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Proposed regulations: Allocation and apportionment of deductions to foreign source section 951A category income and DEI

The U.S. Treasury Department and IRS today released **proposed regulations** (REG-117273-25) related to the allocation and apportionment of deductions to foreign source section 951A category income for foreign tax credit (FTC) limitation purposes and for purposes of calculating deduction eligible income (DEI), to reflect various changes made under the "One Big Beautiful Bill Act" (OBBBA).

Background

For tax years beginning after December 31, 2025, section 250 (as amended by the OBBBA) allows a domestic corporation to deduct 33.34% of the corporation's foreign-derived deduction eligible income (FDDEI), which is the DEI of any domestic corporation derived in connection with (1) property sold to any person that is not a U.S. person and is for a foreign use, or (2) services provided to any person, or with respect to property, not located within the United States.

Prior to its amendment by the OBBBA, section 250(b)(3)(A) defined DEI as the excess (if any) of a domestic corporation's gross income determined without regard to six categories of gross income, described in section 250(b)(3)(A)(i)(I) through (VI), over the deductions (including taxes) properly allocable to such gross income. The OBBBA amended section 250(b)(3)(A)(ii) to reduce gross income by the "expenses and deductions (including taxes), other than interest expense and research or experimental expenditures, properly allocable to such gross income," effective for tax years beginning after December 31, 2025.

The OBBBA also made several changes with respect to the FTC rules, including rules for allocating and apportioning deductions for purposes of determining the FTC limitation, effective for tax years beginning after December 31, 2025. In particular, the OBBBA added section 904(b)(5), which provides special rules for allocating and apportioning deductions to foreign source income for purposes of applying section 904(a) with respect to section 951A category income. Section 904(b)(5)(A) provides that any deduction allowed under section 250(a)(1)(B) and any deduction allowed under section 164(a)(3) for taxes imposed on amounts described in section 250(a)(1)(B) are allocated and apportioned to foreign source section 951A category income. Section 904(b)(5)(B) provides that no amount of interest expense or research and experimental (R&E) expenditures is allocated or apportioned to foreign source section 951A category income. Section 904(b)(5)(C) provides that any other deduction is allocated and apportioned to foreign source section 951A category income only if the deduction is directly allocable to such income. Pursuant to the second sentence of section 904(b)(5), any amount or deduction that would (but for section 904(b)(5)(B) and (C)) have been allocated or apportioned to foreign source section 951A category income is only allocated or apportioned to U.S. source income.

Proposed regulations

The proposed regulations would update the existing section 250 regulations to reflect the amendment to section 250(b)(3)(A)(ii) made by the OBBBA.

- The proposed regulations would provide that a taxpayer's gross DEI and gross FDDEI for a tax year are reduced by the properly allocable expenses and other deductions (referred to collectively as "deductions") that the taxpayer deducts in the tax year. The proposed regulations would add the term "expenses" to existing Treas. Reg. § 1.250(b)-1(a) in order to reflect the addition of this term, and the related term "interest expense," in amended section 250(b)(3)(A)(ii). By taking into account amounts that are deducted in the taxable year in order to compute DEI and FDDEI, the proposed regulations would reflect that DEI and FDDEI are measures of taxable income.

- The proposed regulations would also provide that taxpayers must determine their deductions for the tax year properly allocable to gross DEI and gross FDDEI without regard to interest expense and R&E expenditures. The proposed regulations would define interest expense as any amount that is deductible under section 163 (including original issue discount). To reflect that interest expense is no longer allocable to gross DEI and gross FDDEI, the proposed regulations would remove the reference to section 163(j) in existing Treas. Reg. § 1.250(b)-1(d)(2)(ii). The proposed regulations would define R&E expenditures as any expenditure that a taxpayer deducts (including as an amortization deduction) in a tax year under section 174, 174A, or 59(e)(2)(B).

The proposed regulations also provide proposed rules under newly added section 904(b)(5), as well as certain conforming amendments to the existing regulations in Treas. Reg. § 1.861-8.

- The proposed regulations would clarify certain deductions that are not "directly allocable" to section 951A income for purposes of section 904(b)(5)(C), and thus may be reallocated to U.S. source income under the second sentence of section 904(b)(5) (e.g., similar to interest deductions). These include deductions for:
    - Stewardship expenses;
    - Legal and accounting fees and expenses;
    - Damages awards, prejudgment interest, and settlement payments; and
    - Supportive expenses (such as overhead, general and administrative, and supervisory expenses).
- On the other hand, the proposed regulations would provide that foreign source section 986(c) loss that is assigned to the section 951A category is "directly allocable" for purposes of section 904(b)(5)(C).
- The proposed regulations would also provide that section 904(b)(5) is taken into account in determining the separate limitation loss (SLL) and U.S. source loss components of a net operating loss (NOL) incurred in a taxable year beginning after December 31, 2025. Accordingly, the portion of an NOL attributable to section 904(b)(5) "reallocated deductions" is treated as a U.S. source loss component rather than an SLL component.
- Lastly, the proposed regulations would provide that section 904(b)(5) reallocation occurs for all purposes of section 904, and thus may cause a taxpayer to sustain (or increase the amount of) an overall domestic loss (ODL).

The preamble to the proposed regulations states that Treasury and the IRS intend to issue separate guidance regarding section 250, which would update the existing section 250 regulations to reflect other amendments made by the OBBBA. Separate guidance would address, for example, the removal of the deemed tangible income return and deemed intangible income from calculation of the deduction provided under section 250(a)(1)(A) for tax years beginning after December 31, 2025.

The proposed regulations are generally proposed to apply to tax years beginning after December 31, 2025. The preamble to the proposed regulations states that taxpayers may rely on the proposed regulations before the date the regulations are finalized, provided that the taxpayer and its related parties follow the proposed regulations in their entirety.

Comments on the proposed regulations, and requests for a public hearing, are due by the date that is 60 days after the proposed regulations are published in the Federal Register, which is scheduled to be September 11, 2026.

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