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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9292

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Partner's Distributive Share: Foreign Tax Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations regarding the allocation of creditable foreign tax expenditures by partnerships. The regulations are necessary to clarify the application of section 704(b) to allocations of creditable foreign tax expenditures. The final regulations affect partnerships and their partners.

DATES: Effective Date: These regulations are effective October 19, 2006.

Applicability Date: These regulations apply to partnership taxable years beginning on or after October 19, 2006.

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SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 704 of the Internal Revenue Code (Code). On April 21, 2004, temporary regulations (TD 9121) relating to the proper allocation of partnership expenditures for foreign taxes were

published in the **Federal Register** (69 FR 21405). A notice of proposed rulemaking (REG-139792-02) cross-referencing the temporary regulations was also published in the **Federal Register** (69 FR 21454) on April 21, 2004. A public hearing was requested and held on September 14, 2004. The IRS received a number of written comments responding to the temporary and proposed regulations. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision and the corresponding temporary regulations are removed.

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided, be determined by the partnership agreement. Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if the allocation to a partner under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect. Thus, in order to be respected, partnership allocations either must have substantial economic effect or must be in accordance with the partners' interests in the partnership.

In general, for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that, in the event there is an economic burden or benefit that corresponds to the allocation, the partner to whom the allocation is made must receive the economic benefit or bear such economic burden. See §1.704-1(b)(2)(ii). As a general rule, the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or

allocations) will affect substantially the dollar amounts to be received, independent of tax consequences. See §1.704-1(b)(2)(iii). Even if the allocation affects substantially the dollar amounts, the economic effect of the allocation (or allocations) is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. See §1.704-1(b)(2)(iii).

The temporary and proposed regulations clarified the application of the regulations under section 704 to foreign taxes paid or accrued by a partnership and eligible for credit under section 901(a) (creditable foreign tax expenditures or CFTEs). While allocations of CFTEs that are disproportionate to the related income may have economic effect in that they reduce the recipient partner's capital account and affect the amount the recipient partner is entitled to receive on liquidation, this effect will almost certainly not be substantial after taking U.S. tax consequences into account. For example, the after-tax economic consequences to a foreign or other tax-indifferent partner whose share of the tax expense is borne by a U.S. taxable partner will be enhanced by reason of the allocation, and there is a strong likelihood that the after-tax economic consequences to a U.S. partner will not be substantially diminished since the allocation of the CFTE increases the allowable foreign tax credit and results in a dollar-for-dollar reduction in the U.S. tax the partner would otherwise owe.

The temporary and proposed regulations were based on the assumption that partnerships specially allocate foreign taxes where the recipient partner would elect to claim the CFTE as a credit, rather than as a deduction. As a matter of administrative convenience, the regulations applied to all allocations of CFTEs even though, in rare instances, a partner may instead elect to deduct the CFTEs. Thus, the temporary and proposed regulations provided that partnership allocations of CFTEs cannot have substantial economic effect and, therefore, must be allocated in accordance with the partners' interests in the partnership.

The temporary and proposed regulations provided a safe harbor under which partnership allocations of CFTEs will be deemed to be in accordance with the partners' interests in the partnership. Under this safe harbor, if the partnership agreement satisfies the requirements of §1.704-1(b)(2)(ii)(b) or (d) (capital account maintenance, liquidation according to capital accounts, and either deficit restoration obligations or qualified income offsets), then an allocation of CFTEs that is proportionate to a partner's distributive share of the partnership income to which such taxes relate (including income allocated pursuant to section 704(c)) will be deemed to be in accordance with the partners' interests in the partnership. If the allocation of CFTEs does not satisfy this safe harbor, then the allocation of CFTEs will be tested under the partners' interests in the partnership standard set forth in §1.704-1(b)(3).

Summary of Comments and Explanation of Provisions

These final regulations retain the provisions of the proposed and temporary regulations excluding allocations of CFTEs from the substantial economic effect safe harbor of §1.704-1(b)(2), and provide a safe harbor under which allocations of CFTEs

will be deemed to be in accordance with the partners' interests in the partnership. As provided in the temporary and proposed regulations, the final regulations provide that allocations of CFTEs must be in proportion to the distributive shares of income to which the CFTEs relate in order to satisfy the safe harbor.

The final regulations provide that the income to which a CFTE relates is the net income in the CFTE category to which the CFTE is allocated and apportioned. A CFTE category is a category of net income attributable to one or more activities of the partnership. The net income in a CFTE category is the net income determined for U.S. federal income tax purposes (U.S. net income) attributable to each separate activity of the partnership that is included in the CFTE category. Income from separate activities is included in the same CFTE category only if the U.S. net income from the activities is allocated among the partners in the same proportions. For this purpose, income from a divisible part of a single activity that is shared in a different ratio than other income from that activity is treated as income from a separate activity. CFTEs are allocated and apportioned to CFTE categories in accordance with §1.904-6 principles, as modified by the final regulations. Therefore, CFTEs generally are allocated to a CFTE category if the income on which the CFTE is imposed (the net income recognized for foreign tax purposes) is in the CFTE category.

Accordingly, the safe harbor of the final regulations requires a three-step process to determine the distributive share of income to which a CFTE relates. First, the partnership must determine its CFTE categories. Second, the partnership must determine the U.S. net income in each CFTE category. Third, the partnership must allocate and apportion CFTEs to the CFTE categories based on the net income in the

CFTE categories that is recognized for foreign tax purposes. To satisfy the safe harbor, the partnership must allocate CFTEs among the partners in the same proportion as the allocations of U.S. net income in the applicable CFTE category.

Summary of Comments

A number of comments were received on the temporary and proposed regulations. The comments included requests for clarification and recommendations relating to the following: (i) the definition of CFTEs, (ii) the CFTE categories, (iii) the distributive share of income to which a CFTE relates, (iv) the application of the principles of §1.904-6, (v) the partners' interests in the partnership, (vi) the effective date and transition rule and (vii) certain other matters. The comments and final regulations are discussed in detail below.

A. Creditable Foreign Tax Expenditures (CFTEs)

The temporary and proposed regulations provide that a CFTE is a foreign tax paid or accrued by a partnership that is eligible for a credit under section 901(a). A qualifying domestic corporate shareholder may claim a credit under section 901(a) for taxes paid or accrued by a foreign corporation and deemed paid by the shareholder under section 902 or 960 upon distribution or inclusion of the associated earnings. Several commentators requested guidance concerning whether taxes deemed paid under section 902 or 960 are subject to these regulations. Although a domestic corporation may be eligible to claim a credit for deemed-paid taxes with respect to stock of a foreign corporation it owns indirectly through a partnership, any such deemed-paid taxes are determined directly by the corporate partner based on the partner's distributive share of dividend income or inclusion. Such deemed-paid taxes, therefore,

are not partnership items and are not taxes paid or accrued (or deemed paid or accrued) by a partnership. Accordingly, foreign taxes deemed paid under section 902 or 960 are not subject to these regulations.

The final regulations retain the definition of CFTE contained in the temporary and proposed regulations. In response to the comment, the final regulations clarify that a CFTE does not include foreign taxes deemed paid by a corporate partner under section 902 or 960. The final regulations also clarify that the regulations do not apply to foreign taxes paid or accrued by a partner (foreign taxes for which the partner has legal liability within the meaning of §1.901-2(f)). Finally, the final regulations clarify that a CFTE does include a foreign tax paid or accrued by a partnership that is eligible for a credit under an applicable U.S. income tax treaty.

B. CFTE Categories

Examples in the temporary and proposed regulations illustrated that the determination of the income to which a CFTE relates must be made separately for certain categories of income when the partnership agreement provides for different allocations of such income. Commentators requested additional guidance regarding the relevant categories for purposes of the safe harbor, including clarification that the safe harbor does not require the partnership to determine its CFTE categories by reference to section 904(d) categories. Subject to the requirements of section 704(b) and other applicable provisions of U.S. law, partners are free to allocate income in any manner they choose. Although partners must assign their distributive shares of partnership items (along with their other items of income and expense) to section 904(d) categories to compute the applicable limitations on the foreign tax credit, the CFTE categories

need not be determined by reference to section 904(d) categories. These principles were illustrated by the examples in the temporary and proposed regulations. However, the IRS and the Treasury Department agree with commentators that it is appropriate to provide additional guidance in determining a partnership's relevant categories of income. Accordingly, the final regulations provide additional guidance for purposes of making this determination. The additional guidance is also intended to assist in the determination of the distributive share of income to which a foreign tax relates. See the discussion at section C in this preamble. Consistent with the comments, the rules provided for in the final regulations rely to the extent possible on U.S. tax principles.

The final regulations clarify that the relevant category of income is the CFTE category, defined in the final regulations as U.S. net income attributable to one or more activities of the partnership. In general, the final regulations provide that U.S. net income from all of the partnership's activities is treated as income in a single CFTE category. This general rule does not apply, however, if the partnership agreement provides for an allocation of U.S. net income from one or more activities that differs from the allocation of U.S. net income from other activities. In that case, U.S. net income from each activity or group of activities that is subject to a different allocation is treated as net income in a separate CFTE category. For this purpose, income from a divisible part of a single activity is treated as income from a separate activity if such income is shared in a different ratio than other income from the activity.

Thus, if a partnership agreement allocates all partnership items in the same manner, the partnership will have a single CFTE category, regardless of the number of activities in which the partnership is engaged. Conversely, a partnership agreement

that provides for different allocations of net income with respect to one or more activities will have multiple CFTE categories. For example, assume a partnership (AB) with two partners is engaged in two activities and that the partnership agreement provides that all partnership items are shared 50-50. In such a case, the partnership has a single CFTE category. However, the partnership would have two CFTE categories if the items from one activity were shared 50-50 and the items from the second activity were shared 80-20.

Different allocations of the partnership's U.S. net income from separate activities and, thus, multiple CFTE categories may result if the partnership agreement contains special allocations. For example, assume that AB partnership agreement allocates all items other than depreciation 50-50, and that deductions for depreciation are allocated 100 percent to one of the partners. In such a case, the allocations of U.S. net income from the two activities will differ if AB's deductions for depreciation relate solely to one activity or if the deductions relate disproportionately to the activities. See paragraph (b)(5) Example 22. A preferential allocation of income will not result in multiple CFTE categories if the allocation relates to all of the partnership's net income. For example, assume partnership AB allocates \$100 of gross income each year to one of the partners and all remaining items 50-50. In such a case, the special allocation of \$100 of gross income affects the overall sharing ratio of partnership net income, but does not result in different sharing ratios with respect to income from the partnership's two activities. Accordingly, the U.S. net income attributable to the two activities is included in a single CFTE category. See paragraph (b)(5) Example 25.

Whether the partnership has different sharing ratios with respect to income from

one or more activities, and therefore has more than one CFTE category, depends on the facts and circumstances. Therefore, the final regulations provide that whether a partnership has one or more activities, and the scope of those activities, must be determined in a reasonable manner taking into account all the facts and circumstances. In evaluating whether aggregating or disaggregating income from particular business or investment operations constitutes a reasonable method of determining the scope of an activity, the principal consideration is whether or not the proposed determination has the effect of separating CFTEs from the related foreign income. Accordingly, relevant facts and circumstances include whether the partnership conducts business or investment operations in more than one geographic location or through more than one entity or branch, and whether certain types of income are exempt from foreign tax or subject to preferential foreign tax treatment. In addition, income from a divisible part of a single activity is treated as income from a separate activity if necessary to prevent the separation of CFTEs from the related foreign income. Finally, the final regulations provide that the partnership's activities must be determined consistently from year to year absent a material change in facts and circumstances.

C. Distributive Share of Income to Which a CFTE Relates

The temporary and proposed regulations required the allocation of a CFTE to be in proportion to the partner's distributive share of income to which it relates. Several commentators requested that the final regulations provide additional guidance in determining a partner's distributive share of income for purposes of the safe harbor. Some commentators believed that it was unclear whether allocations of CFTEs must be proportionate to allocations of income as determined for U.S. tax purposes or as

determined under foreign law. One comment recommended that, at least in cases where there is a preferential allocation of income, income as determined for U.S. tax purposes should control. Other commentators requested that the final regulations clarify whether allocations of CFTEs must follow allocations of gross or net income, and that the final regulations clarify the effect of special allocations and allocations of separately stated items on allocations of CFTEs under the safe harbor. Commentators also requested clarifications regarding section 704(c) allocations, income allocations that are deductible under foreign law, guaranteed payments, and situations in which certain partners' allocable shares of partnership income are excluded from the foreign tax base. In response to the comments, the final regulations provide several clarifications regarding the determination of a partner's distributive share of income to which a CFTE relates.

1. Net income in a CFTE category

The final regulations clarify that the net income in a CFTE category is the net income for U.S. Federal income tax purposes, determined by taking into account all items attributable to the relevant activity or group of activities (or portion thereof). The final regulations provide that the items of gross income included in a CFTE category must be determined in a consistent manner under any reasonable method taking into account all the facts and circumstances. Expenses, losses or other deductions generally must be allocated and apportioned to gross income included in a CFTE category in accordance with the rules of §§1.861-8 and 1.861-8T.

Sections 1.861-8 and 1.861-8T require taxpayers to use special rules contained in §§1.861-9 through 1.861-13T and §1.861-17 to allocate and apportion deductions for

interest expense and research and development (R&D) costs. See §§1.861-8(e)(3) and 1.861-8T(e)(2). Those provisions generally require taxpayers to allocate and apportion such deductions at the partner level and do not provide rules for allocating and apportioning the deductions at the partnership level. See §§ 1.861-9T(e) and 1.861-17(f). Therefore, the final regulations permit a partnership to allocate and apportion deductions for interest and R&D costs for purposes of determining net income in a CFTE category under any reasonable method, including but not limited to the rules contained in §§1.861-9 through 1.861-13T and §1.861-17 .

The final regulations clarify that in applying U.S. Federal income tax principles to determine the net income attributable to an activity of a branch, the only items of gross income taken into account are items of gross income that are recognized by the branch for U.S. federal income tax purposes. Therefore, a payment from one branch to another does not increase the gross income attributable to the activity of the recipient. See paragraph (b)(5) Example 24. Similarly, because U.S. tax principles apply to determine net income attributable to an activity of a branch, the inter-branch payment does not reduce the gross income of the payor. See paragraph (b)(4)(viii)(c)(3)(B) and paragraph (b)(5) Example 24.

The discussion in this preamble addresses the effect of the following factors on the determination of net income in a CFTE category: (a) section 704(c) allocations, (b) preferential income allocations and guaranteed payments, and (c) the exclusion of income of certain partners from the foreign tax base.

(a) Section 704(c) allocations

Several commentators requested clarification of when section 704(c) allocations

should be taken into account. Some commentators believed that section 704(c) allocations should only be taken into account where the built-in gain or loss is also recognized in the foreign jurisdiction. A number of commentators suggested further that section 704(c) allocations should be taken into account only upon the disposition of the section 704(c) property, while other commentators believed that section 704(c) allocations should also be taken into account as the section 704(c) property is depreciated or amortized over time.

After consideration of these comments, the final regulations retain the general principle that all section 704(c) allocations must be taken into account when determining net income in the relevant category. The IRS and the Treasury Department concluded that any attempt to trace the impact of built-in gain (or loss) under foreign tax principles to corresponding items under U.S. tax principles would be difficult to do and impractical to administer. Because allocations of net income from a CFTE category are allocations of the net income recognized for U.S. tax purposes, the IRS and the Treasury Department believe that all section 704(c) allocations (including “reverse” section 704(c) allocations and section 704(c) allocations that are made prior to an asset’s disposition) must be taken into account in determining a partner’s distributive share of income. Thus, the final regulations provide that the net income in a CFTE category is the net income for U.S. income tax purposes, determined by taking into account all items attributable to the relevant activity, including, among other items, items allocated pursuant to section 704(c). See paragraph (b)(5) Example 26.

(b) Preferential income allocations and guaranteed payments

Several commentators requested that the final regulations provide guidance

regarding the treatment of preferential income allocations and guaranteed payments when applying the safe harbor. In particular, clarification was requested as to the relevance of the deductibility of such items under foreign law in determining whether CFTEs are related to such items.

The final regulations generally provide that the income to which a CFTE relates is the net income in the CFTE category to which the CFTE is allocated and apportioned. However, if an allocation of partnership income is treated as a deductible payment under foreign law, then no CFTEs are related to that income because it is not included in the foreign tax base. To reflect this principle, the final regulations provide that income attributable to an activity shall not include an item of partnership income to the extent the allocation of such item of income (or payment thereof) to a partner results in a deduction under foreign law. By removing the income associated with a preferential income allocation that is deductible under foreign law from the net income in a CFTE category, this provision of the final regulations ensures that no CFTE will be related to such income, which is not included in the base upon which the creditable foreign tax is imposed.

The principle that no CFTEs are related to income if the allocation of such income results in a deduction under foreign law applies with equal force to cases in which a guaranteed payment made by a partnership to a partner is deductible by the partnership under foreign law. Conversely, where a partner receives a guaranteed payment and the guaranteed payment is not deductible by the partnership under foreign law (and thus does not reduce the foreign tax base), CFTEs should relate to the guaranteed payment. Accordingly, the final regulations contain two provisions to reflect

these principles. First, under the final regulations, a guaranteed payment is treated as income in a CFTE category to the extent that the payment is not deductible by the partnership under foreign law. Second, the final regulations provide that such a guaranteed payment is treated as a distributive share of income for purposes of the safe harbor. Consequently, the final regulations provide that CFTEs relate to income taken into account as a guaranteed payment to the extent the payment is not deductible under foreign law, and therefore CFTEs must be allocated to the partner receiving the guaranteed payment.

One commentator requested guidance concerning the source and character of guaranteed payments for other U.S. tax purposes. These issues are clearly important, but they are beyond the scope of this project and are not addressed in these final regulations.

(c) Taxes imposed on certain partners' income

A foreign jurisdiction may impose tax with respect to partnership income that is allocable to certain partners and not with respect to partnership income allocable to other partners. For example, as was the case in Vulcan Materials Co. v. Comm'r, 96 T.C. 410 (1991), aff'd in unpublished opinion, 959 F.2d 973 (11th Cir. 1992), nonacq. 1995-2 CB 2, a foreign jurisdiction may impose tax solely with respect to the nonresident partners' shares of partnership income. One commentator suggested that the final regulations provide that in these situations, allocations of CFTEs satisfy the safe harbor if they are allocated to the partner or partners whose income is included in the foreign tax base. The final regulations adopt this comment, and provide that income in a CFTE category does not include net income that foreign law would exclude from the

foreign tax base as a result of the status of the partner. By removing such income from a CFTE category, this provision of the final regulations ensures that CFTEs will be related only to income of those partners whose income is included in the base upon which the creditable foreign tax is imposed.

2. Distributive share of income

The final regulations provide that a partner's distributive share of income generally is the portion of the net income in a CFTE category that is allocated to the partner. Therefore, a partner's distributive share of income is determined under U.S. tax principles, taking into account the modifications described in section C1 under "Net income in a CFTE category."

The final regulations provide a special rule for cases in which more than one partner receives positive income allocations (income in excess of expenses) from a CFTE category and the aggregate of such positive income allocations exceeds the net income in the CFTE category because one or more other partners is allocated a net loss (expenses in excess of income). Because in this situation the sum of the positive income allocations from the CFTE category exceeds 100 percent of the net income in the category, an adjustment to the safe harbor formula is required to ensure that aggregate allocations of CFTEs do not exceed 100 percent of the CFTEs in the category. Accordingly, solely for purposes of allocating CFTEs under the safe harbor, the final regulations limit the distributive share of income of each partner that receives a positive income allocation to the partner's positive income allocation attributable to the CFTE category, divided by the aggregate positive income allocations attributable to the CFTE category, multiplied by the net income in the CFTE category. For example,

assume that the partnership has \$100 of net income (\$130 of gross income and \$30 of expenses) in a CFTE category and that partner A is allocated \$65 of gross income, partner B is allocated \$45 of gross income and partner C is allocated \$20 of gross income and \$30 of expenses. In this case, solely for purposes of the safe harbor, partner A's distributive share of income is \$59 ($\$65/\$110 \times \100) and partner B's distributive share of income is \$41 ($\$45/\$110 \times \100).

3. No net income

The final regulations contain a special rule for cases in which CFTEs are allocated and apportioned to a CFTE category that does not have any net income for U.S. tax purposes in the year the foreign taxes are paid or accrued. In such cases, there is no net income in the CFTE category to which the CFTEs relate. In the absence of a special rule, allocations of such CFTEs among the partners would not fall within the general safe harbor of the final regulations and would be required to be allocated in accordance with the partners' interests in the partnership. To eliminate uncertainty in this situation, the final regulations include a rule that relates such CFTEs to net income recognized for U.S. tax purposes in other years or in other CFTE categories. (For rules relating to the allocation and apportionment of CFTEs to a CFTE category, see section D below.)

Under the final regulations, CFTEs allocated and apportioned to a CFTE category that has no net income for U.S. tax purposes will be deemed to relate to the aggregate net income (if any) recognized by the partnership in that CFTE category during the preceding three-year period (not taking into account years in which there is a net loss in the CFTE category for U.S. tax purposes). Accordingly, the CFTEs in these

situations generally must be allocated among the partners in the same proportion as the allocations of such net income for the prior three-year period to satisfy the safe harbor. If the partnership does not have net income in the applicable CFTE category in either the current year or any of the previous three taxable years, the CFTEs must be allocated among the partners in the same proportion that the partnership reasonably expects to allocate net income in the applicable CFTE category over the succeeding three years. If the partnership does not reasonably expect to have net income in the applicable CFTE category in the succeeding three years, the CFTEs must be allocated among the partners in the same proportion as the total partnership net income for the year is allocated. If the CFTE cannot be allocated under any of the foregoing rules, it must be allocated in proportion to the partners' outstanding capital contributions.

D. Allocation and Apportionment of CFTEs to CFTE Categories

The temporary and proposed regulations provided that the income to which a CFTE relates is determined in accordance with the principles of § 1.904-6. Section 1.904-6, which contains rules for allocating and apportioning foreign taxes to the categories of income described in section 904(d), provides generally that a foreign tax is related to income if the income is included in the base upon which the foreign tax is imposed. Section 1.904-6(a)(1)(ii) contains special rules for apportioning taxes among categories of income when the income on which the foreign tax is imposed includes income in more than one category. It also provides special rules for allocating a foreign tax that is imposed on an item that would be income under U.S. tax principles in another year (timing difference) or an item that does not constitute income under U.S. tax principles (base differences).

A number of comments were received requesting clarification of the §1.904-6 principles that apply for purposes of these regulations. In particular, commentators requested guidance concerning the applicability of the related party interest expense rule in §1.904-6(a)(1)(ii), timing and base differences, and inter-branch payments.

The final regulations retain the rule that the determination of the income to which a CFTE relates is made in accordance with the principles of §1.904-6. In response to the comments, however, the final regulations contain several clarifications and modifications regarding how the principles of §1.904-6 apply in allocating foreign taxes to CFTE categories. The final regulations clarify that in applying §1.904-6 for purposes of the safe harbor, the relevant categories are the CFTE categories determined under the rules described in section B in this preamble. Therefore, the final regulations clarify that application of the principles of §1.904-6 requires a CFTE to be allocated to a CFTE category if the net income on which the tax is imposed (the net income recognized for foreign tax purposes) is in the CFTE category. The final regulations also provide guidance on (a) the apportionment rule in §1.904-6(a)(1)(ii), (b) the rules for timing differences, (c) the rules for base differences and (d) the treatment of inter-branch payments.

1. Apportionment of CFTEs

Section 1.904-6(a)(1)(ii) provides that where foreign taxes are imposed on income that relates to more than one separate category, the foreign taxes must be apportioned among the separate categories pro rata based on the amount of net income in each category. Subject to a special rule for related party interest expense, the net income in each category generally is determined under foreign law. If foreign

law does not provide rules for the allocation and apportionment of expenses, losses or other deductions to a particular category of income, then such items must be allocated and apportioned in accordance with the rules of §§1.861-8 through 1.861-14T.

Commentators requested clarification that the apportionment rule in §1.904-6(a)(1)(ii), which apportions foreign taxes among categories based on relative amounts of net income as determined under foreign law, applies for purposes of apportioning taxes among the categories of income created by the partnership agreement. Commentators recommended that the related party interest expense rule be disregarded for purposes of the apportionment rule.

In response to these comments, the final regulations clarify that the principles of §1.904-6(a)(1)(ii) require a taxpayer to apportion foreign taxes among the CFTE categories based on the relative amounts of net income as determined under foreign law in each CFTE category. In addition, the final regulations modify the apportionment rule in two respects. See §1.704-(b)(4)(viii)(d)(1).

The final regulations adopt the recommendation to disregard the related party interest expense rule contained in §1.904-6(a)(1)(ii) for purposes of apportioning taxes among the CFTE categories on the basis of foreign net income. The IRS and the Treasury Department agree that this rule, which coordinates the characterization of taxes and income for section 904(d) purposes, is not relevant for purposes of apportioning CFTEs to CFTE categories. Rather, the apportionment of CFTEs is based on the partnership income, as determined under foreign law, in the CFTE categories, which may include partnership items in one or more section 904(d) categories.

The final regulations also provide that if foreign law does not provide rules for the

allocation and apportionment of expenses, losses or other deductions allowed under foreign law to a CFTE category of income, then such expenses, losses or other deductions must be allocated and apportioned to gross income as determined under foreign law in a manner that is consistent with the allocation and apportionment of such items for purposes of determining the net income in the CFTE category for U.S. tax purposes.

2. Timing differences

A timing difference arises when an item subject to foreign tax is recognized as income under U.S. tax principles in a different year. The temporary and proposed regulations did not contain a specific textual rule regarding the application of the timing difference rule of §1.904-6(a)(1)(iv) in the context of section 704(b). However, the temporary and proposed regulations included an example that involved a timing difference (Example 27), which indicated that a current year CFTE attributable to an item of income recognized in the prior year for U.S. tax purposes related to, and thus must be allocated in accordance with, the income allocated under the partnership agreement in the prior year.

Upon further consideration, the IRS and the Treasury Department have concluded that relating foreign taxes paid or accrued in one year to income recognized for U.S. tax purposes in another year would be difficult for taxpayers to comply with and for the IRS to administer. In many instances, it would be difficult to identify accurately the extent of timing differences and the years in which such differences would be reversed. Moreover, where income allocations change from year to year, it often would be impossible for partnerships to determine how the partners would share related U.S.

income in subsequent years. Accordingly, the final regulations provide for a more administrable rule that requires the partnership to allocate a CFTE attributable to a timing difference among the partners in the same proportions as the allocations of income recognized for U.S. tax purposes in the relevant CFTE category in the year such taxes are paid or accrued. See paragraph (b)(5) Example 23 (reflecting modifications to Example 27 in the temporary and proposed regulations). This approach should result in allocations of CFTEs that are generally in proportion to the partners' distributive shares of U.S. taxable income over time, and therefore is consistent with the underlying purposes of the foreign tax credit rules to mitigate double taxation. See the discussion at section E in this preamble under "Partners' Interests in the Partnership" for cases in which the partnership agreement allocates CFTEs attributable to a timing difference among the partners in proportion to allocations of U.S. income in an earlier or later year when the income with respect to which the foreign tax is imposed is recognized for U.S. tax purposes.

In addition, the final regulations expressly incorporate the timing difference rule of §1.904-6(a)(1)(iv). Therefore, a CFTE attributable to a timing difference is allocated to the CFTE category to which the income would be assigned if the income were recognized for U.S. tax purposes in the year in which the foreign tax is imposed.

3. Base differences

A base difference arises when an item subject to foreign tax is not income under U.S. tax principles. Several commentators observed that the base difference rule under §1.904-6(a)(1)(iv) provides little indication of how a CFTE attributable to a base difference should be allocated for purposes of the safe harbor. The IRS and the

Treasury Department agree that this issue should be clarified. In the absence of any income to which such a CFTE relates, the final regulations provide that a CFTE attributable to a base difference is related to the income recognized for U.S. tax purposes in the relevant CFTE category in the year such taxes are paid or accrued. For this purpose, a CFTE attributable to a base difference is allocated and apportioned to the CFTE category that includes the partnership items attributable to the activity with respect to which the creditable foreign tax is imposed. Thus, the final regulations adopt similar rules for dealing with timing and base differences. These changes are intended to provide greater certainty for taxpayers and simplify the administration of the safe harbor.

4. Inter-branch transactions

Several commentators requested additional guidance regarding the application of the final regulations to transactions between branches (including disregarded entities owned by the partnership) that are disregarded for U.S. tax purposes. In response to this comment, the final regulations provide that if a branch of the partnership (including a disregarded entity owned by the partnership) is required to include in income under foreign law a payment (inter-branch payment) it receives from the partnership or another branch of the partnership, any CFTE imposed with respect to the payment relates to the income in the CFTE category that includes the items attributable to the recipient. In cases where the partnership agreement results in more than one CFTE category with respect to the recipient, such tax is allocated to the CFTE category that includes the items attributable to the activity to which the inter-branch payment relates. A similar rule applies to payments received by the partnership from a branch of the

partnership. This rule is consistent with the timing and base difference rules in the final regulations because it associates foreign tax imposed on the recipient with net income of the recipient as determined under U.S. tax principles, notwithstanding differences in U.S. and foreign tax rules. Like the timing and base difference rules, this rule avoids the need for complex tracing rules.

It is possible that this approach might result in distortions of the effective foreign tax rates on the partners' distributive shares of income in certain cases. Nevertheless, the IRS and the Treasury Department have concluded that imposing a requirement to trace taxes imposed on the recipient with respect to such inter-branch payments to income recognized under U.S. tax principles by the payor would be difficult for taxpayers to comply with and for the IRS to administer.

Some commentators recommended that at least in cases where the income allocations take such inter-branch payments into account in determining the partners' distributive shares of income, the allocation of CFTEs should be respected if made in proportion to income allocations that reflect such payments. The final regulations do not adopt this comment, as the approach suggested by these commentators would require taxpayers and the IRS to identify the inter-branch payments and relate such amounts to items of income of the payor and to CFTEs imposed on the recipient to substantiate that CFTEs of the payor and recipient were properly allocated. The IRS and the Treasury Department concluded that this approach would be difficult to administer and was therefore ill-suited to inclusion in a safe harbor. See the discussion at section E under "Partners' Interests in the Partnership" for cases in which the partnership agreement allocates partnership items of income to reflect inter-branch payments.

E. Partners' Interests in the Partnership

Some commentators suggested that allocations of CFTEs that are not proportionate to allocations of the related income (and therefore fail to satisfy the safe harbor) will nevertheless be valid as in accordance with the partners' interests in the partnership standard of §1.704-1(b)(3). According to these commentators, the partners' interests in the partnership with respect to a CFTE are conclusively determined by the manner in which the CFTE is allocated under the partnership agreement. The IRS and the Treasury Department believe that this view of the partners' interests in the partnership is incorrect, particularly in the context of a CFTE that is allocated to a partner who can use the associated foreign tax credit. In such a situation, the partner is relieved of a corresponding amount of U.S. tax, and thus does not bear the economic burden of the CFTE. Because of this lack of economic burden, the allocation of the CFTE is meaningless in the determination of the partners' interests in the partnership with respect to the CFTE and with respect to any other partnership item that has a material effect on the amount of CFTE that would be allocated to a partner under the safe harbor of the final regulations. Consequently, the final regulations clarify that in determining the partners' interests in the partnership with respect to an allocation of a partnership item, the allocation of the CFTE itself must be disregarded. This rule does not apply where the partners to whom the taxes are allocated reasonably expect to claim a deduction for such taxes in determining their U.S. tax liabilities.

As indicated in the preamble to the temporary regulations, the IRS and the Treasury Department believe that only in unusual circumstances (such as where the CFTEs are deducted and not credited) will allocations that fail to satisfy the safe harbor

be in accordance with the partners' interests in the partnership. As discussed in this preamble, for administrative reasons, the final regulations do not adopt a tracing approach for timing differences or inter-branch payments. Allocations of foreign taxes in such situations that are based on a tracing approach may constitute an unusual situation where the safe harbor is not satisfied, but the allocations are in accordance with the partners' interests in the partnership.

When a CFTE is attributable to a timing difference, the CFTE category to which the CFTE is allocated may or may not have income for U.S. tax purposes in the year the foreign tax is paid or accrued. In either case, allocations of such CFTEs that are proportionate to allocations of the income at the time such income is recognized for U.S. tax purposes may not qualify for safe harbor treatment, but nonetheless be in accordance with the partners' interests in the partnership.

Allocations of CFTEs imposed on the payor of an inter-branch payment may fail the safe harbor, but nonetheless be in accordance with the partners' interests in the partnership if the allocations of the CFTEs are in the same proportions as the allocations of the income of the payor, other than income that is eliminated from the foreign tax base because the inter-branch payment is deductible under foreign law. See paragraph (b)(5) Example 24 (iv). Similarly, allocations of CFTEs imposed on the recipient with respect to an inter-branch payment may fail the safe harbor, but nonetheless be in accordance with the partners' interests in the partnership, if such allocations are proportionate to the allocations of income recognized for U.S. tax purposes out of which the payment is made. See paragraph (b)(5) Example 24 (iii).

Several commentators also requested guidance regarding whether a reallocation

of CFTEs will cause the IRS to reallocate other partnership items so that the partners' ending capital account balances will remain unchanged. If the reallocation of the CFTEs causes the partners' capital accounts not to reflect their contemplated economic arrangement, the partners may need to reallocate other partnership items to ensure the tax consequences of the partnership allocations are consistent with their contemplated economic arrangement. Consistent with the principles of the proposed and temporary regulations, the final regulations clarify that the IRS generally will not reallocate other partnership items in the year in which a CFTE is reallocated. See paragraph (b)(5) Example 25 (ii). This treatment is also consistent with the results arising from and approach taken with respect to reallocations of other items of income, gain, loss or deduction that are not sustained under section 704(b). The IRS and the Treasury Department believe the parties and not the government should determine what allocations should be changed to reflect their economic arrangement.

F. Effective Date and Transition Rule

The provisions of these final regulations generally apply for partnership taxable years beginning on or after October 19, 2006. A transition rule is provided for existing partnerships. Under the transition rule, if a partnership agreement was entered into before April 21, 2004, then the partnership may apply the provisions of §1.704-1(b) as if the amendments made by these final regulations had not occurred. If the partnership agreement is materially modified on or after April 21, 2004, however, transition relief is no longer afforded, and the rules of §1.704-1T(b)(4)(xi) or these final regulations apply, depending upon the date on which the material modification occurs and the tax year at issue. For this purpose, a material modification includes any change in ownership of

the partnership. This transition rule does not apply if, as of April 20, 2004, persons that are related to each other (within the meaning of sections 267(b) and 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party. However, taxpayers may rely on the provisions of paragraph (b)(4)(viii) of this section for partnership taxable years beginning on or after April 21, 2004.

As stated in this preamble, the temporary and proposed regulations included a limited transition relief provision which ceases to apply upon a material modification of the partnership agreement, including any change in ownership. In addition, transition relief was not provided to partnerships owned by related parties who collectively have the power to amend the partnership agreement. One commentator requested that the IRS and the Treasury Department consider modifying the transition relief provision to indicate that a change in ownership is not a material modification unless there is more than a 50 percent change in ultimate beneficial ownership over a three-year period. The commentator also requested that the final regulations include a rule providing transition relief to partnerships owned by related parties who collectively have the power to amend the partnership agreement only in a way that does not adversely impact unrelated partners.

After careful consideration of these comments, the IRS and the Treasury Department have decided not to expand the transition relief described in the proposed and temporary regulations. Accordingly, the final regulations do not adopt these comments.

G. Other Comments

One commentator suggested that where the partners are unrelated, the safe

harbor should permit the partnership to allocate CFTEs in the same proportion as all other partnership expenses (rather than in proportion to related income). Section 1.704-1(b)(4)(ii) requires partnership credits to be allocated in the same proportions as items giving rise to the credits. Allocating CFTEs in proportion to other partnership expenses would be inconsistent with §1.704-1(b)(4)(ii). Moreover, such an approach would result in the inappropriate separation of CFTEs from the income to which such CFTEs relate. Thus, the final regulations do not incorporate this comment.

The temporary and proposed regulations provided that the safe harbor is available if the partnership agreement satisfied the requirements of §1.704-1(b)(2)(ii)(b) or (d) (capital account maintenance, liquidation according to capital accounts, and either deficit restoration obligation or qualified income offsets) and the partnership agreement provided for the allocation of the CFTE in proportion to the partner's distributive share of partnership income. Commentators suggested that the safe harbor also should be available if the partnership allocations satisfy the economic effect equivalence standard of §1.704-1(b)(2)(ii)(i).

The purpose of the safe harbor is to provide assurance that allocations of CFTEs will be respected if the CFTEs are allocated in proportion to the income to which such CFTEs relate. This purpose is satisfied as long as CFTEs are allocated in proportion to valid allocations of net income, regardless of whether the partnership maintains capital accounts or liquidates in accordance with them. Accordingly, the final regulations adopt these comments by eliminating the requirement that the partnership allocations satisfy the requirements of §1.704-1(b)(2)(ii)(b) or (d), and instead condition eligibility for the safe harbor on the validity of income allocations, as described in this preamble.

One commentator suggested that the final regulations clarify that the underlying allocation of income to which the foreign tax relates itself must be valid in order to qualify for the safe harbor. The commentator pointed out that an income allocation may be valid because it has substantial economic effect, or because it is in accordance with (or is deemed to be in accordance with) the partners' interests in the partnership. If income allocations are not valid, allocations of CFTEs based on such allocations will not be in proportion to the income to which the CFTEs relate. Accordingly, it is appropriate to clarify that the allocations of other items must be valid. However, the IRS and the Treasury Department believe that invalid allocations of other items should not disqualify allocations of CFTEs for safe harbor treatment unless the invalid allocations, in the aggregate, materially affect the allocation of CFTEs. Therefore, the final regulations provide that allocations of CFTEs may qualify for safe harbor treatment so long as allocations of all other partnership items that, in the aggregate, have a material effect on the amount of CFTEs allocated to the partners are valid.

Commentators suggested that the safe harbor should be available if the partnership agreement is silent with regard to the allocation of CFTEs, but actual allocations of CFTEs are made in proportion to related income. The IRS and the Treasury Department agree. Accordingly, the final regulations allow safe harbor treatment if the CFTE is allocated (whether or not pursuant to an express provision in the partnership agreement) and reported on the partnership return in proportion to the distributive shares of income to which the CFTE relates.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory

action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of this regulation are Timothy J. Leska, Office of the Associate Chief Counsel (Passthroughs & Special Industries) and Michael I. Gilman, Office of the Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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

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

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

1. Paragraph (b)(0) is amended by redesignating the entry in the table of contents for §1.704-1(b)(4)(xi) as the entry for §1.704-1(b)(4)(viii) and by adding entries following the entry for §1.704-1(b)(4)(viii). The entries for §§1.704-1(b)(4)(ix) and 1.704-1(b)(4)(x) are removed.

2. The heading and text of paragraphs (b)(1)(ii)(b) and (b)(5) Examples 25 through 28 are revised.

3. Paragraphs (b)(3)(iv), (b)(4)(viii) and (b)(5) Examples 20 through 24 are added.

4. Paragraph (b)(4)(xi) is removed.

The additions and revisions read as follows:

§1.704-1 Partner's distributive share.

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(b) * * * (0) * * *

Heading	Section
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Allocation of creditable foreign taxes	1.704-1(b)(4)(viii)
In general	1.704-1(b)(4)(viii)(a)
Creditable foreign tax	
expenditures (CFTEs)	1.704-1(b)(4)(viii)(b)
Income to which CFTEs relate.....	1.704-1(b)(4)(viii)(c)
In general	1.704-1(b)(4)(viii)(c)(1)
CFTE category	1.704-1(b)(4)(viii)(c)(2)
Net income in a CFTE	
category	1.704-1(b)(4)(viii)(c)(3)
Distributive shares of	
income	1.704-1(b)(4)(viii)(c)(4)
No net income in a CFTE	
category	1.704-1(b)(4)(viii)(c)(5)
Allocation and apportionment of	
CFTEs to CFTE categories	1.704-1(b)(4)(viii)(d)

In general	1.704-1(b)(4)(viii)(d)(1)
Timing and base differences.....	1.704-1(b)(4)(viii)(d)(2)
Special rules for inter-branch payments.....	1.704-1(b)(4)(viii)(d)(3)

* * * * *

(1) * * *

(ii) * * *

(b) Rules relating to foreign tax expenditures--(1) In general. The provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section (regarding the allocation of creditable foreign taxes) apply for partnership taxable years beginning on or after October 19, 2006. The rules that apply to allocations of creditable foreign taxes made in partnership taxable years beginning before October 19, 2006 are contained in §§1.704-1T(b)(1)(ii)(b)(1) and 1.704-1T(b)(4)(xi) as in effect prior to October 19, 2006 (see 26 CFR part 1 revised as of April 1, 2005). However, taxpayers may rely on the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section for partnership taxable years beginning on or after April 21, 2004.

(2) Transition rule. Transition relief is provided herein to partnerships whose agreements were entered into prior to April 21, 2004. In such case, if there has been no material modification to the partnership agreement on or after April 21, 2004, then the partnership may apply the provisions of paragraph (b) of this section as if the amendments made by paragraphs (b)(3)(iv) and (b)(4)(viii) of this section had not occurred. If the partnership agreement was materially modified on or after April 21, 2004, then the rules provided in paragraphs (b)(3)(iv) and (b)(4)(viii) of this section shall apply to the later of the taxable year beginning on or after October 19, 2006, or the taxable year within which the material modification occurred, and to all subsequent

taxable years. If the partnership agreement was materially modified on or after April 21, 2004, and before a tax year beginning on or after October 19, 2006, see §§1.704-1T(b)(1)(ii)(b)(1) and 1.704-1T(b)(4)(xi) as in effect prior to October 19, 2006 (26 CFR part 1 revised as of April 1, 2005). For purposes of this paragraph (b)(1)(ii)(b)(2), any change in ownership constitutes a material modification to the partnership agreement. This transition rule does not apply to any taxable year (and all subsequent taxable years) in which persons that are related to each other (within the meaning of section 267(b) and 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party.

* * * * *

(3) * * *

(iv) Special rule for creditable foreign tax expenditures. In determining whether an allocation of a partnership item is in accordance with the partners' interests in the partnership, the allocation of the creditable foreign tax expenditure (CFTE) (as defined in paragraph (b)(4)(viii)(b) of this section) must be disregarded. This paragraph (b)(3)(iv) shall not apply to the extent the partners to whom such taxes are allocated reasonably expect to claim a deduction for such taxes in determining their U.S. tax liabilities.

(4) * * *

(viii) Allocation of creditable foreign taxes--(a) In general. Allocations of creditable foreign taxes do not have substantial economic effect within the meaning of paragraph (b)(2) of this section and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership. See paragraph (b)(3)(iv) of

this section. An allocation of a creditable foreign tax expenditure (CFTE) will be deemed to be in accordance with the partners' interests in the partnership if--

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

(2) Allocations of all other partnership items that, in the aggregate, have a material effect on the amount of CFTEs allocated to a partner pursuant to paragraph (b)(4)(viii)(a)(1) of this section are valid.

(b) Creditable foreign tax expenditures (CFTEs). For purposes of this section, a CFTE is a foreign tax paid or accrued by a partnership that is eligible for a credit under section 901(a) or an applicable U.S. income tax treaty. A foreign tax is a CFTE for these purposes without regard to whether a partner receiving an allocation of such foreign tax elects to claim a credit for such tax. Foreign taxes paid or accrued by a partner with respect to a distributive share of partnership income, and foreign taxes deemed paid under section 902 or 960 by a corporate partner with respect to stock owned, directly or indirectly, by or for a partnership, are not taxes paid or accrued by a partnership and, therefore, are not CFTEs subject to the rules of this section. See paragraphs (e) and (f) of §1.901-2 for rules for determining when and by whom a foreign tax is paid or accrued.

(c) Income to which CFTEs relate--(1) In general. For purposes of paragraph (b)(4)(viii)(a) of this section, CFTEs are related to net income in the partnership's CFTE category or categories to which the CFTE is allocated and apportioned in accordance with the rules of paragraph (b)(4)(viii)(d) of this section. Paragraph (b)(4)(viii)(c)(2) of

this section provides rules for determining a partnership's CFTE categories. Paragraph (b)(4)(viii)(c)(3) of this section provides rules for determining the net income in each CFTE category. Paragraph (b)(4)(viii)(c)(4) of this section provides guidance in determining a partner's distributive share of income in a CFTE category. Paragraph (b)(4)(viii)(c)(5) of this section provides a special rule for allocating CFTEs when a partnership has no net income in a CFTE category.

(2) CFTE category--(i) Income from activities. A CFTE category is a category of net income (or loss) attributable to one or more activities of the partnership. Net income (or loss) from all the partnership's activities shall be included in a single CFTE category unless the allocation of net income (or loss) from one or more activities differs from the allocation of net income (or loss) from other activities, in which case income from each activity or group of activities that is subject to a different allocation shall be treated as net income (or loss) in a separate CFTE category.

(ii) Different allocations. Different allocations of net income (or loss) generally will result from provisions of the partnership agreement providing for different sharing ratios for net income (or loss) from separate activities. Different allocations of net income (or loss) from separate activities generally will also result if any partnership item is shared in a different ratio than any other partnership item. A guaranteed payment described in paragraph (b)(4)(viii)(c)(3)(ii) of this section, gross income allocation, or other preferential allocation will result in different allocations of net income (or loss) from separate activities only if the amount of the payment or the allocation is determined by reference to income from less than all of the partnership's activities. For purposes of this paragraph (b)(4)(viii)(c)(2), a partnership item shall not include any item

that is excluded from income attributable to an activity pursuant to the second sentence of paragraph (b)(4)(viii)(c)(3)(ii) of this section (relating to allocations or payments that result in a deduction under foreign law).

(iii) Activity. Whether a partnership has one or more activities, and the scope of each activity, shall be determined in a reasonable manner taking into account all the facts and circumstances. In evaluating whether aggregating or disaggregating income from particular business or investment operations constitutes a reasonable method of determining the scope of an activity, the principal consideration is whether the proposed determination has the effect of separating CFTEs from the related foreign income. Accordingly, relevant considerations include whether the partnership conducts business in more than one geographic location or through more than one entity or branch, and whether certain types of income are exempt from foreign tax or subject to preferential foreign tax treatment. In addition, income from a divisible part of a single activity shall be treated as income from a separate activity if necessary to prevent separating CFTEs from the related foreign income. The partnership's activities must be determined consistently from year to year absent a material change in facts and circumstances.

(3) Net income in a CFTE category--(i) In general. The net income in a CFTE category means the net income for U.S. Federal income tax purposes, determined by taking into account all partnership items attributable to the relevant activity or group of activities, including items of gross income, gain, loss, deduction, and expense and items allocated pursuant to section 704(c). The items of gross income attributable to an activity shall be determined in a consistent manner under any reasonable method taking into account all the facts and circumstances. Except as otherwise provided below,

expenses, losses or other deductions shall be allocated and apportioned to gross income attributable to an activity in accordance with the rules of §§1.861-8 and 1.861-8T. Under these rules, if an expense, loss or other deduction is allocated to gross income from more than one activity, such expense, loss or deduction must be apportioned among each such activity using a reasonable method that reflects to a reasonably close extent the factual relationship between the deduction and the gross income from such activities. See §1.861-8T(c). For purposes of determining net income in a CFTE category, the partnership's interest expense and research and experimental expenditures described in section 174 may be allocated and apportioned under any reasonable method, including but not limited to the methods prescribed in §1.861-9 through §1.861-13T (interest expense) and §1.861-17 (research and experimental expenditures). For purposes of determining the net income attributable to any activity of a branch, the only items of gross income taken into account in applying this paragraph (b)(4)(viii)(c)(3) are those items of gross income recognized by the branch for U.S. income tax purposes. See paragraph (b)(5) Example 24 of this section (relating to inter-branch payments).

(ii) Special rules. Income attributable to an activity shall include the amount included in a partner's income as a guaranteed payment (within the meaning of section 707(c)) from the partnership to the extent that the guaranteed payment is not deductible by the partnership under foreign law. See paragraph (b)(5) Example 25 (iv) of this section. Except for an inter-branch payment described in paragraph (b)(4)(viii)(d)(3) of this section, income attributable to an activity shall not include an item of partnership income to the extent the allocation of such item of income (or payment thereof) results

in a deduction under foreign law. See paragraph (b)(5) Example 25 (iii) and (iv) of this section. Similarly, income attributable to an activity shall not include net income that foreign law would exclude from the foreign tax base as a result of the status of a partner. See paragraph (b)(5) Example 27 of this section.

(4) Distributive shares of income. For purposes of paragraph (b)(4)(viii)(a)(1) of this section, distributive share of income means the net income from each CFTE category, determined in accordance with paragraph (b)(4)(viii)(c)(3) of this section, that is allocated to a partner. A guaranteed payment shall be treated as a distributive share of income for purposes of paragraph (b)(4)(viii)(a)(1) of this section to the extent that the guaranteed payment is treated as income attributable to an activity pursuant to paragraph (b)(4)(viii)(c)(3)(ii) of this section. See paragraph (b)(5) Example 25 (iv) of this section. If more than one partner receives positive income allocations (income in excess of expenses) from a CFTE category, which in the aggregate exceed the total net income in the CFTE category, then for purposes of paragraph (b)(4)(viii)(a)(1) of this section such partner's distributive share of income from the CFTE category shall equal the partner's positive income allocation from the CFTE category, divided by the aggregate positive income allocations from the CFTE category, multiplied by the net income in the CFTE category.

(5) No net income in a CFTE category. If a CFTE is allocated or apportioned to a CFTE category that does not have net income for the year in which the foreign tax is paid or accrued, the CFTE shall be deemed to relate to the aggregate of the net income (disregarding net losses) recognized by the partnership in that CFTE category in each of the three preceding taxable years. Accordingly, except as provided below, such

CFTE must be allocated in the current taxable year in the same proportion as the allocation of the aggregate net income for the prior three-year period in order to satisfy the requirements of paragraph (b)(4)(viii)(a)(1) of this section. If the partnership does not have net income in the applicable CFTE category in either the current year or any of the previous three taxable years, the CFTE must be allocated in the same proportion that the partnership reasonably expects to allocate the aggregate net income (disregarding net losses) in the CFTE category for the succeeding three taxable years. If the partnership does not reasonably expect to have net income in the CFTE category for the succeeding three years and the partnership has net income in one or more other CFTE categories for the year in which the foreign tax is paid or accrued, the CFTE shall be deemed to relate to such other net income and must be allocated in proportion to the allocations of such other net income. If any CFTE is not allocated pursuant to the above provisions of this paragraph then the CFTE must be allocated in proportion to the partners' outstanding capital contributions.

(d) Allocation and apportionment of CFTEs to CFTE categories--(1) In general. CFTEs are allocated and apportioned to CFTE categories in accordance with the principles of §1.904-6. Under these principles, a CFTE is related to income in a CFTE category if the income is included in the base upon which the foreign tax is imposed. In accordance with §1.904-6(a)(1)(ii) as modified by this paragraph (b)(4)(viii)(d), if the foreign tax base includes income in more than one CFTE category, the CFTEs are apportioned among the CFTE categories based on the relative amounts of taxable income computed under foreign law in each CFTE category. For purposes of this paragraph (b)(4)(viii)(d), references in §1.904-6 to a separate category or separate

categories shall mean “CFTE category” or “CFTE categories” and the rules in §1.904-6(a)(1)(ii) are modified as follows:

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

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

(2) Timing and base differences. A foreign tax imposed on an item that would be income under U.S. tax principles in another year (a timing difference) is allocated to the CFTE category that would include the income if the income were recognized for U.S. tax purposes in the year in which the foreign tax is imposed. A foreign tax imposed on an item that would not constitute income under U.S. tax principles in any year (a base difference) is allocated to the CFTE category that includes the partnership items attributable to the activity with respect to which the foreign tax is imposed. See paragraph (b)(5) Example 23 of this section.

(3) Special rules for inter-branch payments. Notwithstanding any other provision of this paragraph (d), the rules of this paragraph (b)(4)(viii)(d)(3) shall apply if a branch (including an entity described in §301.7701-2(c)(2)(i) of this chapter) of the partnership

is required to include in income under foreign law a payment it receives from another branch of the partnership. The foreign tax imposed on such payments (“inter-branch payments”) is allocated to the CFTE category that includes the items attributable to the relevant activities of the recipient branch. In cases where the partnership agreement results in more than one CFTE category with respect to activities of the recipient branch, such tax is allocated to the CFTE category that includes the items attributable to the activity to which the inter-branch payment relates. The rules of this paragraph (b)(4)(viii)(d)(3) shall also apply to payments between a partnership and a branch of the partnership. See paragraph (b)(5) Example 24 of this section.

* * *

(xi) [Reserved].

(5) * * *

Example 20. (i) A and B form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and earns income from passive investments in country X. Country X imposes a 40 percent tax on business M income, which tax is a CFTE, but exempts from tax income from passive investments. In 2007, AB earns \$100,000 of income from business M and \$30,000 from passive investments and pays or accrues \$40,000 of country X taxes. For purposes of section 904(d), the income from business M is general limitation income and the income from the passive investments is passive income. Pursuant to the partnership agreement, all partnership items, including CFTEs, from business M are allocated 60 percent to A and 40 percent to B, and all partnership items, including CFTEs, from passive investments are allocated 80 percent to A and 20 percent to B. Accordingly, A is allocated 60 percent of the business M income (\$60,000) and 60 percent of the country X taxes (\$24,000), and B is allocated 40 percent of the business M income (\$40,000) and 40 percent of the country X taxes (\$16,000). The income from the passive investments is allocated \$24,000 to A and \$6,000 to B. Assume that allocations of all items other than CFTEs are valid.

(ii) Because the partnership agreement provides for different allocations of the net income attributable to business M and the passive investments, the net income attributable to each is income in a separate CFTE category. See paragraph (b)(4)(viii)(c)(2) of this section. AB must determine the net income in each CFTE category and the CFTEs allocable to each CFTE category. Under paragraph

(b)(4)(viii)(c)(3) of this section, the net income in the business M CFTE category is the \$100,000 attributable to business M and the net income in the passive investments CFTE category is the \$30,000 attributable to the passive investments. Under paragraph (b)(4)(viii)(d) of this section, the \$40,000 of country X taxes is allocated to the business M CFTE category and no portion of the country X taxes is allocated to the passive investments CFTE category. Therefore, the \$40,000 of country X taxes are related to the \$100,000 of net income in the business M CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the net income from the business M CFTE category 60 percent to A and 40 percent to B, and the country X taxes 60 percent to A and 40 percent to B, the allocations of the CFTEs are in proportion to the distributive shares of income to which the CFTEs relate. Because AB satisfies the requirement of paragraph (b)(4)(viii) of this section, the allocations of the country X taxes are deemed to be in accordance with the partners' interests in the partnership. Because the business M income is general limitation income, all \$40,000 of taxes are attributable to the general limitation category. See §1.904-6.

Example 21. (i) A and B form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and business N in country Y. Country X imposes a 40 percent tax on business M income, country Y imposes a 20 percent tax on business N income, and the country X and country Y taxes are CFTEs. In 2007, AB has \$100,000 of income from business M and \$50,000 of income from business N. Country X imposes \$40,000 of tax on the income from business M and country Y imposes \$10,000 of tax on the income of business N. Pursuant to the partnership agreement, all partnership items, including CFTEs, from business M are allocated 75 percent to A and 25 percent to B, and all partnership items, including CFTEs, from business N are split evenly between A and B (50 percent each). Accordingly, A is allocated 75 percent of the income from business M (\$75,000), 75 percent of the country X taxes (\$30,000), 50 percent of the income from business N (\$25,000), and 50 percent of the country Y taxes (\$5,000). B is allocated 25 percent of the income from business M (\$25,000), 25 percent of the country X taxes (\$10,000), 50 percent of the income from business N (\$25,000), and 50 percent of the country Y taxes (\$5,000). Assume that allocations of all items other than CFTEs are valid. The income from business M and business N is general limitation income for purposes of section 904(d).

(ii) Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each business is income in a separate CFTE category even though all of the income is in the general limitation category for section 904(d) purposes. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the business M CFTE category is the \$100,000 attributable to business M and the net income in the business N CFTE category is \$50,000 attributable to business N. Under paragraph (b)(4)(viii)(d) of this section, the \$40,000 of country X taxes is allocated to the business M CFTE category and the \$10,000 of country Y taxes is allocated to the business N CFTE category. Therefore, the \$40,000 of country X taxes are related to

the \$100,000 of net income in the business M CFTE category and the \$10,000 of country Y taxes are related to the \$50,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the \$40,000 of country X taxes in the same proportion as the net income in the business M CFTE category, and the \$10,000 of country Y taxes in the same proportion as the net income in the business N CFTE category, the allocations of the country X taxes and the country Y taxes are in proportion to the distributive shares of income to which the foreign taxes relate. Because AB satisfies the requirements of paragraph (b)(4)(viii) of this section, the allocations of the country X and country Y taxes are deemed to be in accordance with the partners' interests in the partnership.

Example 22. (i) The facts are the same as in Example 21, except that the partnership agreement provides for the following allocations. Depreciation attributable to machine X, which is used in business M, is allocated 100 percent to A. B is allocated the first \$20,000 of gross income attributable to business N, which allocation does not result in a deduction under foreign law. All remaining items, except CFTEs, are allocated 50 percent to A and 50 percent to B. For 2007, assume that business M generates \$120,000 of income, before taking into account depreciation attributable to machine X. The total amount of depreciation attributable to machine X is \$20,000, which results in \$100,000 of net income attributable to business M for U.S. and country X tax purposes. Business N generates \$70,000 of gross income and has \$20,000 of expenses, resulting in \$50,000 of net income for U.S. and country Y tax purposes. Pursuant to the partnership agreement, A is allocated \$40,000 of the net income attributable to business M (\$60,000 of business M income less \$20,000 of depreciation attributable to machine X), and \$15,000 of the net income attributable to business N. B is allocated \$60,000 of the net income attributable to business M and \$35,000 of the net income attributable to business N (\$20,000 of gross income, plus \$15,000 of net income).

(ii) As a result of the special allocations, the net income attributable to business M (\$100,000) is allocated 40 percent to A and 60 percent to B. The net income attributable to business N (\$50,000) is allocated 30 percent to A and 70 percent to B. Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income from each of businesses M and N is income in a separate CFTE category. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the business M CFTE category is the \$100,000 of net income attributable to business M and the net income in the business N CFTE category is the \$50,000 of net income attributable to business N. Under paragraph (b)(4)(viii)(d)(1) of this section, the \$40,000 of country X taxes is allocated to the business M CFTE category and the \$10,000 of country Y taxes is allocated to the business N CFTE category. Therefore, the \$40,000 of country X taxes relates to the \$100,000 of net income in the business M CFTE and the \$10,000 of country Y taxes relates to the \$50,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. The allocations of the country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes

are allocated 40 percent to A and 60 percent to B. The allocations of the country Y taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 30 percent to A and 70 percent to B.

(iii) Assume that for 2008, all the facts are the same as in paragraph (i) of this Example 22, except that business M generates \$60,000 of income before taking into account depreciation attributable to machine X and country X imposes \$16,000 of tax on the \$40,000 of net income attributable to business M. Pursuant to the partnership agreement, A is allocated 25 percent of the income from business M (\$10,000), and B is allocated 75 percent of the income from business M (\$30,000). Allocations of the country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 25 percent to A and 75 percent to B.

Example 23. (i) The facts are the same as in Example 21, except that AB does not actually receive the \$50,000 of income accrued in 2007 with respect to business N until 2008 and AB accrues and receives an additional \$100,000 with respect to business N in 2008. Also assume that A, B, and AB each report taxable income on an accrual basis for U.S. tax purposes and AB reports taxable income using the cash receipts and disbursements method of accounting for country X and country Y purposes. In 2007, AB pays or accrues country X taxes of \$40,000. In 2008, AB pays or accrues country Y taxes of \$30,000. Pursuant to the partnership agreement, in 2007, A is allocated 75 percent of business M income (\$75,000) and country X taxes (\$30,000) and 50 percent of business N income (\$25,000). B is allocated 25 percent of business M income (\$25,000) and country X taxes (\$10,000) and 50 percent of business N income (\$25,000). In 2008, A and B are each allocated 50 percent of the business N income (\$50,000) and country Y taxes (\$15,000).

(ii) For 2007, the \$40,000 of country X taxes paid or accrued by AB relates to the \$100,000 of net income in the business M CFTE category. No portion of the country X taxes paid or accrued in 2007 relates to the \$50,000 of net income in the business N CFTE category. For 2008, the net income in the business N CFTE category is the \$100,000 attributable to business N. See paragraph (b)(4)(viii)(c)(3) of this section. Under paragraph (b)(4)(viii)(d)(1) of this section, \$20,000 of the country Y tax paid or accrued in 2008 is allocated to the business N CFTE category. The remaining \$10,000 of country Y tax is allocated to the business N CFTE category under paragraph (b)(4)(viii)(d)(2) of this section (relating to timing differences). Therefore, the \$30,000 of country Y taxes paid or accrued by AB in 2008 is related to the \$100,000 of net income in the business N CFTE category for 2008. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the \$40,000 of country X taxes and the \$30,000 of country Y taxes in proportion to the distributive shares of income to which the taxes relate, the allocations of the country X and country Y taxes satisfy the requirements of paragraphs (b)(4)(viii)(a)(1) and (2) of this section and the allocations of the country X and Y taxes are deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section.

Example 24. (i) The facts are the same as in Example 21, except that businesses M and N are conducted by entities (DE1 and DE2, respectively) that are corporations for country X and Y tax purposes and disregarded entities for U.S. tax purposes. Also, assume that DE1 makes payments of \$75,000 during 2007 to DE2 that are deductible by DE1 for country X tax purposes and includible in income of DE2 for country Y tax purposes. As a result of such payments, DE1 has taxable income of \$25,000 for country X purposes on which \$10,000 of taxes are imposed and DE2 has taxable income of \$125,000 for country Y purposes on which \$25,000 of taxes are imposed. For U.S. tax purposes, \$100,000 of AB's income is attributable to the activities of DE1 and \$50,000 of AB's income is attributable to the activities of DE2. Pursuant to the partnership agreement, all partnership items, including CFTEs, from business M are allocated 75 percent to A and 25 percent to B, and all partnership items, including CFTEs, from business N are split evenly between A and B (50 percent each). Accordingly, A is allocated 75 percent of the income from business M (\$75,000), 75 percent of the country X taxes (\$7,500), 50 percent of the income from business N (\$25,000), and 50 percent of the country Y taxes (\$12,500). B is allocated 25 percent of the income from business M (\$25,000), 25 percent of the country X taxes (\$2,500), 50 percent of the income from business N (\$25,000), and 50 percent of the country Y taxes (\$12,500).

(ii) Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each of business M and business N is income in separate CFTE categories. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3) of this section, the \$100,000 of net income attributable to business M is in the business M CFTE category and the \$50,000 of net income attributable to business N is in the business N CFTE category. Under paragraph (b)(4)(viii)(d)(1) of this section, the \$10,000 of country X taxes is allocated to the business M CFTE category and \$10,000 of the country Y taxes is allocated to the business N CFTE category. Under paragraph (b)(4)(viii)(d)(3) of this section, the additional \$15,000 of country Y tax imposed with respect to the inter-branch payment is assigned to the business N CFTE category. Therefore, the \$10,000 of country X taxes is related to the \$100,000 of net income in the business M CFTE category and the \$25,000 of country Y taxes is related to the \$50,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the \$10,000 of country X taxes in the same proportion as the distributive shares of income to which the taxes relate and the \$25,000 of country Y taxes in the same proportion as the distributive shares of income to which the taxes relate, AB satisfies the requirements of paragraph (b)(4)(viii) of this section and the allocations of the country X and country Y taxes are deemed to be in accordance with the partners' interests in the partnership. No inference is intended with respect to the application of other provisions to arrangements that involve disregarded payments. See paragraph (b)(1)(iii) of this section (relating to the effect of sections of the Internal Revenue Code other than section 704(b)).

(iii) Assume that the facts are the same as paragraph (i) of this Example 24, except that the partnership agreement provides that the \$15,000 of country Y tax imposed with respect to the inter-branch payment is allocated 75 percent to A (\$11,250) and 25 percent to B (\$3,750) and that the remaining \$10,000 of country Y tax is allocated 50 percent to A (\$5,000) and 50 percent to B (\$5,000). Thus, the country Y taxes are allocated 65 percent to A and 35 percent to B while the income in the business N CFTE category is allocated 50 percent to A and 50 percent to B. The allocations of the country Y tax are not deemed to be in accordance with the partners' interests because they are not in proportion to the allocations of the distributive shares of income from the business N CFTE category. However, upon sufficient substantiation that \$15,000 of country Y tax paid by DE2 with respect to the \$75,000 inter-branch payment relates to income that is recognized by DE1 for U.S. tax purposes, the allocations of the country Y taxes may be established to be actually in accordance with the partners' interests in the partnership. The allocations of the \$10,000 of country X taxes are deemed to be in accordance with the partners' interests in the partnership because the country X taxes are allocated in the same proportion as the distributive shares of income to which they relate.

(iv) Assume that the facts are the same as in paragraph (i) of this Example 24, except that in order to reflect the \$75,000 payment from DE1 to DE2, the partnership agreement allocates \$75,000 of the income attributable to business M equally between A and B (50 percent each). Therefore, the total income attributable to business M is allocated 56.25 percent to A (75 percent of \$25,000 plus 50 percent of \$75,000) and 43.75 percent to B (25 percent of \$25,000 and 50 percent of \$75,000). The allocation of the country X taxes (75 percent to A and 25 percent to B) is not deemed to be in accordance with the partners' interests because it is not in proportion to the allocations of the distributive shares of income from the business M CFTE category. However, upon sufficient substantiation that all \$10,000 of country X tax paid by DE1 relates to the \$25,000 of DE1's income that is shared in the same 75-25 ratio, the allocations of the country X taxes may be established to be actually in accordance with the partners' interests in the partnership. The allocations of the \$25,000 of country Y taxes are deemed to be in accordance with the partners' interests in the partnership because the country Y taxes are allocated in the same proportion as the distributive shares of income to which they relate.

Example 25. (i) A contributes \$750,000 and B contributes \$250,000 to form AB, an eligible entity (as defined in §301.7701-3(a) of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X. Country X imposes a 20 percent tax on the net income from business M, which tax is a CFTE. In 2007, AB earns \$300,000 of gross income, has deductible expenses of \$100,000, and pays or accrues \$40,000 of country X tax. Pursuant to the partnership agreement, the first \$100,000 of gross income each year is allocated to A as a return on excess capital contributed by A. All remaining partnership items, including CFTEs, are split evenly between A and B (50 percent each). The gross income allocation is not deductible in determining AB's taxable income under country X law. Assume that allocations of all items other than CFTEs are valid.

(ii) AB has a single CFTE category because all of AB's net income is allocated in the same ratio. See paragraph (b)(4)(viii)(c)(2). Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the single CFTE category is \$200,000. The \$40,000 of taxes is allocated to the single CFTE category and, thus, related to the \$200,000 of net income in the single CFTE category. In 2007, AB's partnership agreement allocates \$150,000 or 75 percent of the net income to A (\$100,000 attributable to the gross income allocation plus \$50,000 of the remaining \$100,000 of net income) and \$50,000 or 25 percent of the net income to B. AB's partnership agreement allocates the country X taxes in accordance with the partners' shares of partnership items remaining after the \$100,000 gross income allocation. Therefore, AB allocates the country X taxes 50 percent to A (\$20,000) and 50 percent to B (\$20,000). AB's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section, because they are not in proportion to the allocations of the distributive shares of income to which the country X taxes relate. Accordingly, the country X taxes will be reallocated according to the partners' interest in the partnership. Assuming that the partners do not reasonably expect to claim a deduction for the CFTE in determining their U.S. tax liabilities, a reallocation of the CFTEs under paragraph (b)(3) of this section would be 75 percent to A (\$30,000) and 25 percent to B (\$10,000). If the reallocation of the CFTEs causes the partners' capital accounts not to reflect their contemplated economic arrangement, the partners may need to reallocate other partnership items to ensure that the tax consequences of the partnership's allocations are consistent with their contemplated economic arrangement over the term of the partnership. The Commissioner will not reallocate other partnership items after the reallocation of the CFTEs.

(iii) The facts are the same as in paragraph (i) of this Example 25, except that the \$100,000 allocation of gross income is deductible under country X law and that AB pays or accrues \$20,000 of foreign tax. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the single CFTE category is the \$100,000 of net income, determined by disregarding the \$100,000 of gross income that is allocated to A and deductible in determining AB's taxable income under the law of country X. See paragraph (b)(4)(viii)(c)(3)(ii) of this section. The \$20,000 of country X tax is allocated to the single CFTE category, and, thus, related to the \$100,000 of net income in the single CFTE category. See paragraphs (b)(4)(viii)(c)(1) and (d) of this section. No portion of the tax is related to the \$100,000 of gross income allocated to A. Pursuant to the partnership agreement, AB allocates the country X taxes 50 percent to A (\$10,000) and 50 percent to B (\$10,000). AB's allocations of country X taxes are deemed to be in accordance with the partners' interests in the partnership under paragraph (b)(4)(viii) of this section.

(iv) The results in (ii) and (iii) of this Example 25 would be the same assuming all of the facts except that, rather than being a preferential gross income allocation, the \$100,000 was a guaranteed payment to A within the meaning of section 707(c). See paragraph (b)(4)(viii)(c)(3) of this section.

Example 26. (i) A and B form AB, an eligible entity (as defined in §301.7701-3(a)

of this chapter), treated as a partnership for U.S. tax purposes. AB operates business M in country X and business N in country Y. A, a U.S. corporation, contributes a building with a fair market value of \$200,000 and an adjusted basis of \$50,000 for both U.S. and country X purposes. The building contributed by A is used in business M. B, a country X corporation, contributes \$800,000 cash. The AB partnership agreement provides that AB will make allocations under section 704(c) using the traditional method under §1.704-3(b) and that all other items, excluding creditable foreign taxes, will be allocated 20 percent to A and 80 percent to B. The partnership agreement provides that creditable foreign taxes will be allocated in proportion to the partners' distributive shares of net income in each CFTE category, which shall be determined by taking into accounts items allocated pursuant to section 704(c). Country X and Country Y impose tax at a rate of 20 percent and 40 percent, respectively, and such taxes are CFTEs. In 2007, AB sells the building contributed by A for \$200,000, thereby recognizing taxable income of \$150,000 for U.S. and country X purposes, and recognizes \$250,000 of other income from the operation of business M. AB pays or accrues \$80,000 of country X tax on such income. Also in 2007, business N recognizes \$100,000 of taxable income for U.S. and country Y purposes and pays or accrues \$40,000 of country Y tax. Pursuant to the partnership agreement, A is allocated \$200,000 of business M income (\$150,000 of taxable income in accordance with section 704(c) and \$50,000 of other business M income) and \$40,000 of country X tax, and 20 percent of both business N income (\$20,000) and country Y tax (\$8,000). B is allocated \$200,000 of business M income and \$40,000 of country X tax and 80 percent of both the business N income (\$80,000) and country Y tax (\$32,000). Assume that allocations of all items other than CFTEs are valid.

(ii) The net income attributable to business M (\$400,000) is allocated 50 percent to A and 50 percent to B while the net income attributable to business N (\$100,000) is allocated 20 percent to A and 80 percent to B. Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each activity is income in a separate CFTE category. See paragraph (b)(4)(viii)(c)(2) of this section. Under paragraph (b)(4)(viii)(c)(3) of this section, the net income in the business M CFTE category is the \$400,000 of net income attributable to business M and the net income in the business N CFTE category is the \$100,000 of net income attributable to business N. Under paragraph (b)(4)(viii)(d)(1) of this section, the \$80,000 of country X tax is allocated to the business M CFTE category and the \$40,000 of country Y tax is allocated to the business N CFTE category. Therefore, the \$80,000 of country X tax relates to the \$400,000 of net income in the business M CFTE category and the \$40,000 of country Y tax relates to the \$100,000 of net income in the business N CFTE category. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the \$80,000 of country X taxes and \$40,000 of country Y taxes in proportion to the distributive shares of income to which such taxes relate, the allocations are deemed to be in accordance with the partners' interest in the partnership under paragraph (b)(4)(viii) of this section.

Example 27. (i) A, a U.S. citizen, and B, a country X citizen, form AB, a country X eligible entity (as defined in §301.7701-3(a) of this chapter), treated as

a partnership for U.S. tax purposes. AB's only activity is business M, which it operates in country X. Country X imposes a 40 percent tax on the portion of AB's business M income that is the allocable share of AB's owners that are not citizens of country X, which tax is a CFTE. The partnership agreement provides that all partnership items, excluding CFTEs, from business M are allocated 40 percent to A and 60 percent to B. CFTEs are allocated 100 percent to A. In 2007, AB earns \$100,000 of net income from business M and pays or accrues \$16,000 of country X taxes on A's allocable share of AB's income (\$40,000). Pursuant to the partnership agreement, A is allocated 40 percent of the business M income (\$40,000) and 100 percent of the country X taxes (\$16,000), and B is allocated 60 percent of the business M income (\$60,000) and no country X taxes. Assume that allocations of all items other than CFTEs are valid.

(ii) AB has a single CFTE category because all of AB's net income is allocated in the same ratio. See paragraph (b)(4)(viii)(c)(2). Under paragraph (b)(4)(viii)(c)(3) of this section, the \$40,000 of business M income that is allocated to A is included in the single CFTE category. Under paragraph (b)(4)(viii)(c)(3)(ii) of this section, no portion of the \$60,000 allocated to B is included in the single CFTE category. Under paragraph (b)(4)(viii)(d) of this section, the \$16,000 of taxes is allocated to the single CFTE category.

Therefore, the \$16,000 of country X taxes is related to the \$40,000 of net income in the single CFTE category that is allocated to A. See paragraph (b)(4)(viii)(c)(1) of this section. Because AB's partnership agreement allocates the country X taxes in proportion to the distributive share of income to which the taxes relate, AB satisfies the requirement of paragraph (b)(4)(viii) of this section, and the allocation of the country X taxes is deemed to be in accordance with the partners' interests in the partnership.

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§1.704-1T [Removed]

Par. 3. Section 1.704-1T is removed.

Deputy Commissioner for Services and Enforcement.
Mark E. Matthews

Approved: September 12, 2006

Acting Deputy Assistant Secretary of the Treasury.
Eric Solomon