Tax Insights
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Services

Proposed rules address OBBBA expense apportionment of deductions to foreign source income

September 11, 2026

In brief

What happened?

Treasury and the IRS on September 11 published proposed regulations implementing the One Big Beautiful Bill Act (OBBBA) amendments to Section 250(b)(3) and the new Section 904(b)(5). With respect to Section 904(b)(5), the proposal interprets the statutory 'directly allocable' standard to determine which expenses continue to reduce Section 951A category income and provides rules for reallocating other deductions from Section 951A category income to US source income.

Why is it relevant?

The proposed rules may require taxpayers to reassess deductions historically apportioned to Section 951A category income. Treasury would treat the vast majority of expenses (e.g., stewardship, legal and accounting, damages and settlement payments, and supportive expenses) as not directly allocable. Interest expense and other deductions that are not 'directly allocable' and that otherwise would have been allocated or apportioned to the Section 951A category generally would instead reduce US source income for all purposes of Section 904. Given this broad reallocation mechanic, the proposed rules also clarify the interaction of reallocated expenses and the overall domestic loss (ODL), overall foreign loss (OFL), and separate limitation loss (SLL) rules. Finally, the proposed rules also provide guidance on the interaction of Section 904(b)(5) and net operating loss (NOL) deductions, as well as the OBBBA amendments to allocating expenses for purposes of determining foreign-derived deduction eligible income (FDDEI).

Actions to consider

Taxpayers should identify the deductions currently allocated or apportioned to Section 951A category income before applying Section 904(b)(5). Taxpayers should then evaluate those deductions under the proposed ‘directly allocable’ standard and model the effect of any reallocation on the Section 951A limitation, US source income, NOL attributes, and ODL accounts. Taxpayers also should evaluate the deductions currently allocated and apportioned for FDDEI purposes.

Companies should consider providing comments on the proposed regulations, which are due by November 10, 2026.

In detail

Background

The OBBBA amended Section 250(b)(3) and added Section 904(b)(5), generally effective for tax years beginning after December 31, 2025. For Section 250, the statute excludes interest expense and research and experimental (R&E) expenditures from the deductions taken into account in determining deduction eligible income (DEI). For Section 904, the statute provides that Section 951A category income is reduced by any Section 250(a)(1)(B) deduction and certain tax deductions under Section 164(a)(3), as well as other expenses that are ‘directly allocable’ to such income. Other expenses not directly allocable to Section 951A category income, including interest and R&E expenses, that otherwise would be allocated and apportioned to such income are instead reallocated to US source income. The proposed regulations provide rules for applying these statutory changes within the existing Section 861 expense-allocation framework.

Proposed regulations

Allocation and apportionment of deductions to DEI

The proposed regulations would conform Reg. 1.250(b)-1 to amended Section 250(b)(3)(A). Taxpayers would continue to apply the Section 861 regulations to allocate and apportion deductions to gross DEI and gross FDDEI, and the deduction pool would continue to be determined under the existing framework, but without regard to interest expense or R&E expenditures.

Interest expense would include amounts deductible under Section 163, including original issue discount. R&E expenditures would include amounts deducted, including through amortization, under Sections 174, 174A, or 59(e)(2)(B). The proposed regulations also would remove the existing reference to Section 163(j), reflecting that the statute now excludes interest expense itself rather than addressing the expense through the Section 163(j) limitation.

As a result, under the proposed regulations, interest and R&E expenditures would not reduce DEI or FDDEI even though the amounts may remain deductible in computing taxable income. Depending on the taxpayer’s facts, this may increase DEI and FDDEI. Treasury and the IRS state that separate guidance will address other post-OBBBA Section 250 changes.

Observation: The Section 250 computation may require an expense-allocation analysis that differs from allocations used for other purposes. For example, the proposed regulations treat R&E expenses deducted under Section 162 as expenditures that may be apportioned to DEI. Additionally, the proposed regulations appear to require interest equivalents that historically have been apportioned in the same manner as interest expense to continue being apportioned to DEI and FDDEI. Finally, these proposed regulations address only select post-OBBBA Section 250 changes, so taxpayers should monitor for additional Section 250 guidance that Treasury and the IRS indicate is forthcoming.

Section 904(b)(5)

Proposed Reg. 1.904(b)-4 would implement Section 904(b)(5) and, importantly, define the statute's otherwise undefined 'directly allocable' standard and prescribe how certain deductions not directly allocable to the Section 951A category are reallocated to US source income.

Consistent with the statutory language, the Section 250(a)(1)(B) deduction and certain state and local income tax deductions under Section 164(a)(3) would reduce Section 951A category income to the extent attributable to the taxpayer's net controlled foreign corporation (CFC) tested income or related Section 78 gross-up. In contrast, interest expense that otherwise would be allocated and apportioned to Section 951A category income is reallocated to US source income. R&E expenditures are not allocated to the Section 951A category under existing Reg. 1.861-17 and, accordingly, no change is made with respect to those expenditures for this purpose.

For other deductions, Treasury and the IRS interpret 'directly allocable' more narrowly than the 'properly allocable' standard generally used under the Section 861 regulations. Under the proposed regulations, a deduction can be directly allocable only if it is of a type that is not subject under the otherwise applicable rules to apportionment based on relative asset values or amounts of US gross income, including modified gross income. This determination is not based on how a deduction is apportioned by the taxpayer but on whether the deduction is of a type that could be apportioned based on the relative value of assets or amounts of US gross income.

Observation: Under the proposed regulations, the determination of whether a deduction is 'directly allocable' hinges on whether the deduction is of a type that could be apportioned based on relative value of assets or amounts of US gross income, irrespective of the actual apportionment methodology used. It is unclear how this standard would be applied given that an apportionment method under the Section 861 framework for expenses that do not have a prescribed method is grounded in whether the method approximates to a reasonably close extent the factual connection of the expense to the class of gross income.

The proposed regulations specifically identify stewardship expenses, legal and accounting fees, damages awards, prejudgment interest, settlement payments, and supportive expenses such as overhead and general and administrative (G&A) as not directly allocable. Thus, any such expenses that otherwise would be allocated and apportioned to Section 951A category income are instead reallocated to US source income. In contrast, Section 986(c) losses associated with foreign source Section 951A category previously taxed earnings and profits (PTEP) and NOL deductions (generally limited to pre-OBBBA NOLs) allocated and apportioned to Section 951A category income are identified as deductions that are directly allocable to Section 951A category income and reduce the Section 904 limitation in the category.

For expenses that are not considered directly allocable to Section 951A category income, the proposed regulations use a two-step approach. First, taxpayers determine the amount of each deduction that otherwise would have been allocated or apportioned to Section 951A category income under the otherwise applicable allocation and apportionment rules. Second, Section 904(b)(5) is applied to reallocate to US source income the amount of deductions that are not considered to be directly allocable to the Section 951A category as described above. This reallocation to US source of such expenses applies for all purposes of Section 904, including for purposes of applying the ODL, OFL, and SLL rules.

Because the reallocated deductions are treated as reducing US source income for all purposes of Section 904, those reallocated deductions may create or increase a US source loss. For example, the reallocated deductions may give rise to a current year ODL under Section 904(g), limiting a taxpayer's ability to utilize current-year foreign tax credits (FTCs), including FTCs in the Section 951A category. Similarly, a US source loss can reduce separate limitation income proportionately under Section 904(f)(5)(D) for purposes of determining separate limitation income. For NOLs arising after the applicability date, the proposed regulations would take Section 904(b)(5) into account in determining the source and separate-category components of the NOL, which is intended to prevent deductions excluded from the Section 951A category from effectively returning to that category through an NOL carryover.

Observation: Prior to the issuance of the proposed regulations, there was public commentary regarding the appropriate impact the reallocation of deductions under the statute should have on the application of the Section 904 limitation with respect to the various Section 904 categories of income. The issue is grounded in the interpretation of the meaning of the statute's prescription that the rules in Section 904(b)(5) apply "Solely for purposes of the application of…[Section 904(a)] with respect to amounts described in… [Section 904(d)(1)(A)]." One example commentators focused on was whether expenses reallocated under the statute to US source income could create a domestic loss that offsets foreign source income and thereby decreases the benefit of reallocating deductions away from Section 951A category income. The preamble does not explicitly address this commentary or the merits of the arguments made. As discussed, the proposed regulations treat the reallocated deductions as reducing US source income for all purposes of Section 904, and acknowledge in the preamble that this approach may cause a taxpayer to sustain, or increase the amount of, a domestic loss that is taken into account in determining the taxpayer's ODL under Section 904(g)(2)(A). Further comments may address this approach as some commentators believed that the proposed approach is inconsistent with the benefit that Congress intended to provide. Taxpayers should model the effect of removing deductions from the Section 951A category through the full Section 904 calculation.

Applicability dates and reliance

The statutory changes and proposed regulations apply to tax years beginning after December 31, 2025. The proposed regulations permit reliance before final regulations are published, subject to the applicable consistency requirements.

Provision	**Applicability**
Section 250(b)(3) / proposed Reg. 1.250(b)-1	Tax years beginning after December 31, 2025
Section 904(b)(5) / proposed Reg. 1.904(b)-4	
Proposed Reg. 1.861-8(e)(8)(i) NOL rule	
Reliance	Permitted for applicable post-2025 tax years before final regulations are published, provided the applicable proposed rules are followed in their entirety

See also

- **Tax Insight:** Proposed rules clarify Section 250 property dispositions (August 24, 2026)

Let's talk

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

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