NEW YORK STATE BAR ASSOCIATION
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Report No. 1520
January 11, 2026

The Honorable Scott Bessent
Secretary
Department of the Treasury
and
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Kenneth Kies
Assistant Secretary (Tax Policy)
Department of the Treasury
and
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: NYSBA Tax Section Report No. 1520 - Report on Notice 2025-72

Dear Secretary Bessent and Assistant Secretary Kies:

Please find attached Report No. 1520 of the Tax Section of the New York State Bar Association. The Report provides certain comments and recommendations of the Tax Section regarding Notice 2025-72, released on November 25, 2025 (the "**Notice**").

Public Law 119-21, commonly known as the One Big Beautiful Bill Act ("**OBBBA**") repealed Section 898(c)(2) of the Internal Revenue Code, which historically allowed certain specified foreign corporations ("**SFCs**") to elect a tax year beginning one month earlier than their majority U.S. shareholder's tax year, for tax years beginning after November 30, 2025. As a result, SFCs with a one-month deferral election will have a short tax year to align with their U.S. shareholder's tax year. The OBBBA directs Treasury to issue regulations or other guidance for allocating foreign taxes paid or accrued in the first (short) required (taxable) year beginning after November 30, 2025, and the succeeding taxable year, "among such taxable years in the manner the Secretary determines appropriate to carry out the purposes of this section."

The Notice announces forthcoming proposed regulations and prescribes an ordering and allocation methodology for 'specified foreign income taxes' that certain specified foreign corporations will incur in the short tax year created by the repeal of Section 898(c)(2). The Notice also announces forthcoming modifications to the Section 987 regulations with respect to the election to recognize pretransition Section 987 gains or losses over a 10-year period, specifically adjusting how taxpayers recognize pretransition Section 987 gains or losses when short tax years occur, including short tax years resulting from the repeal of Section 898(c)(2).

We appreciate your consideration of this Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Andrew Walker
Chair

Enclosure

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Report No. 1520

New York State Bar Association

Comments on Notice 2025-72 on the Allocation of Foreign Income Taxes Resulting from the Repeal of Section 898(c)(2) and the Recognition of Pretransition Gain or Loss under Section 987

January 11, 2026

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Report No. 1520

I. Introduction

This report (the "**Report**")[1] of the Tax Section of the New York State Bar Association ("**NYSBA**") addresses Notice 2025-72 (the "**Notice**"), which was released by the Department of the Treasury and the Internal Revenue Service (collectively, "**Treasury**") on November 25, 2025.[2] The Notice announced Treasury's intention to issue proposed regulations under section 70352 of the One, Big, Beautiful Bill Act (the "**OBBBA**").[3] The OBBBA repeals section 898(c)(2) and directs Treasury to issue guidance on the allocation of foreign taxes paid or accrued by foreign corporations affected by that repeal (the "**Transition Rule**").[4] The Notice also announces that Treasury intends to issue proposed regulations under section 987 that would modify the election to recognize pretransition gain or loss ratably over the transition period.

The repeal of section 898(c)(2) requires many foreign corporations to adopt a new taxable year. To transition to their new taxable year, those corporations would be required to have a one-month short taxable year, which could result in distortions under the Code's international tax provisions. To address this, the Transition Rule directs Treasury to issue regulations or other guidance for allocating foreign taxes that are paid or accrued in such first taxable year and the succeeding taxable year among such taxable years in the manner Treasury determines appropriate to carry out the purposes of the Transition Rule. The Notice does this by formulaically allocating a portion of the foreign income taxes that would otherwise accrue during an affected corporation's short taxable year to the succeeding taxable year.

We believe that the approach set forth in the Notice to allocating foreign income taxes among taxable years generally represents an appropriate method to mitigate distortions in a manner consistent with the purposes underlying the Transition Rule. This Report addresses the Notice and provides comments on the forthcoming proposed regulations. The Report is divided into four parts. Following this Introduction (Part I), Part II summarizes our principal recommendations for consideration. Part III provides an overview of the relevant statutory and regulatory provisions and summarizes the proposed regulations described in the Notice. Finally, Part IV contains a detailed discussion of our comments and recommendations.

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[1] The principal author of this Report is Raymond Stahl. This report reflects comments received from Kimberly Blanchard, Michael Caballero, Kevin Glenn, Stephen Massed, Michael Schler, Wade Sutton, Shun Tosaka, and Andrew Walker.

[2] 2025-51 I.R.B. 788 (Dec. 15, 2025).

[3] Public Law 119-21, 139. Stat. 72 (July 4, 2025).

[4] Unless otherwise noted, "**section**" refers to a section of the Internal Revenue Code of 1986 (the "**Code**").

II. Summary of Proposed Recommendations

The following is a summary of the principal recommendations in this Report. All defined terms used in this Part II have the meanings ascribed to them in Parts I, III, and IV.

A. The proposed regulations should apply the Allocation Rule separately with respect to different subpart F income groups, tested income groups, and PTEP groups.

B. A foreign income tax accruing in a succeeding taxable year should be subject to allocation if it relates to a foreign taxable year that includes the first required year and, during an affected corporation's first required year, the affected corporation (i) is subject to a subpart F income high-tax exception election or GILTI high-tax exclusion election or (ii) recognizes income or gain by reason of an extraordinary transaction.

C. The proposed regulations should provide that specified foreign income taxes that are allocated to a succeeding taxable year should be further allocated among taxpayers under the principles of the Covered Event Rules.

D. The proposed regulations should treat a partner's distributive share of foreign income taxes paid or accrued by a partnership as specified foreign income taxes when (i) the partner is an affected corporation, (ii) the partnership must adopt a new taxable year by reason of one or more of its partners being required to adopt a new taxable year, and (iii) the partnership's first new taxable year coincides with the partner's first required year.

E. Proposed regulations should extend the monthly convention, which the Notice applies solely to pretransition gain or loss, to certain other items recognized by an affected corporation in its first required year.

III. Background

A. Section 898

1. Section 898 in General

Section 898 establishes the required taxable year for a "specified foreign corporation," which is a controlled foreign corporation (a "**CFC**"),[5] 50 percent of the stock of which is owned, by vote or value, by a United States shareholder (a "**U.S. shareholder**")[6] on each testing day (such

[5] A CFC is a foreign corporation that is owned more than 50 percent, by vote or value, by U.S. shareholders. I.R.C. § 957(a).

[6] A U.S. shareholder is a U.S. person that owns 10 percent or more of the vote or value of the foreign corporation. I.R.C. § 951(b).

U.S. shareholder, the "**majority U.S. shareholder**").[7] A testing day is the first day of the CFC's taxable year (determined without regard to section 898), or certain other days as may be prescribed by regulation.[8]

Thus, on the first day of a specified foreign corporation's taxable year, its taxable year generally must conform to its required taxable year. The required taxable year is the taxable year of each majority U.S. shareholder.[9] Prior to its repeal by the OBBBA, section 898(c)(2) permitted a specified foreign corporation to elect a taxable year beginning (and thus ending) one month earlier than the majority U.S. shareholder year (a "**one-month deferral election**" and the resulting taxable year, a "**one-month deferral year**") rather than the majority U.S. shareholder year.

The OBBBA repealed section 898(c)(2) for taxable years of specified foreign corporations beginning after November 30, 2025.[10] As a result, any specified foreign corporation with a one-month deferral election in effect must adopt the majority U.S. shareholder year as its taxable year for its first taxable year beginning on or after December 1, 2025. Absent any other events that close the specified foreign corporation's taxable year, the transition to its majority U.S. shareholder year will result in a one-month long taxable year ending on the last day of the majority U.S. shareholder year.[11]

For example, if a U.S. shareholder with a calendar year taxable year owned 100 percent of the stock of a specified foreign corporation on the first day of the CFC's taxable year, the CFC's taxable year must be the calendar year. Alternatively, before the repeal of section 898(c)(2), the CFC could elect a taxable year ending on November 30. However, if the CFC made a one-month deferral election, then its taxable year ending on November 30, 2025, would be its last taxable year subject to the one-month deferral election. The CFC's first required year would begin on December 1, 2025, and end on December 31, 2025, which is the end of its majority U.S. shareholder year.

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[7] I.R.C. § 898(a) & (b). For purposes of determining ownership, the indirect and constructive ownership rules of section 958(a) and (b) apply. I.R.C. § 898(b)(2)(B).

[8] I.R.C. § 898(c)(2)(B). In connection with the repeal of section 898(c)(2), former section 898(c)(3) was redesignated as section 898(c)(2). OBBBA § 70352(a). Proposed regulations issued in 1993 would provide for additional testing days. *See* Prop. Reg. § 1.898-3(a)(5).

[9] I.R.C. § 898(c)(1)(A). If there is no such year, the required taxable year is the taxable year prescribed by regulations. Proposed regulations would require the adoption of a taxable year resulting in the least aggregate deferral of income. *See* Prop. Reg. § 1.898-3(a)(3).

[10] OBBBA § 70352.

[11] Certain taxpayers may elect to use a 52-53-week taxable year that ends with reference to their required taxable year. *See generally* Treas. Reg. § 1.441-2.

2. The Transition Rule

The repeal of section 898(c)(2) would, in the absence of transition relief, yield distortive foreign tax credit outcomes for many taxpayers. To prevent this, Congress enacted the Transition Rule. In relevant part, section 70352(c)(1) of the OBBBA provides as follows:[12]

> (1) IN GENERAL.—In the case of a corporation that is a specified foreign corporation as of November 30, 2025, such corporation's first taxable year beginning after such date shall end at the same time as the first required year (within the meaning of section 898(c)(1) of the Internal Revenue Code of 1986) ending after such date. If any specified foreign corporation is required by the amendments made by this section to change its taxable year for its first taxable year beginning after November 30, 2025--
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> […]
>
> (C) the Secretary shall issue regulations or other guidance for allocating foreign taxes that are paid or accrued in such first taxable year and the succeeding taxable year among such taxable years in the manner the Secretary determines appropriate to carry out the purposes of this section.

Although there is no legislative history discussing the Transition Rule, its purpose may be inferred from its effects.[13] As discussed more fully below, without the Transition Rule, foreign income taxes paid or accrued by a CFC in its first required year that would otherwise have been available to be claimed as a foreign tax credit under section 960 would often become unavailable because they would accrue during the CFC's short taxable year.

[12] OBBBA section 70352(c) also provides that a change to the specified foreign corporation's taxable year will be treated as initiated by the corporation and as having been made with the consent of the Secretary. Although each of these provisions is part of the statutory transition rule, references to the Transition Rule in this Report refer solely to the directive in section 70352(c)(1)(C) of the OBBBA.

[13] On July 29, 2025, Senate Finance Committee Republican staff released a section-by-section summary of Part VII of the OBBBA. In its description of the repeal of section 898(c)(2), the summary states as follows: "This provision applies to taxable years of specified foreign corporations beginning after November 30, 2025. A transition rule provides that a specified foreign corporation's first taxable year beginning after November 30, 2025, ends at the same time as the first required year (within the meaning of Section 898(c)(1)) ending after such date, and provides authority for the Treasury Secretary to issue guidance for allocating foreign taxes paid or accrued in such year and the succeeding taxable year among such taxable years."

3. Deemed Paid Credit

A taxpayer may claim a credit for the amount of any foreign income taxes paid or accrued during a taxable year.[14] The allowable foreign tax credit is limited to the amount of U.S. federal income tax that would have otherwise been paid on the taxpayer's foreign source income.[15] In applying this limitation, foreign source income and foreign income taxes are divided into four separate limitation categories: (i) any amount includible in gross income under section 951A (other than passive category income); (ii) foreign branch income; (iii) passive category income; and (iv) general category income.[16]

For purposes of the foreign tax credit provisions of the Code, a domestic corporation that is a U.S. shareholder of a CFC is deemed to pay foreign income taxes paid or accrued by the CFC. Section 960(a) deems a domestic corporation that is a U.S. shareholder of a CFC to have paid foreign income taxes that are properly attributable to subpart F income of the CFC that is included in gross income by the U.S. shareholder under section 951(a).[17] Similarly, under section 960(d), if a domestic corporation includes an amount in gross income under section 951A, the domestic corporation is deemed to have paid a percentage of the aggregate tested foreign income taxes paid or accrued by CFCs in which the domestic corporation is a U.S. shareholder.[18] A tested foreign income tax is a tax that is paid or accrued by a CFC that is properly attributable to tested income of the CFC that is taken into account by a domestic corporation.[19] A CFC's gross income may also include distributions of previously taxed earnings and profits ("**PTEP**") described in section 959(b), which the regulations assign to "PTEP groups." To the extent that a PTEP distribution received by a CFC is subject to a foreign tax, such as a withholding tax, the tax may be allocated

[14] I.R.C. § 901(a) & (b); Treas. Reg. §§ 1.901-1(a) & 1.901-2(a).

[15] *See* I.R.C. § 904(a) ("The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire income) bears to his entire taxable income for the same taxable year.").

[16] I.R.C. § 904(d)(1). Taxes paid or accrued with respect to certain "specified separate category income"–income re-sourced under an income tax treaty–is also subject to a separate limitation. *See* I.R.C. §§ 865(g), 904(d)(6) & (h); Treas. Reg. § 1.904-4(k) & (m).

[17] I.R.C. § 960(a).

[18] I.R.C. § 960(d). Specifically, for taxable years ending on or before December 31, 2025, a domestic corporate U.S. shareholder of a CFC is deemed to have paid 80 percent of the product of the U.S. shareholder's inclusion percentage multiplied by the tested foreign income taxes paid or accrued by the CFC. I.R.C. § 960(d)(1). Generally, the inclusion percentage reflects the percentage of a U.S. shareholder's pro rata share of tested income that is included in gross income under section 951A. I.R.C. § 960(d)(2). For example, assume that in 2026, a U.S. shareholder's pro rata share of tested income was \$100, its pro rata share of a tested loss was \$15, and the U.S. shareholder had no other relevant items. In that case, the U.S. shareholder's inclusion percentage generally would be 85 percent.

[19] I.R.C. § 960(d)(3).

to that PTEP group and deemed paid under section 960(b) in connection with subsequent PTEP distributions to a U.S. shareholder.[20]

Complex rules apply to attribute foreign income taxes paid or accrued by a CFC to subpart F income and tested income for purposes of section 960. A CFC's gross income is separated into different section 904 categories and then assigned to subpart F income, tested income, and residual income groups within each category.[21] While the tested income within each section 904 category generally comprises a single income group, subpart F income is further divided into numerous groups based on a number of factors, including its type.[22] For example, gross foreign base company sales income described in section 954(d) would generally constitute a single subpart F income group within the general category.[23] Passive category foreign personal holding company income items are subdivided even further, including by reference to the "tested unit" (such as a disregarded entity or hybrid partnership)[24] that earned the income.[25]

After deductions (including deductions for foreign income taxes) are allocated and apportioned to the income groups within each section 904 category, the amount of foreign income tax that is deemed paid with respect to the subpart F income and tested income items within each

[20] *See generally* I.R.C. § 960(b) & Treas. Reg. § 1.960-3. For this purpose, Treas. Reg. § 1.960-3 separates PTEP by category and into various PTEP groups, which are treated as income groups for purposes of allocating and apportioning a foreign income tax. *Id.*

[21] Treas. Reg. § 1.960-1(c)(1)(i) & (d). A CFC may also earn residual income, which is current year income of a CFC that is not subpart F income, tested income, or PTEP. Treas. Reg. § 1.960-1(d)(2)(ii)(D). A U.S. shareholder is not deemed to pay, and therefore is not entitled to claim a credit for, any foreign income tax allocated and apportioned to the residual income group. Treas. Reg. § 1.960-1(e).

[22] Treas. Reg. § 1.960-1(d)(1) & (2).

[23] *See* Treas. Reg. § 1.960-1(d)(2)(ii)(B)(*2*)(*i*).

[24] More specifically, a "tested unit" includes (i) a CFC itself, (ii) certain interests in a hybrid partnership or a disregarded entity held by a CFC, and (iii) certain branches of a CFC. *See* Treas. Reg. § 1.951A-2(c)(7)(iv)(A). Tested units of a CFC that are subject to tax in the same country may be grouped and treated as a single tested unit for purposes of the GILTI high-tax exclusion election (which is discussed in Part III.B). *See* Treas. Reg. § 1.951A-2(c)(7)(iv)(C). It is unclear whether that grouping applies for purposes of segregating passive income items. *See* Treas. Reg. § 1.904-4(c)(4) (incorporating the tested unit definition in Treas. Reg. § 1.951A-2(c)(7)(iv) to separate passive income items by reference to tested units).

[25] Specifically, Treas. Reg. § 1.960-1(d)(2)(ii)(B)(*2*)(*i*) defines a subpart F income group to include gross income treated as a single item of income under Treas. Reg. § 1.954-1(c)(1)(iii). For this purpose, passive foreign personal holding company income categories described in section 954(c)(1) are segregated and then further divided into items by reference to the separate income groups described in Treas. Reg. § 1.904-4(c)(3), (4), and (5) (the "high-tax kickout" rules). *See* Treas. Reg. § 1.954-1(c)(1)(iii)(A) & (B); *see also* Treas. Reg. § 1.960-1(d)(2)(ii)(E)(1) (Ex. 1). The high-tax kickout rules divide passive income into several narrow groups based on the type and rate of foreign tax that applies to the income, the tested unit that earned the income, and other factors.

group is determined under Treas. Reg. § 1.960-2 using different computational rules.[26] If the amount in any income group is zero or less than zero, no amount of the foreign income tax allocated and apportioned to that group is deemed paid. Put differently, a U.S. shareholder is deemed to pay foreign income taxes that are attributable to subpart F income or tested income within an income group only when the U.S. shareholder includes that subpart F income or tested income in gross income. When the income in a group is negative, there is no income from the income group for a U.S. shareholder to include in its gross income, and no foreign income taxes attributable to that income are deemed paid.[27] Foreign income taxes that are not deemed paid may not be carried forward to another year, and thus are permanently unavailable as a foreign tax credit.[28]

4. The Need for the Transition Rule

Negative subpart F income or tested income in an income group can arise from differences in timing relating to when items accrue, including by reason of differences between U.S. and foreign taxable years. Under the accrual method, a foreign income tax generally accrues as of the close of a taxpayer's foreign taxable year.[29] Thus, when a full foreign taxable year ends with or within a short U.S. taxable year of a CFC, all of the foreign income taxes accrue in that short taxable year. If those foreign income taxes, which are deductible in computing a CFC's subpart F

[26] The different computational rules take into account the distinct statutory provisions relating to amounts deemed paid with respect to subpart F income and tested income. For example, the formula for computing deemed paid credits under section 960(d) includes the 20 percent "haircut" in section 960(d)(1) and the reduction based on a taxpayer's inclusion percentage. *See* Treas. Reg. § 1.960-2(c)(1) & (2). Under the OBBBA, this haircut would be reduced to 10 percent for taxable years beginning after December 31, 2025. *See* OBBBA § 70312(a)(1)(B).

[27] Statutorily, this is because section 960 provides for a credit only when a U.S. shareholder takes into account subpart F income to which a foreign income tax is properly attributable (in the case of section 960(a)) or tested income to which a tested foreign income tax is properly attributable (in the case of section 960(d)). The regulations give effect to this formulaically. *See* Treas. Reg. § 1.960-2(b)(3) & (c)(5).

[28] *See* Treas. Reg. § 1.960-1(c)(1) & (2) (taking into account, for purposes of computing foreign income taxes deemed paid, only current year income items and foreign income taxes that accrue in the CFC's current year).

[29] Treas. Reg. § 1.905-1(d)(1)(i) ("Foreign income taxes accrue in the taxable year in which all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. See §§ 1.446-1(c)(1)(ii)(A) and 1.461-4(g)(6)(iii)(B). For purposes of the preceding sentence, a foreign income tax that is contingent on a future distribution of earnings does not meet the all events test until the earnings are distributed. A foreign income tax liability determined on the basis of a foreign taxable year becomes fixed and determinable at the close of the taxpayer's foreign taxable year. Therefore, foreign income taxes that are computed based on items of income, deduction, and loss that arise in a foreign taxable year accrue in the United States taxable year with or within which the taxpayer's foreign taxable year ends.").

income and tested income, cause subpart F income or tested income in an income group to be negative, then the CFC's U.S. shareholders are not entitled to a deemed paid credit.[30]

> Example 1. Foreign income tax accrued during a first required year.[31] USP owns all of the stock of FC, which is a specified foreign corporation. USP's taxable year is the calendar year. Pursuant to a one-month deferral election, FC's U.S. taxable year ends on November 30, 2025. For Country X income tax purposes, FC's taxable year is the calendar year. As a result of the repeal of section 898(c)(2), FC's taxable year beginning on December 1, 2025, must end on December 31, 2025. During each month in 2025, FC accrues $60 of gross tested income and $10 of deductions (other than deductions for foreign income taxes). FC's income tax liability for its Country X taxable year ending on December 31, 2025, is $120.
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> For U.S. federal income tax purposes, the $120 of Country X income tax accrues on December 31, 2025. In its taxable year ending December 31, 2025, FC's tested income equals -$70 (=$60-($10+$120)). Without the Transition Rule, USP would not be deemed to pay any portion of the $120 of Country X foreign income taxes.[32]

Example 1 represents a common fact pattern, as many specified foreign corporations that made a one-month deferral election did not or could not adopt the same taxable year for foreign income tax purposes. By granting Treasury the authority to allocate a portion of the foreign taxes that would ordinarily accrue in a taxpayer's first (short) required year to the succeeding taxable year, the Transition Rule prevents the loss of a deemed paid foreign tax credit resulting from the concentration of foreign income taxes in the first required year.

B. Subpart F High Tax Exception and GILTI High-Tax Exclusion

A U.S. shareholder must include in gross income its pro rata share of certain income earned by a CFC, including (i) subpart F income and (ii) global intangible low-tax income ("**GILTI**").[33]

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[30] Questions arise as to whether a taxpayer may waive "allowable" deductions for purposes of increasing the net income in an income group, permitting a foreign tax credit to be deemed paid when it otherwise would not have been deemed paid. *See, e.g.*, *Standard Oil Co. (N.J.) v. U.S.*, 338 F.2d 4 (2d Cir. 1964) ("we find it difficult to say that a taxpayer must as a matter of law take every deduction to which he is entitled."). For a discussion of whether, as a policy matter, foreign income taxes should be deductible for purposes of computing subpart F income and tested income, see Michael J. Caballero, *Abandoning §78 and the After-Tax Computation of GILTI: How Getting the Math Right Became Getting the Math Wrong*, Tax Management International Journal, 50 TMIJ 01 (December 31, 2020).

[31] For ease of illustration, all amounts described in the examples in this Report are expressed in U.S. dollars.

[32] *See* Treas. Reg. § 1.960-2(c)(5).

[33] I.R.C. §§ 951(a) & 951A(a) (2025). For taxable years beginning after December 31, 2025, section 951A has been amended such that a U.S. shareholder takes into account its pro rata share of "net CFC tested income" rather than GILTI. *See* OBBBA § 70323.

Subpart F income includes, among other things, insurance income (as defined in section 953) and foreign base company income (as defined in section 954). However, under the subpart F income high-tax exception, a taxpayer may elect to exclude an item of income from insurance income or foreign base company income if the item was subject to an effective rate of foreign income tax greater than 90 percent of the maximum rate of tax specified in section 11 (which is 21 percent, such that an item may qualify for the subpart F income high-tax exception if it is subject to a foreign effective rate of 18.9 percent or greater).[34]

A U.S. shareholder's GILTI is determined based on the U.S. shareholder's pro rata share of its CFCs' tested income, tested loss, and certain other items.[35] GILTI inclusions are potentially eligible for a 50 percent deduction.[36] A CFC's tested income generally equals the excess of its gross tested income over properly allocated deductions (including taxes).[37] Gross tested income does not include, among other things, "any gross income excluded from the foreign base company income (as defined in section 954) and the insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4)."[38] Treasury regulations provide that a U.S. shareholder may elect to exclude other high-taxed tested income from gross tested income under section 954(b)(4).[39] Specifically, under the GILTI high-tax exclusion, a taxpayer may elect to exclude from gross tested income a "tentative gross tested income item" if the tentative tested (net) income item with respect to the tentative gross tested income item is subject to an effective foreign tax rate greater than the rate specified under section 954(b)(4) (which, as described above, is 18.9 percent).[40]

C. Covered Events and Partnership Variations

1. The Taxpayer for Foreign Tax Credit Purposes

For purposes of the foreign tax credit provisions of the Code, the person by whom a foreign income tax is considered paid (the "**section 901 taxpayer**") is the person on whom foreign law

[34] I.R.C. § 954(b)(4); Treas. Reg. § 1.954-1(d).

[35] I.R.C. § 951A (2025).

[36] Section 250(a)(1)(B) (2025). For taxable years beginning after December 31, 2025, net tested CFC tested income inclusions are eligible for a 40 percent deduction. OBBBA § 70321(a)(2).

[37] Section 951A(c)(2)(A).

[38] Section 951A(c)(2)(A)(i)(III). Other categories of excluded income include effectively connected income, subpart F income, dividends from related persons, and foreign oil and gas extraction income. *See* I.R.C. § 951A(c)(2)(A)(i).

[39] *See* T.D. 9902, 85 Fed. Reg. 44620 (July 23, 2020).

[40] Treas. Reg. § 1.951A-2(c)(7)(i). Generally, a tentative gross tested income item is the gross income of a CFC that is attributable to a tested unit of the CFC (such as a disregarded entity) under Treas. Reg. § 1.951A-2(c)(7)(ii).

imposes legal liability for the tax.[41] When a disregarded entity is legally liable for a foreign income tax, the person that is treated as owning the assets of the disregarded entity for U.S. federal income tax purposes is deemed to be legally liable for the foreign income tax.[42] A partnership is treated as legally liable for entity-level foreign income taxes imposed on partnership income (including income earned through a disregarded entity) and therefore is considered the section 901 taxpayer for U.S. federal income tax purposes.[43] Partners in a partnership take into account their distributive share of foreign income taxes that have been paid or accrued by the partnership and may claim a credit for those taxes.[44]

2. Covered Event Rules

Regulations under section 901 provide that foreign taxes imposed on a disregarded entity, partnership, or corporation must be allocated among taxpayers when certain "covered events" occur (such regulations, the "**Covered Event Rules**").[45] For this purpose, a covered event is a partnership termination, a transfer of a disregarded entity, or a change in the entity classification of a disregarded entity or a corporation.[46] When a covered event occurs with respect to a disregarded entity, partnership, or corporation, and the entity's foreign taxable year does not close, the foreign income taxes imposed as of the close of the foreign year are allocated to certain predecessor entities (a corporation or partnership that undergoes a change in entity classification) or prior owners of a disregarded entity.[47] For example, if a foreign corporation elects to be treated as a disregarded entity during its foreign taxable year, foreign income taxes accruing at the end of its foreign taxable year are allocated between the predecessor entity (the foreign corporation) and the owner of the disregarded entity. Similarly, if one person sells a disregarded entity to another person during the foreign year, a portion of foreign income taxes that would ordinarily accrue in the hands of the buyer at the end of the foreign taxable year are allocated to the prior owner of the disregarded entity (that is, the seller). Similar rules apply to changes in a partner's interest in a partnership that is treated as paying a foreign income tax.[48]

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[41] Treas. Reg. § 1.901-2(f)(1).

[42] Treas. Reg. § 1.901-2(f)(4)(ii). A "**disregarded entity**" is an entity described in Treas. Reg. § 301.7701-2(c)(2)(i) ("a business entity that has a single owner and is not a corporation […] is disregarded as an entity separate from its owner").

[43] Treas. Reg. § 1.901-2(f)(4)(i).

[44] I.R.C. § 702(a)(6); Treas. Reg. § 1.702-1(a)(6). For rules relating to the determination of a partner's distributive share of such tax, see Treas. Reg. § 1.704-1(b)(4)(viii).

[45] Treas. Reg. § 1.901-2(f)(5)(i).

[46] Treas. Reg. § 1.901-2(f)(5)(ii).

[47] Treas. Reg. § 1.901-2(f)(5)(i).

[48] Treas. Reg. § 1.901-2(f)(5)(iv).

The allocation of foreign taxes is determined based on the respective portions of the taxable income (as determined under foreign law) for the continuing foreign taxable year that are attributable under the principles of Treas. Reg. § 1.1502-76(b) to the period of existence or ownership of each predecessor entity or prior owner of a disregarded entity that was transferred during the foreign taxable year.[49]

D. Taxable Years of a Partnership

A partner's taxable income includes its distributive share of a partnership's income, gain, loss, deduction or credit in the partner's taxable year in which, or with which, the partnership's taxable year ends.[50] Section 706(b) provides rules for determining the taxable year of a partnership that are similar to the rules governing the taxable year of a specified foreign corporation. Under section 706(b)(1)(B), a partnership's taxable year must be (i) the majority interest taxable year, (ii) the taxable year of all the principal partners of the partnership if there is no majority interest taxable year, or (iii) the calendar year (or another year specified in regulations) if there is neither a majority interest taxable year nor a taxable year of all the principal partners.[51]

The majority interest taxable year is the taxable year of one or more partners having an aggregate interest in partnership profits and capital of more than 50 percent on each testing day.[52] A testing day is the first day of the partnership taxable year or the days that Treasury may prescribe.[53] Thus, if a partnership's taxable year on a testing day does not conform to the taxable year required under section 706(b)(1)(B), the partnership must conform its taxable year to the required year. Similar to the transition that occurs under section 898, this can result in the partnership having a short taxable year.

However, in certain circumstances, a taxpayer may establish a business purpose (which does not include deferral of income to a partner) for maintaining a different partnership taxable

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[49] *Id*. Under Treas. Reg. § 1.1502-76(b), when a corporation becomes or ceases to be a member of a consolidated group, its taxable year is treated as closing at the end of that day. By default, items are allocated between the two periods under a closing-of-the books approach, but a taxpayer may elect to apply a ratable allocation method (subject to exceptions for extraordinary items).

[50] I.R.C. § 706(a); Treas. Reg. § 1.706-1(a)(1). However, a partnership's taxable year closes with respect to a partner whose entire interest terminates (for example, by reason of a sale). I.R.C. § 706(c)(2)(A). For this purpose, the partnership's income for the year is allocated by an interim closing-of-the-books method or an elective pro ration method. Treas. Reg. § 1.706-4.

[51] Regulations provide that if there is no majority interest taxable year or principal partners' taxable year, the partnership's taxable year must be the taxable year that produces the least aggregate deferral of income. Treas. Reg. § 1.706-1(b)(2)(C).

[52] I.R.C. § 706(b)(4)(A)(i).

[53] I.R.C. § 706(b)(4)(A)(ii).

year.[54] Furthermore, even without a business purpose, a partnership may elect to adopt a taxable year other than the required year, subject to certain limitations.[55]

E. The Notice on the Allocation of Foreign Income Taxes

1. Scope of Allocation Rule

The Notice describes proposed regulations that Treasury intends to issue implementing the Transition Rule. The Notice's scope is established through a number of defined terms, each of which is discussed in this Part III.E.1.

The Notice's rules for allocating foreign income taxes apply to "**affected corporations**."[56] An affected corporation is a specified foreign corporation that takes into account foreign income taxes under an accrual method of accounting and that, pursuant to section 70352(c) of the OBBBA, must change its first taxable year beginning after November 30, 2025.[57] The Notice's allocation rule applies solely to an affected corporation's "**specified foreign income taxes**."[58] A specified foreign income tax is a "**foreign net income tax**"[59] accrued by an affected corporation in its "**first required year**."[60]

An affected corporation's first required year is its first taxable year beginning after November 30, 2025.[61] In the case of an affected corporation transitioning to the calendar year as its taxable year, the first required year would generally be the short taxable year of the affected corporation beginning on December 1, 2025, and ending on December 31, 2025. Finally, the Notice allocates a portion of an affected corporation's specified foreign income taxes that accrue during its first required year to the "**succeeding taxable year**."[62] A succeeding taxable year is a specified foreign corporation's taxable year immediately following its first required year.[63] For an

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[54] I.R.C. § 706(b)(1)(C).

[55] *See* I.R.C. § 444.

[56] Notice 2025-72 § 3.04.

[57] *Id*. § 3.02(1).

[58] *Id*. § 3.04.

[59] The Notice defines a foreign net income tax as "a foreign income tax determined on the basis of items of income, gain, deduction, and loss that arise in a foreign taxable year." *Id*. § 3.02(3).

[60] *Id*. § 3.02(4).

[61] *Id.* § 3.02(2).

[62] *Id.* § 3.04.

[63] *Id*. § 3.02(5).

affected corporation with a first required year ending on December 31, 2025, the taxable year beginning on January 1, 2026, would be its succeeding taxable year.

By defining specified foreign income taxes to include only net income taxes, the Notice excludes withholding taxes. A withholding tax accrues as of the date a payment is made under foreign law rather than as of the close of a taxable period,[64] such that the mismatch between the accrual of income and foreign income tax liability that the Transition Rule is intended to address is in some instances not implicated. On the other hand, when a withholding tax is imposed on a payment (such as a royalty or service payment), but the underlying income accrues (for U.S. federal income tax purposes) over time, the Notice offers no relief. Similarly, by excluding other foreign taxes that are computed over the course of a taxable year, but that are not computed by reference to a net income base, the Notice does not allocate to a succeeding taxable year foreign taxes that otherwise might have been creditable by reason of section 903.[65]

Moreover, the Notice defines specified foreign income taxes as foreign net income taxes with respect to which an affected corporation is the section 901 taxpayer.[66] As a result, an affected corporation's distributive share of foreign income taxes paid or accrued by a partnership would not be subject to allocation under the Notice.[67] A partnership, rather than its partners, is treated as the person that paid foreign income taxes imposed on the partnership's income (that is, the partnership is the section 901 taxpayer).[68] The Notice indicates that this approach was taken because, under section 706(a), an affected corporation that is a partner in a partnership would ordinarily take into account its distributive share of a full year of partnership income in its first required year at the same time that it takes into account its distributive share of the related foreign income tax.[69]

Finally, because a specified foreign income tax must accrue in the first required year, no foreign income tax that accrues in a succeeding taxable year is allocated to the first required year.[70]

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[64] Treas. Reg. § 1.905-1(d)(1)(i).

[65] Under section 901, a taxpayer may claim a credit for "income, war profits, and excess profits taxes" (an "income tax"). *See* Treas. Reg. §§ 1.901-1 & 1.901-2. For foreign tax credit purposes, certain taxes paid in lieu of an income tax are treated as income taxes. *See* I.R.C. § 903 & Treas. Reg. § 1.903-1.

[66] Notice 2025-72 § 3.03(1).

[67] *Id*. § 3.03(1).

[68] Treas. Reg. § 1.901-2(f)(4)(i).

[69] For example, assume that an affected corporation with a one-month deferral election in effect through November 30, 2025, was a partner in a partnership that used the calendar year as its taxable year. On December 31, 2025, the affected corporation generally would take into account 12 months of income attributable to the partnership, and any related foreign income taxes, in the affected corporation's first required year.

[70] Notice 2025-72 § 3.03.

The Notice states that allocating taxes from a succeeding taxable year into the first required year would present administrative challenges, in part because a succeeding taxable year would typically end after U.S. federal income tax returns including the income and foreign tax credits associated with the first required year would be due.[71]

2. The Allocation Rule

Before allocating its specified foreign income taxes between its first required year and its succeeding taxable year, an affected corporation must allocate and apportion its specified foreign income taxes to subpart F income groups, tested income groups, and PTEP groups.[72] As a result, foreign income taxes generally would be allocated and apportioned by reference to the affected corporation's income arising in its final one-month deferral year and its first required year rather than the affected corporation's income arising in its succeeding taxable year.[73] For example, assume that an affected corporation earned $100 of income subject to a 20 percent foreign income tax that accrued on December 31, 2025 (the close of the affected corporation's first required year). Further assume that, under Treas. Reg. § 1.861-20, $70 of the foreign income was assigned to a tested income group and $30 was assigned to a subpart F income group, such that $14 of the foreign income tax would be assigned to the tested income group and $6 would be assigned to the subpart F income group. A portion of the affected corporation's specified foreign income tax assigned to

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[71] *Id*.

[72] *Id.* § 3.04(2). The Notice provides that specified foreign income taxes are allocated and apportioned to the income groups described in Treas. Reg. § 1.960-1(d)(2), which include a single tested income group within each section 904(d) category (that is, a CFC has one general category tested income group and, in rare cases, one passive category tested income group). To facilitate the application of the GILTI high-tax exclusion, the Notice provides that tentative gross tested income items–the tested income items that are analyzed separately to determine whether they may be excluded from gross tested income–are treated as an income group for this purpose. *Id*. In this Report, a reference to a tested income group should, as the context requires, be understood to include a reference to tentative gross tested income item (notwithstanding the fact that a tentative gross tested income item ultimately may, if a GILTI high-tax exclusion election is in effect, be excluded from gross tested income).

[73] Treas. Reg. § 1.861-20 provides rules for allocating and apportioning foreign income taxes among statutory and residual groupings, including among categories for purposes of section 904 and income groups within categories for purposes of section 960. *See* Treas. Reg. §§ 1.904-6(a) & 1.960-1(d)(3)(ii). To allocate and apportion a foreign tax, a taxpayer assigns items of foreign gross income to statutory and residual groupings (for example, income groups), allocates and apportions deductions allowed under foreign law to those foreign gross income items, and apportions the foreign tax imposed on the resulting income items based on the amount of net income assigned to each statutory and residual grouping. *See* Treas. Reg. § 1.861-20(c). The rules for assigning foreign gross income items to statutory and residual groupings are complex and address a number of specific situations (for example, timing differences, disregarded payments, etc.). Generally, when foreign income tax is imposed on foreign taxable income that includes an item of foreign gross income with respect to which the taxpayer also realizes, recognizes, or takes into account a "corresponding U.S. item," then the item of foreign gross income is assigned to the grouping to which the corresponding U.S. item is assigned. Treas. Reg. § 1.861-20(d)(1). In this context, corresponding U.S. items include both U.S. gross income items arising in the first required year and U.S. gross income items arising in the preceding year. *See* Treas. Reg. § 1.861-20(b)(2).

each statutory grouping would be allocated to the succeeding taxable year (2026), but those amounts would not be reassigned to different income groups by reference to the income earned by the affected corporation in the succeeding taxable year. If, for example, 100 percent of the affected corporation's income in 2026 was tested income, 30 percent of the affected corporation's specified foreign income taxes would still be assigned to a subpart F income group.

After specified foreign income taxes are allocated and apportioned, the amount assigned to each income group is multiplied by the affected corporation's allocation percentage, with the resulting amounts allocated to the first required year and the remaining amounts allocated to the succeeding taxable year (the "**Allocation Rule**").[74] The allocation percentage equals (i) the portion of foreign taxable income attributable under the principles of Treas. Reg. § 1.1502-76(b) to the first required year divided by (ii) total foreign taxable income for the foreign taxable year.[75] In applying the principles of Treas. Reg. § 1.1502-76(b), either the closing-of-the-books method or the pro rata method may be applied to allocate foreign items to the first required year.[76]

The amounts of a specified foreign income tax allocated to the first required year and the succeeding taxable year are treated as accruing in each respective year.[77] Thus, amounts allocated to a succeeding taxable year may be deemed paid under section 960 to the extent there is sufficient taxable income in the relevant income groups. Amounts allocated to subpart F income items or tested income items are also taken into account under the subpart F income high-tax exception and the GILTI high-tax exclusion.[78]

This accrual occurs for all purposes of the Code, subject to two exceptions.[79] First, for purposes of section 905(c), foreign tax redeterminations (for example, additional foreign tax

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[74] Notice 2025-72 § 3.04(3). This Report refers to the statutory provision in section 70532(c)(1)(C) of the OBBBA as the "Transition Rule" and the more specific rule implementing the Transition Rule in section 3.05 of Notice 2025-72 as the "Allocation Rule."

[75] *Id.* § 3.05(1)(a). The amount of a specified foreign income tax assigned to any PTEP group under section 3.04(2) of the Notice is allocated to the first required year and the foreign law taxable income (which would ordinarily be a dividend) on which the foreign income tax is imposed is excluded in determining the allocation percentage. *Id.* § 3.05(1)(b). Thus, for example, if an affected corporation with a first required year ending on December 31, 2025, received a PTEP distribution in December of 2025, any specified foreign income tax imposed on that dividend would not be allocated to the succeeding taxable year, and the dividend income would be excluded from foreign taxable income for purposes of computing the allocation percentage. A specified foreign income tax imposed on a dividend received by the same corporation in November would not be subject to this exception because no specified foreign income tax that accrued in the first required year would be assigned to a PTEP group by reason of the receipt of the PTEP dividend. *See* Treas. Reg. § 1.960-1(d)(3)(ii)(B).

[76] Notice 2025-72 § 3.05(1)(a).

[77] *Id.* § 3.04(4)(a).

[78] *Id*.

[79] *Id*. § 3.04(4)(b).

assessments or refunds) with respect to specified foreign income taxes are treated as accruing in the first required year.[80] As a result, subsequent redeterminations of a specified foreign income tax would initially relate back to the first required year. After the amount of foreign income tax accrued in the first required year is adjusted, the Allocation Rule would be reapplied, resulting in an adjustment to the allocation in each of the first required year and the succeeding taxable year.[81] Second, foreign income taxes allocated to a succeeding taxable year are not treated as accruing in that year for purposes of section 986(a), such that translation conventions applicable to such taxes would be determined by reference to the first required year rather than the succeeding taxable year.[82]

3. Interactions with the Covered Event Rules

The Notice includes two rules addressing the interaction of the Covered Event Rules and the Transition Rule. Under the first rule, if an affected corporation is the section 901 taxpayer of a portion of a specified foreign income tax due to the application of the Covered Event Rules and the affected corporation's period of ownership of a disregarded entity or an interest in a partnership began on or before the beginning of the first required year, the denominator of the fraction used to compute the allocation percentage is the total foreign taxable income attributable to the affected corporation's period of ownership under the Covered Event Rules.[83] Thus, for example, if an affected corporation's first required year ended on December 31, 2025, and the affected corporation sold its interests in a disregarded entity on December 15, 2025, the denominator of the fraction used to determine the allocation percentage would include foreign taxable income through December 15, 2025, rather than through December 31, 2025.

Under the second rule, if the affected corporation is the section 901 taxpayer of a portion of a specified foreign income tax due to the application of the Covered Event Rules, and the affected corporation's period of ownership began after the beginning of the first required year, the allocation percentage is deemed to be 100 percent, effectively providing an exception to the Allocation Rule.[84] For example, if an affected corporation's first required year ended on December 31, 2025, and the affected corporation acquired all of the interests in a disregarded entity on December 15, 2025, the Covered Event Rules would allocate and apportion foreign income taxes accruing on December 31, 2025, to the acquiring affected corporation by reference to the portion

[80] *See generally* Treas. Reg. §§ 1.905-3 & 1.905-4.

[81] Notice 2025-72 § 3.06.

[82] *Id*.

[83] *Id*. § 3.05(3).

[84] *Id*.

of the foreign taxable income from December 15, 2025, through December 31, 2025. The Allocation Rule would not allocate any portion of that tax to a succeeding taxable year.

F. The Notice on the Recognition of Pretransition Gain or Loss

The regulations under section 987 include transition rules for the first taxable year in which the final section 987 regulations apply.[85] Under those rules, the owner of a section 987 qualified business unit ("**QBU**") must determine the accumulated section 987 gain or loss attributable to the section 987 QBU for periods before the owner's transition to the final regulations.[86] Pretransition losses are, by default, suspended and may only be recognized when certain section 987 gains are subsequently recognized.[87] However, taxpayers may elect to amortize pretransition gain or loss over a period of ten years beginning with the transition year.[88]

The Notice provides that if an amortization election is made, then each owner to which the election applies would recognize pretransition gain or loss ratably over 120 months beginning with the first day of the first taxable year in which the section 987 regulations apply.[89]

IV. Discussion

A. Overview

The Transition Rule directs Treasury to allocate foreign taxes between a specified foreign corporation's first required year and the succeeding taxable year "in the manner the Secretary determines appropriate to carry out the purposes" of the Transition Rule.[90] No legislative history describes those purposes, but it is clear that the rule's purpose is to prevent distortions resulting from the accrual of foreign income taxes in the first required year, including (most notably) the potential loss of deemed paid credits under section 960. At the same time, other timing differences between U.S. and foreign tax law frequently result in similar distortions. We believe that any allocation under the Transition Rule should address potential problems that arise by reason of a foreign corporation's mandatory short U.S. taxable year resulting from the repeal of section 898(c)(2), and solely those problems. In this Part IV, we make several recommendations consistent

[85] Treas. Reg. § 1.987-10.

[86] Treas. Reg. § 1.987-10(e).

[87] Treas. Reg. § 1.987-10(e)(5)(i)(B)(*1*).

[88] Treas. Reg. § 1.987-10(e)(5)(ii).

[89] Notice 2025-72 § 4.02. To coordinate the application of this rule with any short years preceding the first required year, the Notice provides that if a taxpayer had previously taken into account pretransition gain or loss in a short taxable year ending before November 25, 2025, such short taxable year is deemed to have twelve months. *Id*. §4.03.

[90] OBBBA § 70352(c)(1)(C).

with that principle, aiming primarily to prevent outcomes that would not have occurred absent the repeal of section 898(c)(2).

B. Potential Mismatches

The Notice provides that specified foreign income taxes are allocated and apportioned to subpart F income, tested income, and PTEP in the first required year, taking into account an affected corporation's income attributable to both its first required year and its last one-month deferral year.[91] This allocation and apportionment occurs before the specified foreign income taxes are assigned to the succeeding taxable year. As a result, when an affected corporation earns different types of income in the succeeding taxable year than it did in the preceding years, mismatches may occur that would prevent taxes allocated to the succeeding taxable year from being deemed paid. Although allocating and apportioning specified foreign income taxes by reference to income earned by an affected corporation in a succeeding taxable year would prevent this mismatch, we believe the approach taken in the Notice is appropriate because the mismatch would in most situations be unrelated to the repeal of section 898(c)(2).[92]

> <u>Example 2. Timing difference</u>. FC is an affected corporation with a first required year ending on December 31, 2025. For Country X income tax purposes, FC's taxable year is the calendar year. FC earns $100 of income from the sale of inventory to customers outside of Country X and pays $20 of Country X income tax with respect to its 2025 Country X taxable year. For U.S. federal income tax purposes, FC recognizes $110 of general category tested income in its taxable year ending on November 30, 2025 ($20 of which arose in December of 2024, and the remaining $90 of which arose from January 1, 2025, through November 30, 2025), and $10 of general category tested income during its first required year. The income would be foreign base company sales income described in section 954(d)(1), except that FC substantially contributes to the manufacturing of the inventory.[93] Under Treas. Reg. § 1.861-20, all $20 of the Country X income tax is allocated and apportioned to FC's general category tested income group.[94]
>
> Under the principles of Treas. Reg. § 1.1502-76(b), (i) $90 of FC's Country X taxable income is allocated to the period from January 1, 2025, through November

[91] *See* Notice 2025-72 § 3.04(2).

[92] In certain cases, the change in year itself could change the character of the related income. For example, if expenses or activities occurred periodically, but not during the first required year, one or more activities-based exceptions from subpart F income treatment could be met or fail to be met by reason of the required short taxable year.

[93] *See* Treas. Reg. § 1.954-3(a)(4)(iv).

[94] Unless otherwise stated, assume that the subpart F income high-tax exception election and the GILTI high-tax exclusion election is not made with respect to FC in any of the examples in this Report.

30, 2025, and (ii) $10 of FC's Country X taxable income is allocated to the period from December 1, 2025, through December 31, 2025. Under the Allocation Rule, $18 of the Country X income tax is allocated to, and treated as accruing in, FC's succeeding taxable year.

In its succeeding taxable year (January 1, 2026, through December 31, 2026), FC earns $100 from the sale of inventory. Due to changes in its business, FC does not substantially contribute to the manufacturing of inventory and all of the income FC earns in 2026 is classified for U.S. federal income tax purposes as foreign base company sales income. Because FC earns no general category tested income in 2026, no portion of the $18 of 2025 Country X income taxes allocated to that year are deemed paid.[95]

Example 2 may raise other concerns from a tax policy standpoint, but the lost foreign tax credits do not result from the repeal of section 898(c)(2). If section 898(c)(2) had not been repealed, FC's general category tested income in its taxable year ending on November 30, 2026, would have equaled -$10 (=$10-$20), such that no portion of the 2025 Country X income tax would have been deemed paid. Thus, while broader guidance may be appropriate to consider timing differences' effects on deemed paid foreign tax credits, guidance implementing the Transition Rule ought not yield more favorable outcomes than would have occurred if section 898(c)(2) had not been repealed.

On the other hand, there are instances when the Allocation Rule itself would cause avoidable mismatches. The Allocation Rule applies a single blended allocation percentage to allocate foreign income taxes assigned to different income groups. In some instances, this would separate specified foreign income taxes from income items in a manner that would not have occurred if section 898(c)(2) had not been repealed or if the Transition Rule did not apply. For instance, an affected corporation may recognize a subpart F income item of a type that it does not ordinarily recognize in its first required year, but not in the succeeding taxable year. In that case, allocating specified foreign income taxes related to that item to the succeeding taxable year would separate specified foreign income taxes from the related income, such that a deemed paid credit would become unavailable. This result is arguably inconsistent with the purpose underlying the Transition Rule, which is to limit the instances in which a short taxable year resulting from the repeal of section 898(c)(2) prevents a credit from being available.

<u>Example 3. Timing difference resulting from the Allocation Rule</u>. FC is an affected corporation with a first required year ending on December 31, 2025. For Country X income tax purposes, FC's taxable year is the calendar year. FC recognizes $100 of gain from the sale of inventory over the course of the full taxable year and $50

[95] *See* Treas. Reg. § 1.960-2(c)(5).

of gain from the sale of stock on December 15th.[96] FC's Country X income tax liability for 2025 is $30. For U.S. federal income tax purposes, FC recognizes $110 of general category tested income in its taxable year ending on November 30, 2025 ($20 of which arose in December of 2024, and the remaining $90 of which arose from January 1, 2025, through November 30, 2025). During its first required year, FC recognizes $10 of general category tested income and $50 of passive category income foreign personal holding company income described in section 954(c)(1)(B) (subpart F income). Under Treas. Reg. § 1.861-20, $20 of the Country X income tax is allocated and apportioned to FC's general category tested income group and $10 is allocated and apportioned to a passive subpart F income group.

Under the principles of Treas. Reg. § 1.1502-76(b), $90 of FC's Country X income, attributable solely to gain from inventory sales, arises between January 1, 2025, and November 30, 2025, and $60 of FC's Country X income, attributable to gain from inventory sales and gain from the sale of stock, arises between December 1, 2025, through December 31, 2025.

Under the Allocation Rule, FC's allocation percentage is 40 percent (=$60/$150). This allocation percentage allocates specified foreign income taxes assigned to each income group to the succeeding taxable year, regardless of when the relevant income arose. As a result, $12 of the Country X income taxes (=[1-0.4]*$20) assigned to the general category tested income group are allocated to FC's succeeding taxable year and $6 of the Country X income taxes (=[1-0.4]*$10) assigned to a passive category subpart F income group are allocated to the succeeding taxable year.

Allocation of Country X Items			
Period	**Last one-month deferral year (Jan. 1, 2025-Nov. 30, 2025)**	**First required year (Dec. 1, 2025-Dec. 31, 2025)**	**Succeeding taxable year (Jan. 1, 2026-Dec. 31, 2026)**
Inventory gain	$90	$10	
Stock gain	$0	$50	
Stock loss	$0		
Total	$90	$60	
Allocation percentage		40%	
Tax Allocation			
General category tested income		$8	$12
Passive category subpart F income		$4	$6

In its succeeding taxable year, FC recognizes $100 of gain from the sale of inventory that is treated as general category tested income. FC earns no other income. Because FC earns no passive category subpart F income in the relevant

[96] In certain cases, a foreign country may apply a lower rate of tax to a sale of stock, including by reason of a participation exemption. For ease of illustration, this example assumes that Country X applies a 20 percent tax to all income.

subpart F income group in its succeeding taxable year, no portion of the $6 of 2025 Country X income taxes assigned to that group are deemed paid under section 960.[97]

To address this, we believe that taxpayers should be required to apply the Allocation Rule separately to different statutory and residual groupings (including subpart F income items, tested income items, and PTEP groups).[98] We believe that the increased accuracy of this method strikes the appropriate balance between precision and administrability, in part because it does not require taxpayers or the IRS to obtain additional information or conduct a novel analysis. Under the existing rules for allocating and apportioning foreign income taxes, each foreign income item must be separately assigned to U.S. statutory and residual groupings (for example, subpart F income groups and tested income groups) and a net foreign law income item must be computed by allocating deductions under foreign law and, in some cases, under U.S. federal income tax principles.[99] Thus, separately assigning foreign law items to income groups for purposes of the Allocation Rule would leverage the analysis that must be done to allocate and apportion the relevant specified foreign income tax under Treas. Reg. § 1.861-20.

As applied to the facts in Example 3, this approach would allocate to the first required year all $10 of Country X income tax imposed on the passive category subpart F income. It would also allocate to the succeeding taxable year the correct portion of Country X income tax imposed on general category tested income ($18, or 90 percent of the Country X income tax related to inventory sales).

Allocation of Country X Items			
Period	**Last one-month deferral year (Jan. 1, 2025-Nov. 30, 2025)**	**First required year (Dec. 1, 2025-Dec. 31, 2025)**	**Succeeding taxable year (Jan. 1, 2026-Dec. 31, 2026)**
Inventory gain	$90	$10	
Stock gain	$0	$50	
Stock loss	$0		
Total	N/A	N/A	
Allocation percentage (general tested income item)		10%	
Allocation percentage (passive subpart F income item)		100%	
Tax Allocation			
General category tested income		$2	$18
Passive category subpart F income		$10	$0

[97] *See* Treas. Reg. § 1.960-2(b)(3).

[98] The Notice effectively takes this approach with respect to PTEP groups, because specified foreign income taxes imposed with respect to a PTEP group are not allocated to a succeeding taxable year and the related foreign law income is excluded for purposes of computing the allocation percentage. *See supra* note 75.

[99] *See* Treas. Reg. §§ 1.861-20(c) - (e) & 1.904-6(c); *see also supra* note 73.

Thus, using information and calculations that are already available to taxpayers, the Allocation Rule could be applied separately to different income groups, which would reduce the separation of income and related taxes caused by the Allocation Rule itself.

We observe that this approach does not resolve timing differences that would otherwise exist. For example, if FC sold the stock in July of 2025 in Example 3 rather than in December of 2025, our recommended approach would result in an allocation percentage of 0, with all of the related foreign income tax being allocated to FC's succeeding taxable year and no potential for a deemed paid foreign tax credit. As discussed above, while the potential for lost foreign tax credits by reason of this timing difference may merit further study, the same separation would have occurred if section 898(c)(2) were not repealed; that is, FC would have recognized gain from the stock sale in its taxable year ending on November 30, 2025, but the related foreign income taxes would have accrued in FC's taxable year ending November 30, 2026.[100]

Accordingly, we recommend that the proposed regulations apply the Allocation Rule separately with respect to different subpart F income groups, tested income groups, and PTEP groups.

C. Foreign Income Taxes Accruing in a Succeeding Taxable Year

The Transition Rule directs Treasury to allocate taxes from a succeeding taxable year to the first required year when appropriate: "the Secretary shall issue regulations or other guidance for allocating foreign taxes that are paid or accrued in such first taxable year and the succeeding taxable year among such taxable years in the manner the Secretary determines appropriate to carry out the purposes of this section."[101] However, the Notice does not allocate foreign income taxes that accrue in a succeeding taxable year to the first required year.[102] As the Notice acknowledges, this results in the separation of a foreign income tax from the related income in some fact patterns.[103] For example, an affected corporation may have a first required year ending on December 31, 2025, and a foreign taxable year ending on March 31, 2025. Absent the repeal of section 898(c)(2), that affected corporation's taxable year beginning on December 1, 2025, would end on November 30, 2026, and a foreign income tax that accrued on March 31, 2026, would accrue in the same taxable year as income accruing in December of 2025.

[100] This approach would not produce results that are beneficial to taxpayers in all cases. For example, our approach would decrease the amount of tested foreign income taxes treated as accrued by FC in 2025. If FC's U.S. shareholders were limited from claiming additional foreign tax credits with respect to section 951A category income in 2026 but not in 2025, this approach could increase their U.S. income tax liability.

[101] OBBBA § 70352(c)(1)(C).

[102] Notice 2025-72 §§ 3.02(4) & 3.03(1).

[103] Notice 2025-72 § 3.03(1).

In contrast to the key issue that we believe that the Transition Rule was intended to address—the potential for lost foreign tax credits—this separation would often not result in lost foreign tax credits, as the foreign income taxes usually would still accrue in a (full) succeeding taxable year. A U.S. shareholder would also be deemed to pay those foreign taxes in the same year that it otherwise would have been if the affected corporation had been permitted to retain its prior taxable year end. Moreover, although income accrued during an affected corporation's first required year would be separated from a related foreign income tax, a U.S. shareholder of an affected corporation often would be deemed to have paid foreign income taxes accruing in the affected corporation's last one-month deferral year, often reducing U.S. federal income tax on a U.S. shareholder's inclusions with respect to an affected corporation's first required year. For example, an affected corporation with a taxable year beginning on December 1, 2024, and ending November 30, 2025, would accrue foreign income taxes on December 31, 2024, and those foreign income taxes would typically be deemed paid on November 30, 2025. Thus, in many cases, the need for an allocation of foreign income taxes accruing in a succeeding taxable year is less pressing than it is for foreign income taxes accruing during the first required year.

Nonetheless, in certain specific cases, we believe that it may be appropriate to allocate taxes from a succeeding taxable year to a first required year. First, special rules may be appropriate when a subpart F income high-tax exception election or GILTI high-tax exclusion election is in effect with respect to an applicable corporation. An applicable corporation with a foreign taxable year that ends within the applicable corporation's succeeding (U.S.) taxable year may recognize income in its first required year that is, in fact, high-taxed, but that nonetheless fails to qualify for the subpart F income high-tax exception or GILTI high-tax exclusion solely due to the required short taxable year.

> <u>Example 4. GILTI high-tax exclusion election</u>. FC is organized in Country X. For U.S. federal income tax purposes, FC is an affected corporation whose first required year ends on December 31, 2025. For Country X income tax purposes, FC must maintain a taxable year that ends on March 31, 2026. For both U.S. and Country X income tax purposes, FC earns $100 of income every month from April 1, 2025, through March 31, 2026. The Country X income tax rate equals 30 percent. For U.S. federal income tax purposes, the income is tested income. FC accrues a Country X income tax liability of $360 on March 31, 2026.
>
> A GILTI high-tax exclusion election is in effect with respect to FC during its first required year. Nonetheless, no foreign income taxes accrue in FC's first required year, and no income of FC is excluded from gross tested income for that taxable year.

It would be appropriate for the Transition Rule to apply under the facts in Example 4 to allocate a portion of the Country X income tax accruing on March 31, 2026, to FC's first required year, because that tax is imposed on income recognized for U.S. federal income tax purposes in the first required year. An allocation should be limited to situations in which, but for the repeal of section 898(c)(2), the Country X income tax would relate to FC's income for purposes of determining whether the income should be excluded from gross tested income.

One may view the understated effective tax rate as an appropriate offset to an earlier overstated effective tax rate. In Example 4, when FC first adopted a one-month deferral year, FC would have had an 11-month taxable year, but 12 months of foreign income taxes likely would have accrued within that year. That overstatement could have permitted income to be excluded from FC's gross tested income when it would not have otherwise been excluded. Nonetheless, on balance, we believe that the instances in which taxpayers achieved such a benefit are greatly outnumbered by the instances in which the inappropriate results described in Example 4 would occur.

The second instance in which an exception would be appropriate is when an extraordinary transaction occurs during an affected corporation's first required year.

> <u>Example 5. Extraordinary transaction</u>. FC is an affected corporation with a first required year ending on December 31, 2025. For Country X income tax purposes, FC's taxable year begins on July 1, 2025, and ends on June 30, 2026. FC recognizes \$50 of gain from a December 15 sale of stock. For U.S. federal income tax purposes, the gain is passive category income foreign personal holding company income described in section 954(c)(1)(B). On June 30, 2026, \$10 of Country X income tax accrues (in FC's succeeding taxable year). Under Treas. Reg. § 1.861-20, that Country X income tax is allocated and apportioned to FC's relevant passive subpart F income group.
>
> In its succeeding taxable year, FC recognizes no passive category subpart F income in the relevant subpart F income group. As a result, no portion of the \$10 of Country X income tax assigned to that group in FC's succeeding taxable year is deemed paid.[104]

In Example 5, if FC had not been required to change its taxable year, FC's U.S. shareholder(s) would have recognized subpart F income attributable to the stock sale in its taxable year ending November 30, 2026. As a result, there would have been no separation of the subpart F income from the related foreign income taxes, which ordinarily would have been deemed paid by FC's U.S. shareholder(s). This fact pattern implicates the concerns underlying the Transition Rule, while also occurring solely by reason of the repeal of section 898(c)(2). Therefore, we believe that it would be appropriate to allocate foreign income taxes accruing in a succeeding taxable year to a first required year in fact patterns similar to Example 5; that is, when an

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[104] *See* Treas. Reg. § 1.960-2(b)(3).

extraordinary transaction occurs during an affected corporation's first required year.[105] For this purpose, an extraordinary transaction could be defined in a number of ways, but it generally should include transactions occurring outside of the ordinary course of an affected corporation's business, including sales of stock, certain asset sales, material non-recurring income events, and other similar transactions.

The Notice cites administrative concerns for the decision to not allocate foreign income taxes from a succeeding taxable year to a first required year, including that "an allocation would be difficult to perform before the end of the succeeding taxable year, which, unless the succeeding taxable year is a short taxable year, will be after the due date of the majority U.S. shareholder's income tax return for the taxable year with which the affected corporation's first required year ends."[106] This specific concern may be overemphasized, as we believe that the majority of taxpayers affected by the repeal of section 898(c)(2) file their U.S. federal income tax returns by the extended due date, which is nine months after the close of the first required year.[107] The information necessary to allocate a foreign income tax from an affected corporations succeeding taxable year to its first required year is generally available after the close of the foreign taxable year, not the U.S. taxable year. For example, if an affected corporation's foreign taxable year closed on March 31, 2026, and its succeeding taxable year ended on December 31, 2026, we would expect that a taxpayer would often have the necessary information to allocate a foreign income tax to the first required year before the extended due date for its U.S. shareholders' 2025 income tax return. We acknowledge, however, that there would likely be some instances when the necessary information was not yet available and that amended returns would be necessary in those instances.

However, we believe that those administrative considerations alone are not sufficient to prevent an allocation of foreign income taxes that accrue in a succeeding taxable year when a separation of income and related foreign income taxes could have materially adverse consequences to U.S. shareholders of affected corporations and that separation occurs solely by reason of the repeal of section 898(c)(2). In our view, applying an allocation in the two circumstances discussed in this Part IV.C serves the purposes underlying the Transition Rule while striking the appropriate balance between administrability and precision.

Accordingly, we recommend that a foreign income tax accruing in a succeeding taxable year should be treated as a specified foreign income tax subject to allocation if it relates to a foreign taxable year that includes the first required year and, during an affected corporation's first required

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[105] Consistent with this change, the proposed regulations should extend the exception in section 3.06 of the Notice, which provides that an allocation of specified foreign income taxes from a required taxable year to a succeeding taxable year is not taken into account for purposes of sections 905(c) or 986(a), to any taxes that initially accrued in a succeeding taxable year that are allocated to a first required year.

[106] Notice 2025-72 § 3.03(1).

[107] *See* I.R.C. § 6081(b).

year, it (i) is subject to a subpart F income high-tax exception election or GILTI high-tax exclusion election or (ii) recognizes income or gain by reason of an extraordinary transaction.

D. Interactions with the Covered Event Rules

The Notice includes two rules addressing the interaction of the Transition Rule with the Covered Event Rules. We believe that the proposed regulations should include more comprehensive guidance coordinating the application of the Transition Rule, the Covered Event Rules, and certain transactions in which an affected corporation ceases to exist. As a general principle, we believe that specified foreign income taxes allocated to a succeeding taxable year should be further allocated when necessary to prevent a separation of the specified foreign income taxes from the income needed to treat those amounts as having been deemed paid.

Under the first rule coordinating the Allocation Rule and the Covered Event Rules, the Notice adjusts the amount of specified foreign income taxes allocated to a succeeding taxable year when (i) an affected corporation is the section 901 taxpayer of a portion of a specified foreign income tax under the Covered Event Rules and (ii) the affected corporation's period of ownership of a disregarded entity (or an interest in a partnership) began on or before the beginning of the first required year. Specifically, the Notice provides that the denominator of the fraction used to compute the allocation percentage is the total foreign taxable income attributable to the affected corporation's period of ownership under the Covered Event Rules.

Through the second rule coordinating the Allocation Rule and the Covered Event Rules, the Notice effectively provides an exception to the Transition Rule when the Covered Event Rules allocate the appropriate amount of specified foreign income tax to an acquiring corporation. If the affected corporation is the section 901 taxpayer of a portion of a specified foreign income tax due to the application of the Covered Event Rules, and the affected corporation's period of ownership began after the beginning of the first required year, that affected corporation's allocation percentage is deemed to be 100 percent.

> <u>Example 6. Sale of a Disregarded Entity</u>. FC1 owns 100 percent of the stock of FC2, which owns 100 percent of the interests in DEX, a disregarded entity organized in Country X. FC1 and FC2 are affected corporations and their respective first required years end on December 31, 2025. On December 10, 2025, FC2 sells its interests in DEX to FC1. For Country X income tax purposes, DEX earns $100 of income and pays $20 of foreign income tax in 2025. Under the principles of Treas. Reg. § 1.1502-76(b), (i) $80 of DEX's Country X taxable income arises during FC2's ownership period between January 1, 2025, and November 30, 2025, (ii) $10 of DEX's Country X taxable income arises during FC2's ownership period from December 1, 2025, through December 10, 2025, and (iii) $10 of DEX's Country X taxable income arose during FC1's ownership period from December 11 through December 31, 2025.

Before the Allocation Rule applies, the Covered Event Rules allocate $18 of Country X income tax to FC2 (=$20 x ($90/$100)) and $2 Country X taxable income to FC1 (=$20-$2). Under section 3.05(3) of the Notice, FC2's allocation percentage is determined using $90 as the denominator rather than $100 because FC2 is the section 901 taxpayer of a portion of the Country X income tax under the Covered Event Rules and FC2's ownership period with respect to DEX began before the beginning FC2's first required year. Thus, FC2's allocation percentage equals 11 percent (=$10/$90). As a result, $2 of Country X income tax is treated as accruing during FC2's first required year and $16 ($18-$2) is allocated to FC2's succeeding taxable year.

Because FC1 is the section 901 taxpayer of a portion of the Country X income tax under the Covered Event Rules and FC1's period of ownership began after the beginning of the first required year, FC1 is deemed to have an allocation percentage of 100 percent. As a result, the $2 of Country X income tax allocated to FC1 accrues solely during its first required year (that is, no portion is allocated to the succeeding taxable year).

Allocation of Country X Income: Covered Event Rules & Notice 2025-72 § 3.05(3)				
Period	**Last one-month deferral year (Jan. 1, 2025-Nov. 30, 2025)**	**First required year (Dec. 1, 2025-Dec. 10, 2025)**	**First required year (Dec. 11, 2025-Dec. 31, 2025)**	**Succeeding taxable year (Jan. 1, 2026-Dec. 31, 2026)**
Income	$80	$10	$10	
Allocation percentage		11%		
Country X Tax Allocation				
FC1			$2	
FC2			$2	$16

Example 6 demonstrates that the Notice allocates the correct amounts of specified foreign income taxes to each period, but arguably does not appropriately allocate specified foreign income taxes among taxpayers. FC1 and FC2 each accrue $10 of Country X taxable income and $2 of Country X income tax during their respective first required years, corresponding in each case to 10 percent of the Country X taxable income and income tax liability for the 2025 taxable year. However, the Notice allocates the remaining $16 of Country X income tax to FC2's succeeding taxable year rather than FC1's succeeding taxable year, notwithstanding the fact that FC1 rather than FC2 owns DEX in the succeeding taxable year. This separation of Country X income from the 2025 Country X income tax would, in many cases, defeat the purpose of allocating the 2025 Country X income tax to a succeeding taxable year.

To address this, the proposed regulations should provide that specified foreign income taxes allocated to a succeeding taxable year are allocated among taxpayers under the principles of the Covered Event Rules, treating income earned in the succeeding taxable year as the income to which the specified foreign income taxes relate. Under this approach, if FC1 held DEX throughout the succeeding taxable year, all $80 of the Country X income tax allocated to that taxable year would be treated as paid by FC1.[108]

This approach would also address covered events and partnership variances that occur in the succeeding taxable year. If, in Example 6, FC2 had transferred DEX to FC1 on June 30, 2026, rather than December 10, 2025, the principles of the Covered Event Rules would allocate specified foreign income taxes between FC1 and FC2 by reference to their respective shares of Country X taxable income, as determined under the principles of Treas. Reg. § 1.1502-76(b). Arguably, the Covered Event Rules might be interpreted to provide for the first approach even without further guidance. Those rules allocate foreign income taxes "paid … with respect to the continuing foreign taxable year in which the covered event … occur[s][.]"[109] The Notice provides that specified foreign income taxes allocated to a succeeding taxable year are treated as accruing during such year federal income tax purposes. Whether this deemed accrual should be understood to mean that specified foreign income taxes allocated to a succeeding taxable year are treated as paid "with respect to the subsequent *foreign* year" is not clear, although we believe that would be an appropriate approach and recommend that the proposed regulations adopt that rule.

Furthermore, the Notice does not address situations in which the affected corporation does not have a succeeding taxable year because an affected corporation ceases to exist.

> <u>Example 7. Transfer of a Disregarded Entity in a Section 381(a) Transaction</u>. The facts are the same as in Example 6, except that FC2 does not sell DEX to FC1. Instead, FC2 elects to be treated as a disregarded entity effective December 11, 2025. As a result, on December 10, 2025, FC2 is deemed to have transferred DEX's assets to FC1 in a liquidating distribution described in section 332. As was true in Example 6, FC2's allocation percentage is 11 percent and $16 of Country X income tax is allocated to a succeeding taxable year. However, FC2 does not have a succeeding taxable year and neither the Notice nor the Covered Event Rules address the treatment of specified foreign income taxes allocated to FC2's succeeding taxable year.

We believe that treating FC1 as paying the Country X income tax allocated to FC2's succeeding taxable year is the most appropriate outcome because it relates a specified foreign income tax to the same income to which it would relate if the covered event had not occurred. If FC2 had not liquidated, $16 of Country X income tax would potentially been treated as attributable to income of FC2 for purposes of section 960, including any income earned through DEX. This

[108] If FC1 were not itself an affected corporation, it would be appropriate to treat amounts that would have otherwise been allocated to FC2's succeeding taxable year as accruing in the FC1's taxable year following the year in which it acquires DEX. That approach most closely replicates what would have occurred in the absence of the covered event. Special rules may be appropriate when an acquirer's taxable year is not the same as the taxable year of a transferor.

[109] Treas. Reg. § 1.901-2(f)(5)(i).

approach is consistent with the principles of section 381(a), under which an acquiring corporation inherits a target corporation's tax attributes in connection with a tax-free liquidation or a non-divisive asset reorganization. Our recommended approach would give effect to this outcome, because FC2's transfer of DEX in connection with its entity classification election is a covered event.[110]

Finally, we observe that in some cases, an affected corporation may cease to exist in a transaction that is not a covered event. For example, while a deemed liquidation in connection with an entity classification election would constitute a covered event, an actual legal liquidation would not.[111] Ordinarily, this is appropriate because an actual liquidation would end a foreign corporation's local taxable year, such that its foreign income taxes would accrue immediately before the close of the year. That would result in an alignment between the income earned by such corporation and the foreign income taxes imposed on that income. However, this alignment would not occur to the extent specified foreign income taxes are allocated to a succeeding taxable year and the affected corporation ceased to exist before or during that year. Therefore, consideration should be given to the treatment of foreign income taxes allocated to a succeeding taxable year in those cases. If an affected corporation ceases to exist in connection with a transaction described in section 381(a), we believe that the acquirer of the affected corporation's assets should be treated as paying a portion of the specified foreign income taxes allocated to the succeeding taxable year. This allocation may be accomplished, for example, by applying the principles of the covered event rules (even when the section 381(a) transaction is not a covered event), taking into account foreign law income related to the assets transferred in the transaction.[112]

E. Partnerships with Short Taxable Years

Partnerships with taxable years determined by reference to the taxable years of their partners that are affected corporations will in many cases be required to make corresponding changes to their own taxable years (such partnerships, "**affected partnerships**"). Thus, similar to their affected corporation partners, affected partnerships' transition to a new taxable year would require a transitional one-month long taxable year. If an affected partnership incurs foreign income taxes that accrue during its first short taxable year (either directly or indirectly through one or more

[110] *See* Treas. Reg. § 1.901-2(f)(5)(ii).

[111] If, on the other hand, an interest in a disregarded entity were transferred in connection with the legal liquidation, there would be a covered event with respect to that disregarded entity but not with respect to the liquidating corporation itself. *Id*.

[112] When an affected corporation ceases to exist in a taxable transaction (for example, a liquidation described in section 331) during the first required year and the transaction is not a covered event, we do not believe that a successor rule would be appropriate. We also do not recommend that the proposed regulations accelerate foreign income taxes allocated to the succeeding taxable year in those cases, as this would implicate the problem that the Transition Rule otherwise resolves. Rather, we believe that those specified foreign income taxes should be unavailable to be deemed paid if not allocated under the Covered Event Rules.

disregarded entities), affected corporations that are partners in the partnership would often, in their first required year, take into account their distributive share of foreign income taxes imposed on a full year of income, but only one month of the related income.

> <u>Example 8. Short Partnership Year</u>. FC1 owns 80 percent and FC2 owns 20 percent of the interests in the capital and profits of PRS, a partnership organized in Country X that is subject to tax as a corporation under Country X income tax law. For Country X income tax purposes, PRS's taxable year ends on December 31, 2025. FC1 is an affected corporation whose first required year begins on December 1, 2025, and ends on December 31, 2025. No one-month deferral election is in effect with respect to FC2, whose taxable year is the calendar year.
>
> PRS earns $240 of income ratably over the course of its 2025 Country X taxable year.[113] For U.S. federal income tax purposes, Country X income tax of $48 accrues on December 31, 2025. All of PRS's income is treated as tested income with respect to both FC1 and FC2 and all $48 of the Country X income tax is a tested foreign income tax.
>
> FC1's taxable year ending December 31, 2025, represents a majority interest taxable year because FC1 holds a greater-than-50 percent interest in the capital and profits of PRS on December 1, 2025 (which is a testing day within the meaning of section 706(b)(4)(A)(ii)). Thus, under section 706(b)(1)(B)(i), PRS's taxable year beginning December 1, 2025, must end on December 31, 2025.
>
> For U.S. federal income tax purposes, PRS earns $220 of income in its taxable year ending November 30, 2025, and $20 of income in its short taxable year ending on December 31, 2025. Nonetheless, the full $48 of foreign income tax accrues on December 31, 2025. In its first required year, FC1's distributive share of PRS's income is $16 (=.8 x $20) and its distributive share of Country X income tax is $38.40 (=.8 x $48). FC1's tested income, determined solely with respect to items attributable to PRS, equals -$22.40. Unless FC1 recognizes tested income from other sources in its first required year, FC1's U.S. shareholders would not be entitled to a deemed paid foreign tax credit for any portion of FC1's distributive share of the Country X income tax because FC1 would not have positive tested income.
>
> FC2's distributive share of PRS's income with respect to PRS's taxable year ending November 30, 2025, equals $44 (=.2 x $220) and its distributive share of income with respect to PRS's taxable year ending December 31, 2025, equals $4 (=.2 x

[113] We have assumed, for ease of illustration, that PRS earned $0 and paid or accrued $0 in foreign income tax in calendar year 2024.

$20). FC2's distributive share of PRS's Country X income tax for PRS's taxable year ending December 31, 2025, equals $9.60 (=.2 x $48). FC2 takes into account $48 of PRS's tested income and $9.60 of foreign income taxes accrued by PRS in FC2's taxable year ending December 31, 2025. Unless FC2's other income resulted in FC2 having a net tested loss, FC2's U.S. shareholders would be entitled to a deemed paid foreign tax credit with respect to FC2's distributive share of the Country X income tax.

Distributive share of PRS items			
Period	**Dec. 31, 2024-Nov. 30, 2025**	**Dec. 1, 2025-Dec. 31, 2025**	**Jan. 1, 2026-Dec. 31, 2026**
Tested income (FC1)	$176.00	$16.00	
Country X tax (FC1)	$0.00	$38.40	
Total	***$176.00***	***-$22.40***	
Tested income (FC2)		$48.00	
Country X tax (FC2)		$9.60	
Total		***$38.40***	

Thus, an affected corporation that is a partner in an affected partnership faces the same potential loss of foreign tax credits that it faces when those foreign income taxes are incurred directly. We believe that it would be appropriate for the Allocation Rule to allocate foreign income taxes in those instances. Therefore, we recommend that the proposed regulations treat a partner's distributive share of foreign income taxes paid or accrued by a partnership as specified foreign income taxes when certain conditions are met.

First, only an affected corporation's distributive share of foreign income taxes should be treated as specified foreign income taxes subject to allocation. As Example 8 demonstrates, section 706(a) would cause partners that have a full taxable year ending with the first required year to take into account their distributive share of partnership income for two partnership years. FC2 takes into account its distributive share of PRS's income for its full year ending on November 30, 2025, and its short year ending on December 31, 2025, such that FC2 accrues foreign income taxes and the related income in the same taxable year.

Second, the Transition Rule should only apply to an affected partnership. That is, an allocation should only apply to foreign income taxes paid or accrued by a partnership that must adopt a new taxable year by reason of one or more of its partners being required to adopt a new taxable year. As the Notice observes, an allocation is unnecessary without a short partnership taxable year, because an affected corporation partner would ordinarily take into account its distributive share of a full year of partnership income in its first required year.

Third, for similar reasons, an allocation should occur only when an affected partnership's first new taxable year coincides with a partner's first required year. For example, if an affected partnership had a one-month taxable year ending on December 31, 2025, and it had a partner whose first required year ended on June 30, 2026, the partner's last one-month deferral year ending on May 31, 2026, generally would include taxable income from the partnership attributable to the partnership's full taxable year ending November 30, 2025, and its short taxable year ending on December 31, 2025.

Applying our recommended approach to the facts in Example 8 would prevent FC1's distributive share of foreign income taxes accrued by PRS from exceeding its distributive share of PRS income in FC1's first required year. Specifically, the $38.40 of Country X income tax taken into account by FC1 in its first required year would be treated as a specified foreign income tax, such that $3.20 (=[1/12] x $38.40] of the Country X income tax would be allocated to FC1's first required year and the remaining $35.20 (=$38.40-$3.20) would be allocated to FC1's succeeding taxable year. No portion of FC2's distributive share of Country X income tax would be treated as a specified foreign income tax.

Distributive share of PRS items			
Period	**Dec. 31, 2024-Nov. 30, 2025**	**Dec. 1, 2025-Dec. 31, 2025**	**Jan. 1, 2026-Dec. 31, 2026**
Tested income (FC1)	$176.00	$16.00	
Country X tax (FC1)	$0.00	$3.20	$35.20
Total	***$176.00***	***$12.80***	
Tested income (FC2)		$48.00	
Country X tax (FC2)		$9.60	
Total		***$38.40***	

We believe that this approach would address situations in which foreign income taxes that would otherwise be deemed paid would fail to be deemed paid by reason of a mandatory short taxable year. At the same time, it would not allocate foreign income taxes that do not raise this concern. Accordingly, we recommend that the proposed regulations should treat a partner's distributive share of foreign income taxes paid or accrued by a partnership as specified foreign income taxes when (i) the partner is an affected corporation, (ii) the partnership must adopt a new taxable year by reason of one or more of its partners being required to adopt a new taxable year and (iii) the partnership's first new taxable year coincides with the partner's first required year.

F. Proration of Items Taken into Account Annually

The Notice addresses one instance in which existing rules provide that an item (pretransition gain or loss that is subject to an amortization election under Treas. Reg. § 1.987-10) would be taken into account on an accelerated basis in the event of a short taxable year (including the first required year) by converting a 10-year amortization period into a 120-month amortization period. We believe that the approach taken in the Notice is appropriate. It prevents section 987 gain or loss that that was intended to be taken into account over 12 months from being taken into account in one month. Furthermore, pretransition gain or loss may be allocated to subpart F income and tested income items.[114] As a result, allocating a full year of pretransition loss to a one-month

[114] *See* Treas. Reg. § 1.987-6(b)(1)(iv) & (b)(2).

taxable year would, in some cases, present the same lost deemed paid credit outcomes discussed in Part III.A.4.

A number of other statutory and regulatory regimes apply by reference to multi-year periods. For example, certain foreign research and experimental expenditures to be amortized ratably over the 15-year period beginning with the midpoint of the taxable year in which the expenditures are incurred.[115] Similarly, a taxpayer that must make a positive section 481(a) adjustment in connection with a change in its method of accounting generally may take the adjustment into account over four years.[116] In a number of instances, if an affected corporation's first required year were treated as a full taxable year for purposes recognizing items that were intended to be recognized over the course of multiple years, distortive foreign tax credit outcomes (and other distortions) could occur, raising the same policy concerns that motivate the Transition Rule.

We believe that Treasury should, with respect to an affected corporation's first required year, consider extending the Notice's monthly convention to other items that are accounted for over multiple taxable years. Identifying the appropriate scope of any such rule may be difficult. For example, it may be more appropriate to apply this convention to first required years of an affected corporation only when an item would be taken into account over a number of years by reason of regulatory or other guidance issued by Treasury. In contrast, when a statutory provision requires an item to be taken into account over a period of "taxable years," it may (depending on the provision and any relevant grant of regulatory authority) be less clear that Treasury would have authority to apply a different convention. Furthermore, if Treasury determines that any such guidance should be limited to scenarios in which the acceleration resulted in the loss of deemed paid credits (or a payment that might not otherwise occur, as may be the case when income is accelerated) and similar distortions, a "but for" standard may be appropriate.

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[115] *See* I.R.C. § 174(a).

[116] Rev. Proc. 2015-13 § 7.03.