A as a preferred return on excess capital contributed by A. All remaining partnership items, including CFTEs, are split evenly between A and B (50 percent each). The gross income allocation is not deductible in determining AB's taxable income under country X law. Assume that allocations of all items other than CFTEs are valid.

(b) AB has a single CFTE category because all of AB's net income is allocated in the same ratio. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the single CFTE category is \$200,000. The \$40,000 of taxes is allocated to the single CFTE category and, thus, is related to the \$200,000 of net income in the single CFTE category. In 2016, AB's partnership agreement results in an allocation of \$150,000 or 75 percent of the net income to A (\$100,000 attributable to the gross income allocation plus \$50,000 of the remaining \$100,000 of net income) and \$50,000 or 25 percent of the net income to B. AB's partnership agreement allocates the country X taxes in accordance with the partners' shares of partnership items remaining after the \$100,000 gross income allocation. Therefore, AB allocates the country X taxes 50 percent to A (\$20,000) and 50 percent to B (\$20,000). AB's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section because they are not in proportion to the allocations of the CFTE category shares of income to which the country X taxes relate. Accordingly, the country X taxes will be reallocated according to the partners' interests in the partnership. Assuming that the partners do not reasonably expect to claim a deduction for the CFTEs in determining their U.S. Federal income tax liabilities, a reallocation of the CFTEs under paragraph (b)(3) of this section would be 75 percent to A (\$30,000) and 25 percent to B (\$10,000). If the reallocation of the CFTEs causes the partners' capital accounts not to reflect their contemplated economic arrangement, the partners may need to reallocate other partnership items to ensure that the tax consequences of the partnership's allocations are consistent with their contemplated economic arrangement over the term of the partnership.

(c) The facts are the same as in paragraph (b)(6)(i)(a) of this section, except that country X allows a deduction for the \$100,000 allocation of gross income and, as a result, AB pays or accrues only \$20,000 of foreign tax. Under paragraph (b)(4)(viii)(c)(4)(iii) of this section, the net income in the single CFTE category is \$100,000, determined by reducing the net income in the CFTE category by the \$100,000 of gross income that is allocated to A and for which country X allows a deduction in determining AB's taxable income. Pursuant to the partnership agreement, AB allocates the country X tax 50 percent to A (\$10,000) and 50 percent to B (\$10,000). This allocation is in proportion to the partners' CFTE category shares of the \$100,000 net income. Accordingly, AB's allocations of country X taxes are deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii)(a) of this section.

(d) The facts are the same as in paragraph (b)(6)(i)(c) of this section, except that, in addition to \$20,000 of country X tax, AB is subject to \$30,000 of country Y withholding tax with respect to the \$300,000 of gross income that it earns in 2016. Country Y does not allow any deductions for purposes of determining the withholding tax. As described in paragraph (b)(6)(i)(b) of this section, there is a single CFTE category with respect to AB's net income. Both the \$20,000 of country X tax and the \$30,000 of country Y withholding tax relate to that income and are therefore allocated to the single CFTE category. Under paragraph (b)(4)(viii)(c)(4)(iii) of this section, however, net income in a CFTE category is reduced by the amount of an allocation for which a deduction is allowed in determining a foreign taxable base, but only for purposes of applying paragraph (b)(4)(viii)(a) of this section to allocations of CFTEs that are attributable to that foreign tax. Accordingly, because the \$100,000 allocation of gross income is deductible for country X tax purposes but not for country Y tax purposes, the allocations of the CFTEs attributable to country X tax and country Y tax are analyzed separately. For purposes of applying paragraph (b)(4)(viii)(a)(1) of this section to allocations of the CFTEs attributable to the \$20,000 tax imposed by country X, the analysis described in paragraph (b)(6)(i)(c) of this section applies. For purposes of applying paragraph (b)(4)(viii)(a)(1) of this section to allocations of the CFTEs attributable to the \$30,000 tax imposed by country Y, which did not allow a deduction for the \$100,000 gross income allocation, the net income in the single CFTE category is \$200,000. Pursuant to the partnership agreement, AB allocates the country Y tax 50 percent to A (\$15,000) and 50 percent to B (\$15,000). These allocations are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section because they are not in proportion to the partners' CFTE category shares of the \$200,000 of net income in the category, which is allocated 75 percent to A and 25 percent to B under the partnership agreement. Accordingly, the country Y taxes will be reallocated according to the partners' interests in the partnership as described in paragraph (b)(6)(i)(b) of this section.

(e) If, rather than being a preferential gross income allocation, the \$100,000 was a guaranteed payment to A within the meaning of section 707(c), the amount of net income in the single CFTE category of AB for purposes of applying paragraph (b)(4)(viii)(a)(1) of this section to allocations of CFTEs would be the same as in the fact patterns described in paragraphs (b)(6)(i)(b), (c), and (d) of this section. See paragraph (b)(4)(viii)(c)(4)(ii) of this section.

(ii) Example 2. (a) A, B, and C form ABC, an eligible entity (as defined in §301.7701-3(a) of this chapter) treated as a partnership for U.S. Federal income tax purposes. ABC owns three entities, DEX, DEY, and DEZ, which are organized in, and treated as corporations under the laws of, countries X, Y, and Z, respectively, and as disregarded entities for U.S. Federal income tax purposes. DEX operates business X in country X, DEY operates business Y in country Y, and DEZ operates business Z in country Z. Businesses X, Y, and Z relate to the licensing and sublicensing of intellectual property owned by DEZ. During 2016, DEX earns \$100,000 of royalty income from unrelated payors on which it pays no withholding taxes. Country X imposes a 30

percent tax on DEX's net income. DEX makes royalty payments of \$90,000 during 2016 to DEY that are deductible by DEX for country X purposes and subject to a 10 percent withholding tax imposed by country X. DEY earns no other income in 2016. Country Y does not impose income or withholding taxes. DEY makes royalty payments of \$80,000 during 2016 to DEZ. DEZ earns no other income in 2016. Country Z does not impose income or withholding taxes. The royalty payments from DEX to DEY and from DEY to DEZ are disregarded for U.S. Federal income tax purposes.

(b) As a result of these payments, DEX has taxable income of \$10,000 for country X purposes on which \$3,000 of taxes are imposed, and DEY has \$90,000 of income for country X withholding tax purposes on which \$9,000 of withholding taxes are imposed. Pursuant to the partnership agreement, all partnership items from business X, excluding CFTEs paid or accrued by business X, are allocated 80 percent to A and 10 percent each to B and C. All partnership items from business Y, excluding CFTEs paid or accrued by business Y, are allocated 80 percent to B and 10 percent each to A and C. All partnership items from business Z, excluding CFTEs paid or accrued by business Z, are allocated 80 percent to C and 10 percent each to A and B. Because only business X has items that are regarded for U.S. Federal income tax purposes (the \$100,000 of royalty income), only business X has partnership items. Accordingly A is allocated 80 percent of the income from business X (\$80,000) and B and C are each allocated 10 percent of the income from business X (\$10,000 each). There are no partnership items of income from business Y or Z to allocate.

(c) Because the partnership agreement provides for different allocations of partnership net income attributable to businesses X, Y, and Z, the net income attributable to each of businesses X, Y, and Z is income in separate CFTE categories. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3)(iv) of this section, an item of gross income that is recognized for U.S. Federal income tax purposes is assigned to the activity that generated the item, and disregarded inter-branch payments are not taken into account in determining net income attributable to an activity. Consequently, all \$100,000 of ABC's income is attributable to the business X activity for U.S. Federal income tax purposes, and no net income is in the business Y or Z CFTE category. Under paragraph (b)(4)(viii)(d)(1) of this section, the \$3,000 of country X taxes imposed on DEX is allocated to the business X CFTE category. The additional \$9,000 of country X withholding tax imposed with respect to the inter-branch payment to DEY is also allocated to the business X CFTE category because for U.S. Federal income tax purposes the related \$90,000 of income on which the country X withholding tax is imposed is in the business X CFTE category. Therefore, \$12,000 of taxes (\$3,000 of country X income taxes and \$9,000 of the country X withholding taxes) is related to the \$100,000 of net income in the business X CFTE. See paragraph (b)(4)(viii)(c)(1) of this section. The allocations of country X taxes will be in proportion to the CFTE category shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 80 percent to A and 10 percent each to B and C.

(iii) Example 3. (a) Assume that the facts are the same as in paragraph (b)(5)(ii)(a) of this section, except that in order to reflect the \$90,000 payment from DEX to DEY and the \$80,000 payment from DEY to DEZ, the partnership agreement treats only \$10,000 of the gross income as attributable to the business X activity, which the partnership agreement allocates 80 percent to A and 10 percent each to B and C. Of the remaining \$90,000 of gross income, the partnership agreement treats \$10,000 of the gross income as attributable to the business Y activity, which the partnership agreement allocates 80 percent to B and 10 percent each to A and C; and the partnership agreement treats \$80,000 of the gross income as attributable to the business Z activity, which the partnership agreement allocates 80 percent to C and 10 percent each to A and B. In addition, the partnership agreement allocates the country X taxes among A, B, and C in accordance with which disregarded entity is considered to have paid the taxes for country X purposes. The partnership agreement allocates the \$3,000 of country X income taxes 80 percent to A and 10 percent to each of B and C, and allocates the \$9,000 of country X withholding taxes 80 percent to B and 10 percent to each of A and C. Thus, ABC allocates the country X taxes \$3,300 to A (80 percent of \$3,000 plus 10 percent of \$9,000), \$7,500 to B (10 percent of \$3,000 plus 80 percent of \$9,000), and \$1,200 to C (10 percent of \$3,000 plus 10 percent of \$9,000).

(b) In order to prevent separating the CFTEs from the related foreign income, the special allocations of the \$10,000 and \$80,000 treated under the partnership agreement as attributable to the business Y and the business Z activities, respectively, which do not follow the allocation ratios that otherwise apply under the partnership agreement to items of income in the business X activity, are treated as divisible parts of the business X activity and, therefore, as separate activities. See paragraph (b)(4)(viii)(c)(2)(iii) of this section. Because the divisible part of the business X activity attributable to the portion of the disregarded payment received by DEY and not paid on to DEZ (\$10,000) and the net income from the business Y activity (\$0) are both shared 80 percent to B and 10 percent each to A and C, that divisible part of the business X activity and the business Y activity are treated as a single CFTE category. Because the divisible part of the business X activity attributable to the disregarded payment paid to DEZ (\$80,000) and the net income from the business Z activity (\$0) are both shared 80 percent to C and 10 percent each to A and B, that divisible part of the business X activity and the business Z activity are also treated as a single CFTE category. See paragraph (b)(4)(viii)(c)(2)(i) of this section. Accordingly, \$10,000 of net income attributable to business X is in the business X CFTE category, \$10,000 of net income of business X attributable to the net disregarded payments of DEY is in the business Y CFTE category, and \$80,000 of net income of business X attributable to the disregarded payment to DEZ is in the business Z CFTE category.

(c) Under paragraph (b)(4)(viii)(d)(1) of this section, the \$3,000 of country X tax imposed on DEX's income is allocated to the business X CFTE category. Because the \$90,000 on which the country X withholding tax is imposed is split between the business Y CFTE category and the business Z CFTE category, those withholding taxes are allocated on a pro rata basis, \$1,000 [$\$9,000 \times (\$10,000 / \$90,000)$] to the business Y CFTE category and \$8,000 [$\$9,000 \times (\$80,000 / \$90,000)$] to the business Z CFTE

category. See paragraph (b)(4)(viii)(d)(1) of this section. To satisfy the safe harbor of paragraph (b)(4)(viii) of this section, the \$3,000 of country X taxes allocated to the business X CFTE category must be allocated in proportion to the CFTE category shares of income to which they relate, and therefore would be deemed to be in accordance with the partners' interests in the partnership if such taxes were allocated 80 percent to A and 10 percent each to B and C. The allocation of the \$1,000 of country X withholding taxes allocated to the business Y CFTE category would be in proportion to the CFTE category shares of income to which they relate, and therefore would be deemed to be in accordance with the partners' interests in the partnership if such taxes were allocated 80 percent to B and 10 percent each to A and C. The allocation of the \$8,000 of country X withholding taxes allocated to the business Z CFTE category would be in proportion to the CFTE category shares of income to which they relate, and therefore would be deemed to be in accordance with the partners' interests in the partnership if such taxes were allocated 80 percent to C and 10 percent each to A and B. Thus, to satisfy the safe harbor, ABC must allocate the country X taxes \$3,300 to A (80 percent of \$3,000 plus 10 percent of \$1,000 plus 10 percent of \$8,000), \$1,900 to B (10 percent of \$3,000 plus 80 percent of \$1,000 plus 10 percent of \$8,000), and \$6,800 to C (10 percent of \$3,000 plus 10 percent of \$1,000 plus 80 percent of \$8,000).

(d) ABC's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section because they are not in proportion to the partners' CFTE category shares of income to which the country X taxes relate. Accordingly, the country X taxes will be reallocated according to the partners' interests in the partnership.

* * * * *

Par. 3. Section 1.704-1T is amended by:

1. Removing reserved paragraphs (a) through (b)(1)(ii)(a), paragraph (b)(1)(ii)(b), and reserved paragraphs (b)(1)(iii) through (b)(2)(iv)(f)(5).
2. Adding paragraphs (a), (b)(1), and (b)(2) introductory text and reserved paragraphs (b)(2)(i) through (b)(2)(iv)(e) and (b)(2)(iv)(f)(1) through (5).
3. Removing reserved paragraphs (b)(2)(iv)(g) through (b)(4)(viii)(a) introductory text, paragraph (b)(4)(viii)(a)(1), reserved paragraphs (b)(4)(viii)(a)(2) through (b)(4)(viii)(b), paragraph (b)(4)(viii)(c), paragraph (b)(4)(viii)(d) heading, paragraph (b)(4)(viii)(d)(1), reserved paragraphs (b)(4)(viii)(d)(1)(i) through (b)(5) Example 24, paragraphs (b)(5) Examples 24 through 37, and reserved paragraphs (c) through (e).

4. Adding paragraph (b)(2)(iv)(g), reserved paragraphs (b)(2)(iv)(h) through (s), paragraph (b)(3), reserved paragraphs (b)(4) through (6), paragraph (c), and reserved paragraphs (d) through (e).

5. Removing paragraph (g).

The additions read as follows:

§1.704-1T Partner's distributive share (temporary).

(a) For further guidance, see §1.704-1(a).

(b)(1) For further guidance, see §1.704-1(b)(1).

(2) For further guidance, see §1.704-1(b)(2)(i) through (b)(2)(iv)(f)(5).

(i) through (iii) [Reserved]

(iv)(a) through (e) [Reserved]

(f)(1) through (5) [Reserved]

* * * * *

(g) For further guidance, see §1.704-1(b)(2)(iv)(g) through (s).

(h) through (s) [Reserved]

(3) For further guidance, see §1.704-1(b)(3) through (6).

(4) through (6) [Reserved]

(c) For further guidance, see §1.704-1(c) through (e).

(d) through (e) [Reserved]

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Kirsten Wielobob,

Approved: May 30, 2019.

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