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Proposed regulations: Allocation of foreign taxes following repeal of section 898(c)(2) one-month deferral election and foreign tax credit disallowance under section 960(d)(4)

The U.S. Treasury Department and IRS today issued proposed regulations (REG-115145-25) relating to (1) the allocation of foreign taxes of foreign corporations affected by the repeal of the one-month deferral election under section 898(c)(2) by section 70352 of Pub. L. No. 119-21 (the "One Big Beautiful Bill Act" (OBBBA)), and (2) the disallowance of foreign tax credits (FTCs) on certain distributions of previously taxed earnings and profits (PTEP) under section 960(d)(4), as added by section 70312 of the OBBBA.

Background

Section 70352 of the OBBBA (1) repeals the one-month deferral election under for a specified foreign corporation's (SFC's) first tax year beginning after November 30, 2025, (2) provides a special transition rule under which SFCs with one-month deferral elections in place have, for their first tax year beginning after November 30, 2025, a one-month short tax year as the mechanism to conform to the majority U.S. shareholder year, and (3) grants authority for Treasury to issue guidance for allocating foreign taxes accrued between the short tax year required under the transition rule and the following tax year.

In Notice 2025-72, Treasury and the IRS announced their intent to issue proposed regulations under section 70352 of the OBBBA providing 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 Treas. Reg. § 1.1502-76 based on the income under foreign law in first required year as compared with the full foreign tax year. Any remaining foreign 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). Notably, the allocation rules would only apply to foreign income taxes (and not withholding taxes) that are imposed in the first required year (and not to taxes imposed in 2026 that may relate under foreign law to income earned in the first required year).

Treasury and the IRS also announced in Notice 2025-72 their intent to issue proposed regulations under section 987 regarding the election to recognize pretransition section 987 gain or loss ratably over a transition period. However, the preamble to the proposed regulations states that Treasury and the IRS intend to issue separate proposed regulations under section 987 in the near future.

Section 70312(a)(1) of the OBBBA increased the percentage in section 960(d)(1) from 80% to 90%, thereby decreasing the reduction in foreign income taxes deemed paid from 20% to 10%. Section 70312(b) of the OBBBA added section 960(d)(4), which correspondingly disallows an FTC for 10% of the foreign income taxes paid or accrued (or deemed paid under section 960(b)(1)) with respect to a distribution of PTEP resulting from a section 951A inclusion after June 28, 2025.

In Notice 2025-77, Treasury and the IRS announced their intent to issue proposed regulations under section 960(d)(4), including regarding application of the effective date of section 960(d)(4). In particular, the notice clarified that proposed regulations would apply the 10% haircut to PTEP distributions arising from section 951A inclusions for taxable years ending after June 28, 2025 (e.g., calendar year 2025 inclusions). Notably, the Joint Committee on Taxation's "Bluebook" released after enactment of the OBBBA appears to adopt a broader interpretation of the effective date of section 960(d)(4), suggesting that it applies to any distribution of section 951A PTEP made after June 28, 2025, regardless of when the section 951A amount was included in income.

Proposed regulations

The proposed regulations include the rules described in Notice 2025-72, with several taxpayer-favorable modifications in response to public comments. In particular, to reduce compliance burdens and prevent the mismatch of income and taxes, the proposed regulations would introduce several new elections:

- Election to treat specified distributive shares of creditable foreign tax expenditures (CFTEs) from affected partnerships as specified foreign income taxes, allowing them to be allocated
- Irrevocable election to allow the allocation of relevant succeeding year taxes if an SFC's foreign tax year does not align with its succeeding tax year
- Election to compute and apply an income group specific allocation percentage based on a closing of the books method rather than a single total income percentage
- Election to not allocate specified foreign income taxes at all, keeping them entirely in the first required year

The proposed regulations include the rules in Notice 2025-77 without modification.

The proposed regulations under section 898(c) would apply to tax years of SFCs beginning after November 30, 2025, and taxpayers may rely on them before finalization if applied in their entirety and in a consistent manner. The proposed regulations under section 960(d)(4) are proposed to apply to foreign taxes paid or accrued (or deemed paid) on distributions of PTEP from section 951A inclusions occurring in tax years of U.S. shareholders ending after June 28, 2025, and taxpayers may rely on them before finalization if applied in their entirety and in a consistent manner.

Comments on the proposed regulations, and requests for a public hearing, are due by the date that is 45 days after the proposed regulations are published in the Federal Register, which is scheduled to be August 3, 2026.

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