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June 2023

Practical Tax Strategies

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CLAIMING A FOREIGN TAX CREDIT WILL BE MORE DIFFICULT UNDER THE NEW FINAL REGULATIONS

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This article examines final regulations that fundamentally change the rules for determining the creditability of a foreign tax under Sections 901 and 903.

U.S. taxpayers are generally subject to U.S. tax on their worldwide income, but may be provided a tax credit for foreign income taxes paid or accrued. The main purpose of the foreign tax credit is to mitigate the double taxation of foreign source income that might occur if such income is taxed by both the United States and a foreign country. An individual U.S. taxpayer may receive a "direct" foreign tax credit for foreign taxes that the taxpayer pays to a foreign government. A U.S. corporation that owns at least 10% of stock in a foreign corporation (by vote or value) may receive an "indirect" or "deemed" foreign tax credit for foreign taxes paid by that subsidiary.

IRC Section 901 limits the foreign tax credit to foreign taxes imposed on "income, war profits or excess profits." IRC Section 903 extends the credit to foreign taxes imposed "in-lieu-of" an income tax. Up until very recently, in order to be creditable under either Section 901 or Section 903, a foreign tax levy must be a "tax."

A levy is a tax "if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes." The tax also must be levied by a foreign country pursuant to its taxing authority, not some other authority such as penalties, fines, and custom duties. A foreign levy is not a tax to the extent that an entity receives a "special economic benefit" from a foreign country in exchange for a payment.

Only compulsory payments are considered payments of tax. A payment is not compulsory to the extent that the amount paid exceeds the amount of limitability under foreign law for the tax. Finally, a U.S. taxpayer must exhaust all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the U.S. taxpayer's liability for foreign tax.

What amount of foreign taxes is creditable?

A foreign tax credit (under either Sections 901 or 903) is allowed only to the extent that the creditable foreign tax is "paid or accrued." An amount of tax is not considered paid to the extent that "it is reasonably certain that an amount will be refined, credited, rebated, abated, or forgiven."

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IRC Section 960, as amended by the 2017 Tax Cuts and Jobs Act, adopts a new "properly attributable to" standard to determine the amount of foreign taxes deemed paid by U.S. shareholders of controlled foreign corporations (CFCs). Section 960(a) provides that U.S. corporate shareholders that include "any item of income under Section 951(a)(1)" with respect to any CFC shall be deemed to have paid "so much of such foreign corporation's foreign taxes as are properly attributable to such item of income." Under this standard, a CFC shareholder must gross up the foreign income inclusion amount to the foreign taxes properly attributable to it under IRC Section 78.[1]

This is done to prevent the use of foreign tax credits to reduce tax on U.S. source income. This is expressed by the following formula:

U.S. tax on worldwide income prior to claiming foreign tax credits X foreign-source worldwide taxable income

Foreign tax credit limitation and baskets

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (computed under U.S. tax accounting principles).This limitation is imputed by multiplying a taxpayer's total U.S. tax liability (prior to the foreign tax credit) in that year by the ratio of the taxpayer's foreign source taxable income in that year to the taxpayer's worldwide taxable income in that year.

The limitation is applied separately to specific baskets for passive income, global intangible low tax income (GILTI), foreign branch income, and one general, catchall basket for active business income. The separate basket limitations apply to the total foreign tax credits under Sections 901 and 903.

To apply the separate basket limitations, the taxpayer must take the following steps for each basket:

- Determine the amount of gross income included in the basket.
- Allocate and apportion deductions to that gross income to determine taxable income in the basket.
- Identify foreign tax credits attributable to that taxable income.

We will now review each separate basket for foreign tax credit purposes.

Passive income basket. IRC Section 904(d)(1)(A) provides for a passive category basket. The passive category income tax basket includes income that would be foreign personal holding company income under Section 954(c) if it were received by a foreign corporation. Because it incorporates by reference the Section 954(c) definition of foreign personal holding company income, passive income will generally include such items of income as dividends, interest, royalties, and rents. It also includes gains from the sale or exchange of property (other than inventory) that produces foreign personal holding company income or that produces no income. In addition, passive income includes certain foreign currency gains, gains from certain commodities transactions, certain income that is equivalent to interest, income from notional principal contracts, and certain payments made in lieu of dividends.

Passive income generally does not include royalties or rents derived in the active conduct of a trade or business.[2] The regulations also provide that, for purposes of the Section 904(d)(1)(A) limitation, royalties or rents will be deemed to be derived in the active conduct of a business if the active business test is met by any one of an affiliated group of corporations (related under an 80% ownership test provided for in Section 1504(a)). For purposes of this affiliated group rule, the income tax regulations define an affiliated group to include only U.S. corporations and CFCs in which U.S. members of the group own, directly or indirectly, at least 80% of the stock (by vote and value).[3]

GILTI basket. The 2017 Tax Cuts and Jobs Act added a new category of foreign source income known as GILTI. Unlike subpart F, GILTI is not limited to specific categories of income. GILTI was intended to impose a current year tax on income earned from intangible property and subject to no or a low tax rate outside of the United States.

GILTI is defined as the residual of a CFC's income (excluding subpart F, income that is effectively connected with a U.S. trade or business, and certain other classes of income) above a 10% return on its investment in tangible depreciable assets (defined as "qualified business asset investment" or QBAI). Effectively, these rules presume that tangible property should provide an investment return of no greater than 10%. Consequently, the Internal Revenue Code assumes income earned in excess of a 10% return on a CFC's QBAI is generated from intangible property. GILTI is not

limited to income from intangibles. Any non-excluded income in excess of the above discussed limitation, whether received from intangibles or not, is included as GILTI.

Any GILTI income must be allocated to a GILTI basket for foreign tax credit purposes. This is because GILTI is not only taxed differently than other foreign source income, GILTI provides a number of limitations when calculating a foreign tax credit. For example, any amount includible in the gross income of a CFC under GILTI shall be deemed to have paid foreign income taxes equal to 80% of the product of such CFC's inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued by the CFC. Excess credit in any category other than GILTI is permitted to be carried back to the one immediately preceding taxable year and carried forward to the first ten succeeding taxable years, and credited in such years to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. GILTI credits are ineligible for a carryback or forward.

Under the new "Attribution Requirement," a foreign tax is not creditable unless the tax satisfies one of three tests.

Foreign branch income basket. In addition to GILTI, the 2017 Tax Cuts and Jobs Act added another category of foreign source income known as foreign branch income. Foreign branch income is defined as business profits (other than passive category income) attributable to one or more qualified business units ("QBUs") in one or more foreign countries. IRC Section 989(a) defines a QBU as "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records."

A corporation is a QBU. A foreign branch operation of a U.S. corporation would also in most instances be a QBU. The branch must, however, be conducting activities that constitute a trade or business and maintain a separate set of books and records with respect to such activities.[4] If the branch is an integral extension of a U.S. operation not capable of producing income independently, it would not be a QBU. In that event, the transactions of the foreign branch would be treated with all other transactions of the corporation of which it is a part.

Determining whether activities are a trade or business for this purpose depends upon an analysis of all the surrounding facts and circumstances. A trade or business for this purpose generally "is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise entered into for profit" if the expenses related to the activities are deductible under Sections 162 or 212. To be a trade or business for this purpose, "a group of activities must ordinarily include (1) every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit and (2) the collection of income and the payment of expenses." A vertical, functional, or geographic division of the same trade or business may qualify as a trade or business, and hence, a separate QBU for Section 989 purposes. By contrast, activities "merely ancillary to a trade or business" do not qualify as a trade or business for Section 989 purposes. For foreign tax credit purposes, foreign branch income must be allocated to its own basket.

General limitation income. General limitation income includes all income not described by one of the other categories of income discussed above. Because it is a residual category, there is no specific definition of the types of income that are allocated to this category.

Why foreign income is allocated to separate baskets. Under basic U.S. tax principles, a loss from one business activity ordinarily is deductible against income from any other business activity. This principle ignores two important distinctions that must be made when computing the foreign tax credit limitation: the distinction between the U.S.-source and foreign-source income and the assignment of income to one of the four separate categories of income limitations. As a consequence, for purposes of computing a taxpayer's foreign tax credit limitation, numerous special rules apply when a taxpayer's business activities give rise to allocation of deductions and to a net operating loss.

1 Section 904(a).

2 Reg. 1.904-4(b)(2)(iii).

3 Reg. 1.904-4(b)(2)(iii).

4 Reg. 1.989(a)-1(b)(2)(ii).

5 *See* Tax Executive Part II: "GILTI, FDII, and FTC Guidance and International Tax Planning" (4/11/2019).

6 *See* T.D. 9959 (1/4/2022).

7 *See* Jeffrey L. Rubinger, "Foreign Tax Credit Planning — What Every Practitioner Should Know" (2016).

Allocation of expenses

Prior to the enactment of the 2017 Tax Cuts and Jobs Act, in order to determine foreign source taxable income in each basket for purposes of calculating foreign tax credit limitations, a taxpayer was required to allocate and apportion deductions between U.S.-source gross income and foreign-source gross income. However, the proposed regulations contain a rule to determine the percentage of income and assets of a CFC attributable to GILTI. Under these rules, income and assets are allocated to the general and passive income baskets. Then, the general basket amounts are allocated between GILTI and non-GILTI baskets using an "inclusion percentage" of Section 960(d) which limits the amount of foreign taxes deemed attributable based on a percentage to GILTI divided by aggregate tested income.

As a result of these new proposed rules, a U.S. shareholder of a CFC must allocate expenses to the CFC stock, then further apportion the CFC stock between the passive and general baskets, then divide the general basket between the GILTI and non-GILTI, and finally treat a portion of the assets and income allocated to GILTI as exempt based on the Section 250 deduction.[5]

Losses and excess credit carryovers

Sometimes a foreign operation suffers a loss. An overall foreign loss occurs when the taxpayer's foreign source deductions exceed foreign source gross income. When a taxpayer suffers a foreign loss, the taxpayer must apply separate income limitation rules. This means that a taxpayer must make a separate computation of foreign source taxable income or loss for each separate limitation category.

When a computation results in a net loss in a separate limitation category, that loss is a separate limitation loss. Separate limitation losses are subject to special ordering and recharacterization rules. To maintain the integrity of the separate limitations, in succeeding years, income earned in the category from which a separate limitation loss arose is recharacterized as income in the category to which the loss deduction was allocated and deducted. For example, if a loss from the general category is used to offset income in the passive income category, then any general limitation income earned in succeeding tax years is recharacterized as passive income to the extent of the prior year loss deduction. An exception to this rule is losses from GILTI.

Foreign taxes that exceed the limitation in a given taxable year can typically be carried back one year and forward up to ten years and taken as a credit in a year that the limitation exceeds the amount of creditable foreign taxes. This carryover process must take place, however, within the confines of the separate income categories. In other words, excess credits from one category of foreign income can offset only past or future excess limitations on that type of foreign income. Excess credits that are carried back or forward to another taxable year must be credited and cannot be deducted in the carryback or carryforward year.

Look-through rules

Under Section 904 look-through rules, if a U.S. shareholder (as defined in Section 951(b)) includes income from actual dividends, constructive dividends under subpart F (e.g., subpart F inclusion), GILTI income, interest, rents, or royalties from a foreign corporation, the appropriate limitation basket for the income is determined not with reference to the character of the income itself (e.g., as a dividend) but with reference to the underlying income of the CFC. With respect to CFCs, look-through treatment is mandated by Section 904. It provides that dividends received by a U.S. shareholder from a CFC are not to be treated as income falling within one of the separate categories or baskets of income identified in Section 904 except to the extent attributable to or allocable to income of the CFC in such a separate basket.

The 2022 regulations governing foreign tax credits

On 1/4/2022, the IRS and Treasury issued final regulations regarding whether a foreign tax is eligible to claim as a foreign tax credit.[6] The final regulations promulgated by the IRS and Treasury apply to tax years beginning on or after 12/28/2021. These regulations greatly complicated the rules governing claiming a foreign tax credit.

As indicated above, under Section 901, U.S. persons and corporations are entitled to a foreign tax credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or any possession of the United States." Section 903 extends the credit to foreign taxes

imposed "in lieu of" an income tax. Prior to 12/28/2021, a payment of a foreign tax was creditable for U.S. tax purposes if the following conditions were satisfied:

- A foreign tax was eligible for a credit if it was a compulsory payment pursuant to the authority of a foreign government to levy taxes. A payment is not compulsory to the extent that the amount paid exceeded the amount of liability under foreign law for the tax.

The final regulations change the definition of a foreign levy for purposes of the in-lieu-of taxes rules.

- The predominant character of the foreign tax was an income tax in the U.S. sense in order to be creditable.
- A two-part test had to be satisfied in order to satisfy the "predominant character test." The first requirement is that the foreign tax must be "likely to reach net gain in the normal circumstances in which it applies." Three conditions had to be satisfied for a tax to meet this "net gain" criterion. First, the tax had to meet a "realization requirement." In general, this requirement was satisfied where the tax was imposed upon or subsequent to the occurrence of events that would result in the realization under the U.S. tax law. Second, the foreign tax must have been imposed on the basis of gross receipts computed under a method that was likely to produce an amount that is not greater than its fair market value. Third, the tax must satisfy a "net income requirement" in which the base of the tax must be computed by reducing gross receipts to permit recovery of significant costs and expenses.[7]
- The second requirement under this predominant character test is that the foreign tax had to be an income tax in the U.S. sense only to the extent that liability for the tax could not have been dependent on the availability of a credit for the tax in another country.

In 2020, the IRS and Treasury issued proposed regulations that added a "Jurisdictional Nexus Requirement" to the above requirements in order to claim a credit for a foreign tax. Under this "Jurisdictional Nexus Requirement," a foreign tax will be creditable for U.S. tax purposes only if the foreign country imposing the tax has sufficient nexus to a U.S. taxpayer's business's activities, investment of capital, or other assets that gave rise to the foreign income and foreign tax.

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For a nonresident taxpayer assessed a foreign tax by a foreign country, sufficient nexus was satisfied if one of three nexus tests was met. This included an activities-based nexus, source-based nexus, and property-based nexus. Under these three tests, a U.S. taxpayer assessed a foreign tax was creditable for U.S. tax purposes if any allocation of income, gain, deduction, or loss between a resident taxpayer and a related or controlled entity under the foreign country's transfer pricing rules would follow arm's-length principles without taking into account various destination criteria.

The finalized 2022 regulations generally carry over much of the verbiage of the 2020 proposed regulations. However, the 2022 final regulations change the name of the "Jurisdictional Nexus Requirement" to "Attribution Requirement." The final regulations now also require U.S. taxpayers to understand how a transaction is characterized or sourced under foreign law and compare such analysis to the Internal Revenue Code to determine whether such tax is "reasonable."

The attribution requirement was issued in response to foreign countries adopting novel extraterritorial taxes. This includes a number of digital services taxes that have been introduced by a number of foreign countries. Under this new "Attribution Requirement," a foreign tax is not creditable unless the tax satisfies one of the following three tests:

Activities-based attribution standard. The activities-based attribution requirement is met if the gross receipts and costs that are included in the foreign tax base are limited to those attributable, under reasonable principles, to a nonresident's activities within the foreign country. Gross receipts and costs that may be included in the foreign tax base are limited to those attributable under reasonable principles. This includes a nonresident's activities within the foreign country.

For this purpose, foreign law may not take into account as a significant factor (1) the location of customers, users, or other similar destination-based criteria or (2) the locations of persons from whom the nonresident makes purchases in the foreign country. A foreign country that attributes income under rules similar to IRC Section 864(c) satisfies the activities-based attribution test. Section 864(c) generally provides that a nonresident alien or a foreign corporation engaged in trade or business within the U.S. during a taxable year will be subject to U.S. tax on income that is effectively connected with a trade or business within the U.S.

Source-based attribution standard. The source-based attribution requirement is satisfied if gross income or gross receipts that are included in the foreign tax base are: (1) limited to gross income arising from sources within the foreign country; and 2) determined based on sourcing rules that are reasonably similar to those that apply to Section 864.

Gross income or receipts may be included in the foreign tax base on source-based income as determined based on the sourcing rules found in the Internal Revenue Code. For example, income from services must be sourced based on where the services are performed. Royalty income must be sourced based on the place of use of, or the right to use, the intangible property. Foreign tax imposed on residents of the foreign country permits the worldwide gross receipts of a resident to be included in the foreign tax base, but any profit allocation must be at arm's length as per the U.S. transfer pricing rules.

Foreign tax law governing the sourcing of taxes need not duplicate U.S. tax law. However, foreign tax law sourcing law should have the same general theory as U.S. tax law.

Property-situs attribution standard. The property-situs attribution requirement is satisfied if gross receipts from sales or dispositions of property that are included in the foreign tax base include only gains from the disposition of: (1) real property located in the foreign country, or (2) an interest in a resident corporation or other entity that owns real property, under rules reasonably similar to those under the Foreign Investment in Real Property Tax Act (FIRPTA), and gains from other property only when they include gross receipts attributable to property forming part of a taxable presence in that country similar to effectively connected income rules under Section 864(c).

New in-lieu-of taxes rules. The final regulations change the definition of a foreign levy for purposes of the in-lieu-of taxes rules. Under the new regulations, in order to qualify as an in-lieu-of tax, a foreign levy must be a foreign tax and must satisfy

a substitution requirement. A foreign levy satisfies the substitution requirement if the following four tests are satisfied:

1. The foreign country imposing the tax must also have a "generally-imposed net income tax." In general, the term "net" refers to a value found after expenses have been accounted for.
2. Neither the generally-imposed net income tax nor any other separate net income tax imposed by the same foreign country can be duplicative.
3. There must be a close connection between the tax and any excluded income. This requirement is satisfied only if the taxpayer establishes a "close connection" between the tax and the foreign country's failure to impose a generally imposed net income tax.
4. Finally, the foreign country must have jurisdiction to tax income not otherwise subject to tax by the foreign country.

Conclusion

On 1/4/2022, the IRS and Treasury promulgated a final set of regulations governing the ability of taxpayers to claim foreign tax credits. These regulations fundamentally change the rules for determining the creditability of a foreign tax under Sections 901 and 903. The final regulations now require a foreign tax to satisfy an attribution requirement in order to be creditable against U.S. income tax. Taxpayers with foreign-source income should carefully examine these new rules to determine their ability to claim credit for foreign taxes paid. ■