No. 2025-344
December 5, 2025

KPMG report: Guidance on allocation of foreign income taxes and section 987 transition rules (Notice 2025-72)

The IRS on November 25, 2025, released Notice 2025-72, announcing that the U.S. Treasury Department and IRS intend to issue proposed regulations under section 70352 of Pub. L. No. 119-21 (known as the “One Big Beautiful Bill Act” (OBBBA)).

The statutory provisions (1) repeal the one-month deferral election under section 898(c)(2) for the first tax year of a specified foreign corporation (SFC) beginning after November 30, 2025; (2) provide a special transition rule under which an SFC with a one-month deferral election in place have, for their first tax year beginning after November 30, 2025, a one-month short tax year to conform to the majority U.S. shareholder year; and (3) grant authority for Treasury to issue guidance for allocating foreign income taxes accrued between the short tax year required under the transition rule and the following tax year.

The notice announces (1) that proposed regulations under section 898 will address the allocation of taxes of foreign corporations affected by the repeal of the one-month deferral election, and (2) that proposed regulations under section 987 will modify the election to recognize pretransition section 987 gain or loss ratably over the transition period pursuant to §1.987-10(e)(5)(ii)(A).

Allocation of taxes

The regulatory authority to allocate foreign income tax between the short period occurring by reason of the transition rule and the subsequent tax year would prevent an over-accrual of such taxes for the short period. For example, a controlled foreign corporation (CFC) that currently has a November 30 year-end for U.S. tax purposes and a December 31 year-end for local tax purposes accrues its foreign income taxes for U.S. tax purposes on December 31, the last day of the foreign tax year. Thus, the CFC’s foreign income taxes for 2025 would accrue during the CFC’s one-month short period created by the transition rule, potentially causing a tested loss (if the accrued taxes exceed tested income before taxes), with the result that the taxes would be permanently stranded.

Notice 2025-72 states that the forthcoming proposed section 898 regulations would provide that foreign income taxes imposed in the 2025 short tax year (the “first required year”) would generally be allocated to the first required year by applying the principles of Reg. § 1.1502-76(b) based on the foreign taxable income earned in the first required year as compared with the full foreign tax year. Any remaining foreign income taxes imposed in the first required year would be allocated and treated as paid for U.S. tax purposes in the succeeding tax year (that is, the first tax year beginning after December 31, 2025) (the “tax year allocation”).

As a result, for calendar year taxpayers, any in-scope SFC will have a first required year from December 1, 2025, to December 31, 2025. If the SFC accrues foreign net income taxes on December 31, 2025, a portion of those taxes (e.g., 1/12th assuming the income is allocated ratably under Reg. § 1.1502-76(b)(2)(ii)) would be allocated to the first required year, and the remainder would be allocated to the succeeding tax year.

The allocation rules only apply to "specified foreign income taxes," which notably do **not** include:

- A foreign corporation's distributive share of foreign income taxes paid or accrued by a partnership
- Withholding taxes described in section 901(k)(1)(B)
- Foreign income taxes accrued in the succeeding tax year

The notice states that it excludes a distributive share of foreign income taxes paid or accrued by a partnership because the affected corporation will generally take into account a distributive share of partnership income at the same time. *See* section 706(a) and Reg. § 1.706-1(a). For instance, in Example 1 of the notice, CFCX owns a 40% interest of Partnership Y, which has a calendar year for its U.S. tax year. For its U.S. tax year ending December 31, 2025, Partnership Y accrues Country Y tax of 10,000u. CFCX's distributive share of the Country Y tax is 4,000u. CFCX takes its entire 4,000u distributive share of Country Y tax into account during the first required year and there is no allocation of such tax to CFCX's succeeding tax year.

KPMG observation

As applied to Example 1 of the notice (wherein CFCX is a minority partner), excluding a distributive share of partnership taxes from the tax year allocation appears reasonable because CFCX's distributive share of items from Partnership Y would effectively include 12 months of income and 12 months of foreign income taxes. However, if CFCX held a majority interest, Partnership Y's U.S. tax year may be required to match CFCX's U.S. tax year. Accordingly, creating a short U.S. tax year for CFCX may also create a short U.S. tax year for Partnership Y in which it could accrue 12 months of foreign income taxes but only one month of taxable income. CFCX's distributive share of income and taxes from Partnership Y could thus result in CFCX having a loss with respect to a particular income group for the first required year, the very result that the notice was intended to address. Treasury and the IRS appear to be aware of this issue as they have requested comments on whether the tax year allocation should be extended to "an affected corporation's distributive share of foreign income taxes paid or accrued by a partnership that is required to change its tax year because of the change in tax year of the affected corporation." Therefore, it is hoped, and expected, that the Treasury and the IRS would address this issue in proposed regulations.

The notice also excludes withholding taxes from being allocated between tax years because they generally accrue close in time to the accrual of the income on which these taxes are imposed.

KPMG observation

Existing foreign income tax allocation rules under Reg. § 1.901-2(f)(5) similarly do not apply to withholding taxes for similar reasons. However, in certain situations, an income item, such as interest, on which a withholding tax is imposed could be of the type that accrues ratably for U.S. tax purposes during the foreign tax year.

Finally, the notice does not allocate foreign income taxes that accrue in the succeeding tax year to the first required year due to the administrative and compliance burdens allowing for tax year allocation of such taxes would impose. In particular, according to the notice, an allocation of such taxes would be difficult to perform before the end of the succeeding tax year, which will generally close after the due date for the tax return of the majority U.S. shareholder's income tax return for the tax year with which the affected corporation's first required year ends. For example, if a CFC had a November 30 year-end for foreign tax purposes, the U.S. tax return for the first required year would be due on October 15, 2026 (with extensions) before the foreign net income tax could accrue in the succeeding tax year (November 30, 2026).

KPMG observation

Because foreign income taxes accruing in the succeeding tax year cannot be allocated back to the first required year, CFCs with foreign tax years that do not end within the first required year may earn income in their first required year to which no foreign income taxes are attributed under the notice. This could have deleterious consequences, such as causing a CFC to fail the high-tax exception to foreign base company income or the high-tax exclusion from tested income and thus exposing actually high-taxed foreign income to U.S. tax. While the administrative and compliance burdens of allocating taxes from the succeeding tax year to the first required year may exceed the benefits in many circumstances, the IRS and Treasury may consider providing an election for taxpayers who agree to take on the administrative burdens of such allocation. This election would allow taxpayers to more accurately reflect the amount of foreign income tax that factually relates to income that was earned during the first required year.

The notice provides the following ordering rules for allocating specified foreign income taxes between the first required year and the succeeding tax year:

- First, identify specified foreign income taxes.
- Second, apply Reg. § 1.861-20 (as modified by Reg. § 1.960-1(d)(3)(ii)(B)) to associate the specified foreign income taxes with items of income for U.S. tax purposes.
- Third, allocate specified foreign income tax between the first required year and succeeding tax year.
- Fourth, specified foreign income tax allocated to the first required year (or succeeding tax year) is treated as the amount of tax accrued in that tax year for all purposes of the Code except sections 905(c) and 986(a).

Finally, the notice provides rules that coordinate with existing foreign income tax allocation rules in Reg. § 1.901-2(f)(5) which apply to certain "covered events" (i.e., a partnership termination, a transfer of a disregarded entity, or a change in the entity classification of a disregarded entity or a corporation). If Reg. § 1.901-2(f)(5) allocates foreign taxes to an SFC's first required year, the coordination rule generally computes an allocation percentage based on the amount of foreign taxable income that is attributable to the first required year.

Applicability dates

Notice 2025-72 states that the forthcoming proposed section 898 regulations would apply to tax years of SFCs beginning after November 30, 2025, but taxpayers may rely on the rules described in the notice for foreign taxes paid or accrued in tax years of SFCs beginning after November 30, 2025, and ending before the forthcoming proposed section 898 regulations are published in the Federal Register, provided the taxpayer applies the rules in their entirety and in a consistent manner for the first required year and the succeeding tax year of an SFC.

Section 987

Treasury and the IRS on December 10, 2024, released final regulations under section 987 (the "section 987 regulations"). Read a KPMG report (December 2024) for a discussion of the section 987 regulations. The section 987 regulations provide, among other things, rules for calculating the amount of foreign currency gain or loss recognized by the owner of a qualified business unit (QBU) under section 987(3) and transition rules that apply in the first tax year in which the section 987 regulations are applicable. The transition rules include rules for determining and recognizing section 987 gain or loss that arose before the section 987 regulations became applicable ("pretransition gain or loss"). Taxpayers may elect to recognize pretransition gain or loss ratably over a period of 10 tax years, beginning with the first tax year in which the section 987 regulations apply (the "amortization election").

Because the repeal of the one-month deferral election creates a one-month short period, if such period is treated as a full tax year, the pretransition gain or loss may be recognized in a condensed period of time (e.g., 108 months instead of 120 months). Forthcoming proposed section 987 regulations would modify the effect of the amortization election to take into account pretransition gain or loss for short tax years such that the gain or loss would be recognized ratably over a 120-month period.

Applicability dates

The forthcoming proposed section 987 regulations would apply to tax years beginning after December 31, 2024, and ending on or after November 25, 2025, but taxpayers may rely on the notice before the forthcoming proposed section 987 regulations are published in the Federal Register for a tax year to which the section 987 regulations apply, provided the taxpayer applies the rules in their entirety and in a consistent manner with respect to each section 987 QBU, original deferral QBU, and outbound loss QBU for that tax year and each subsequent tax year.

Request for comments

In addition to a general request for comments on the foreign tax credit and section 987 rules, Treasury and the IRS specifically request comments on whether the allocation rule should apply to any foreign taxes other than specified foreign income taxes, including, as discussed above, an affected corporation’s distributive share of foreign income taxes paid or accrued by a partnership that is required to change its tax year because of the change in tax year of the affected corporation.

Written comments should be submitted by January 24, 2026.

For more information, contact a KPMG tax professional in Washington National Tax:

Jake Burgers | jburgers@kpmg.com
Ron Dabrowski | rdabrowski@kpmg.com
Gary Scanlon | gscanlon@kpmg.com
Sarah Staudenraus | sarahstaudenraus@kpmg.com

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.