Tax Insights
from International Tax
Services

Proposed regulations address Section 898 transition rules and Section 960(d)(4) FTC disallowance

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In brief

What happened?

Treasury and the IRS released, on July 31, 2026, proposed regulations under Sections 898(c) and 960(d)(4). The proposed regulations implement the One Big Beautiful Bill Act (OBBBA) transition from the one-month controlled foreign corporation (CFC) deferral year, prescribe how certain foreign taxes are allocated between the short first required tax year and the succeeding tax year, and apply the statutory 10% foreign tax credit disallowance to taxes associated with distributions of post-June 28, 2025, Section 951A previously taxed earnings and profits (PTEP). These proposed regulations largely adopt the frameworks introduced in Notices 2025-72 and 2025-77, but with some accommodations in response to comments.

Why is it relevant?

The proposed Section 898 rules could materially affect the timing and usability of foreign tax credits for US groups with CFCs that previously used the one-month deferral election. The transition rule in OBBBA created potential mismatches between foreign-law income, foreign tax accruals, and the corresponding US income groups, potentially resulting in a complete loss of foreign tax credits in some circumstances. Those mismatches could affect the amount and timing of deemed-paid foreign tax credits; subpart F and Section 951A computations; high-tax exception and high-tax exclusion determinations; tested income and tested loss calculations; PTEP accounts and related tax pools; foreign tax redeterminations and currency translation; and Form 5471 reporting and supporting workpapers. The proposed regulations address these concerns and provide taxpayers with significant elective flexibility. Specifically, the proposed regulations introduce four new elections: (1) allocation of taxes based on specific income groups as opposed to aggregate foreign taxable income, (2) allocation of certain taxes imposed on a partnership that is required to change its tax year as a result of a change of the tax year of one of its partners, (3) no allocation of taxes to the first full post-Section 898(c)(2) repeal tax year (i.e., the succeeding tax year), and (4) an election to allocate certain taxes paid or accrued in the succeeding tax year to the one-month first required tax year.

The elective provisions could produce significantly different results depending on the timing and character of income. For example, an income-group-specific allocation may preserve credits where a CFC earns different categories of income in its short year and succeeding year, but it could require more detailed foreign-law income data and closing-of-the-books calculations. An example cited to illustrate the need for this election is where taxes are imposed on income (e.g., passive income from a sale of stock) of a type that will not be recognized in the following tax year.

Notice 2025-77 clarified the effective date of Section 960(d)(4) applies to foreign income taxes paid or accrued (or deemed paid under Section 960(b)(1)) for a Section 959(a) distribution to the extent the PTEP results from a Section 951A inclusion of a US shareholder in a tax year ending after June 28, 2025. Consistent with the Notice, the Section 960(d)(4) proposed rules also increase the importance of accurate PTEP tracking. Taxpayers will need to distinguish PTEP based on whether the associated Section 951A inclusion arose in a US shareholder tax year ending before or after June 28, 2025. This distinction can affect the amount of foreign tax credit available when cash is distributed through one or more tiers of CFCs.

Actions to consider

With respect to the Section 898 proposed rules, taxpayers should identify affected CFCs and partnerships, model the default and elective allocation approaches, and prepare Form 5471 reporting and election statements in accordance with the proposed requirements. With respect to the Section 960(d)(4) proposed rules, taxpayers should update PTEP tracking systems and report Form 5471 accurately. The proposed regulations were published in the Federal Register on August 3rd and taxpayer comments are due by September 17, 2026. The Section 898(c) rules are proposed to apply to tax years of specified foreign corporations beginning after November 30, 2025. The Section 960(d)(4) rules generally apply to taxes associated with Section 951A PTEP arising from US shareholder tax years ending after June 28, 2025. Taxpayers may rely on the proposals before finalization if they apply the relevant rules in their entirety and consistently. Treasury and the IRS expect to finalize the regulations by January 4, 2027.

In detail

Section 898 transition rules

The OBBBA repealed the Section 898(c)(2) election that permitted certain specified foreign corporations to use a tax year beginning one month before the tax year of their majority US shareholder. The repeal applies to tax years beginning after November 30, 2025. As a result, an affected CFC generally will have a short ‘first required year,’ often consisting of one month, before moving to the tax year of its majority US shareholder. The proposed regulations establish rules intended to prevent a full year of foreign income taxes from being concentrated in that short period while only a limited amount of related income is recognized for US tax purposes.

Under the proposed rules:

- A foreign net income tax accrued by an affected corporation in its one-month first required tax year generally would be allocated between that year and the succeeding tax year.
- The default allocation percentage would equal the foreign-law taxable income attributable to the first required year divided by total foreign-law taxable income for the relevant foreign tax year.
- The allocation would be applied after the foreign tax is assigned to the relevant income and PTEP groups under the existing foreign tax allocation rules.
- Amounts allocated to each year generally would be treated as accruing in that year for purposes of subpart F, Section 951A, earnings and profits, high-tax determinations, and deemed-paid credits.

Observation: Similar to Notice 2025-72, the proposed regulations would apply only to foreign net income taxes and not to other taxes (e.g., withholding taxes and perhaps certain other in-lieu-of taxes). Other foreign income taxes would remain subject to ordinary accrual rules with no allocation, even if they relate to income earned outside of the first required tax year.

The regulations also provide several elections, including elections to:

- Treat certain distributive shares of creditable foreign tax expenditures from affected partnerships as specified foreign income taxes,
- Apply an income-group-specific allocation percentage in lieu of the default rule based on total foreign taxable income,

- Not allocate specified foreign income taxes and instead accrue them entirely in the first required year, and
- An irrevocable election to allocate certain succeeding-year taxes back to the first required year when the foreign tax year generally straddles both US tax years.

Section 960(d)(4) foreign tax credit disallowance

The proposed regulations also implement the statutory rule disallowing 10% of foreign income taxes paid, accrued, or deemed paid with respect to distributions of PTEP arising from Section 951A inclusions in a US shareholder tax year ending after June 28, 2025. To administer the rule, the regulations would divide Section 951A PTEP into separate groups: pre-June 29, 2025, Section 951A PTEP and post-June 28, 2025, Section 951A PTEP.

The 10% disallowance would apply to foreign taxes attributable to distributions of post-June 28, 2025, Section 951A PTEP, including reclassified PTEP, as well as foreign taxes deemed paid under Section 960(b)(1) in connection with those distributions.

Observation: The Joint Committee on Taxation's recent explanation of the tax provisions in the OBBBA (the 'Blue Book') suggested that the statutory text of Section 960(d)(4) did not reflect the legislative intent underlying the provision and may require a technical correction. The proposed regulations adhere to the plain language of the text.

See also

- **Tax Insight:** Highlights of Treasury guidance on OBBBA international tax items
- **Tax Insight:** Treasury releases guidance addressing the repeal of Section 898(c)(2) and the recognition of Section 987 pretransition gain or loss

Let’s talk

For a deeper discussion of how the proposed regulations might affect your business, please contact:

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