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## Philadelphia Tax Day - November 14, 2018

# Hard Knock Life: The New Worldwide Territoriality and the Enhanced Significance of the Foreign Tax Credit

**November 14, 2018**

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# Agenda

- The Foreign Tax Credit: Background
- Threshold Issues
  - Who may claim a credit?
  - What foreign taxes are creditable?
- Impact of Source Rules
- Credits Under §§901, former 902, and 960
- Foreign Tax Credit Limitation
- Excess GILTI Basket FTC Considerations
- Section 905(c) Adjustments
- Summary of Changes After Tax Reform
- Other Statutory and Regulatory Limits on the FTC

# The Foreign Tax Credit:

## Background

# Purpose, History & Background

- Because U.S. taxpayers are subject to tax on their worldwide income, double taxation may occur on foreign source income
- Prior to 1918 when the FTC was introduced, foreign taxes only were allowed as deductions
- Purpose of the FTC is to provide unilateral relief from double taxation by crediting foreign tax paid or accrued against U.S. tax on foreign source income

# Example: Deduction v. Credit

After Tax Reform

Foreign Taxes = $20

U.S. Tax Rate = 21%

Foreign Source Income = $100

| Deduction | | Credit | |
|---|---|---|---|
| $ 100 | Foreign income | $ 100 | Foreign source income |
| - 20 | Foreign taxes | x .21 | US tax rate |
| 80 | Taxable income | 21 | Tentative U.S. tax |
| x .21 | U.S. tax rate | - 20 | Foreign tax credit |
| $16.80 | U.S. tax liability | $1 | U.S. tax liability |
| Total Taxes paid = $36.80 | | Total taxes paid = $21 | |

## Increased Significance in Light of GILTI

- Under the new GILTI provision, the majority of income of CFCs is subject to current U.S. tax
- Cost to U.S. taxpayers depends on availability of FTCs to offset the resulting U.S. tax
  - What taxes are deemed paid with GILTI inclusion
  - Applicable limitations on using FTCs
- Also impacts the ability of many taxpayers to use FTCs to offset U.S. tax on subpart F income
  - Taxpayers that historically could not use FTCs because of an overall foreign loss may now be creditable
- Taxpayers that historically did not focus on FTC limitation calculation because sufficient “cushion” in general basket foreign source income may now be limited

## Threshold Issues

Who may claim a credit?

What foreign taxes are creditable?

## Who May Claim a Credit?

Technical Taxpayer Rule

- Treas. Reg. §1.901-2(f)(1) provides that the person on whom a foreign government imposes legal liability for taxes may claim a FTC
  - Based on *Biddle,* 1938 Supreme Court case

# What Foreign Taxes are Creditable?

## Voluntary or Noncompulsory Payments

– A voluntary "noncompulsory" payment to a foreign government is not a tax – must be "compulsory"
  - Must determine foreign tax using a reasonable interpretation of foreign law so as to reduce over time the expected liability under foreign law for tax
  - Must exhaust all effective and practical remedies, including CA process under income tax treaties
    - Cost compared to likelihood of success
  - Example: foreign taxes paid in "Structured Passive Investment" deemed noncompulsory
    - See Treas. Reg. §1.901-2(e)(5)(iv)

## What Foreign Taxes are Creditable?

- To be creditable, a foreign levy must meet the following:
  - Must be a tax (not a penalty, fine etc.);
  - Must be imposed by a foreign taxing authority; and
  - Its "predominant character" must be "that of an income tax in the U.S. sense"
    - Reaches "net gain" in normal cases in which it applies
    - Imposed on or after a realization event (and not before)
    - Gross receipts at FMV (or formula likely to produce amounts not in excess of FMV of actual gross receipts)
    - Tax on net income - allows deductions for expenses
  - Is not a soak-up tax, i.e., a tax only imposed if a credit is provided by another country
- A tax treaty may specify a non-creditable tax as creditable

## What Foreign Taxes are Creditable?

“In Lieu of” Taxes – §903

- Taxes that are imposed on other than a net income basis
- Must be in lieu of taxes generally imposed on business income, investment income and personal service income
- Must meet the definition of a tax as well as meet a substitution test, i.e., the tax is imposed in substitution for, and not in addition to, another income tax generally imposed
- Must not be a “soak-up” tax
  - Tax conditioned on the availability of a foreign tax credit
  - Arises when a foreign tax is not imposed on taxpayer unless a credit is available for that tax under laws of another jurisdiction

## What Foreign Taxes are Creditable?

Dividend Withholding Taxes

- Withholding taxes imposed on distributions by CFCs are in principle generally creditable, but certain provisions limit the FTCs that may be claimed in most cases
  - No FTCs are permitted with respect to dividends that are exempt under §245A (or hybrid dividends taxable under §245A(e))
  - Under the proposed §965 regulations, FTCs are limited with respect to distributions of §965 PTI
    - Query whether similar treatment will apply to GILTI PTI
  - Also, section 901(k) holding-period-related restrictions of prior law continue, as noted below

# Impact of Source Rules

# Background on Source Rule

- FTCs can only offset U.S. tax on foreign source income
- The source of income and expenses is therefore critical to the FTC analysis
- Sections 861-865 set out various rules for sourcing income and expenses
- Examples:

Interest income generally sourced to location of payor

Sales of non-inventory property generally sourced to location of seller

Interest expense generally apportioned based on tax book value of taxpayer's assets

Income from services generally sourced to location provided

Income from rentals or royalties generally sourced based on location of property

# New Inventory Source Rule – §863(b)

- Section 863(b) was changed by the TCJA to source 100% of income from the sale of inventory property produced by the taxpayer by the place of production/manufacture
  - Result is that if taxpayer manufactures the inventory property in the U.S., 100% of the sale proceeds will be treated as U.S. source even if the sale occurs outside the U.S.
  - Reverse is true: i.e., sale proceeds from the sale within the U.S. of inventory property the taxpayer manufactured outside the U.S. is 100% foreign source
- Prior rule generally sourced the sales proceeds 50% from the place of manufacture and 50% from the place of sale applying the title passage rule

# Credits under §§901, former 902, and 960

## Section 78 Gross-Up

# Section 901

- Section 901 taxes
  - Foreign taxes imposed directly on a U.S. taxpayer either as a net income tax or a gross basis withholding tax

  - Both individuals and corporations may claim

  - May be claimed in the year paid or accrued
    - A cash basis taxpayer may make an irrevocable election to claim taxes in the year accrued so as to claim in an earlier (or later) U.S. taxable year

## Former §902

Repealed by TCJA

- A **U.S. corporation** (i.e., not an individual) that **received a dividend** from a foreign corporation in which it owned 10% or more of the voting stock was deemed to have paid a portion of the foreign taxes that had been paid by the foreign corporation
  - Also applied to dividends between foreign corporations
- This "indirect" or "deemed paid" credit was calculated based on "pools" of earnings and foreign taxes
  - Foreign corp's earnings and foreign income taxes were combined into multi-year pools, rather than the year-by-year layered approach of pre-1987 years
  - Separate pools with respect to each separate limitation basket under §904
  - Taxes were deemed paid, and removed from the pools, in proportion to the earnings distributed as dividends from each pool

# Section 960 – Modified Deemed Paid Credits

## TCJA Changes

- Prior to TCJA, former §960(a) provided a deemed paid credit for taxes with respect to subpart F inclusions
  - The inclusion was treated as if it were a dividend so that foreign taxes were deemed paid under §902
- New §960(a) generally provides that, if foreign income is included in the gross income of a U.S. corporation under §951, the U.S. corporation is deemed to have paid so much of the CFC's foreign income taxes as are "properly attributable" to such item of income
- New §960(d) provides a deemed paid credit for foreign taxes "properly attributable" to tested income included under §951A
  - Only 80% of such foreign taxes can be credited
  - No carrybacks or carryforwards

## Section 960 – “Properly Attributable”

- How to determine the amount of foreign taxes that are “properly attributable”?
  - Unlike pooling, the “properly attributable” standard is based on facts that tie the foreign taxes to the foreign income
  - The term “properly attributable” is not defined by statute
  - Questions raised by:
    - Timing differences with local tax laws or local tax year
    - Disregarded transactions
    - CFC taxes deferred under the §909 “splitter” rules
    - Section 956 inclusions

# Section 960 – PTI Distributions

## TCJA Changes

- New §960(b) allows deemed paid FTCs for foreign taxes "properly attributable" to PTI distributed through a chain to a US Shareholder from a CFC or to a CFC from another CFC and not already deemed paid
  - Similar to old §960(a)(3)
- New §960(c) increases foreign source income for purposes of the §904(a) limitation by the amount of foreign taxes paid or deemed paid with respect to distributed PTI
  - Similar to old §960(b)
  - No increase in limitation for foreign taxes paid on GILTI PTI attributable to years in which the taxpayer had no inclusions under §951? Statute omits any reference to GILTI

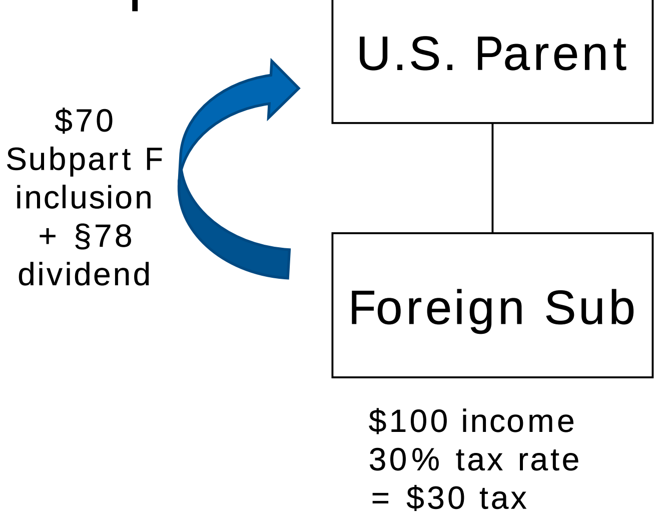
# Section 960 – PTI Distributions

## TCJA Changes

- Proposed §965 regulations provide that only foreign taxes imposed on an upper-tier corporation on distributions of §965 PTI can be credited under old §960(a)(3)
  - No foreign taxes that were paid with respect to earnings treated as PTI as a result of deficit sharing under §965 and would have been deemed paid if the earnings had been included under §965 may be credited
  - Raises significant issue of statutory construction, similar to issue in pending *Ingersoll Rand* case
  - Proposed regulations reserve on treatment under new §960(b), but preamble says government expects to take a similar approach

# Section 78 Gross-Up

- Section 78 requires that the portion of earnings of foreign sub included in U.S. Corp's income be "grossed up"
- Amounts equal to taxes deemed to be paid by U.S. Corp are treated as a dividend received by such U.S. Corp from the foreign corporation
- Example:

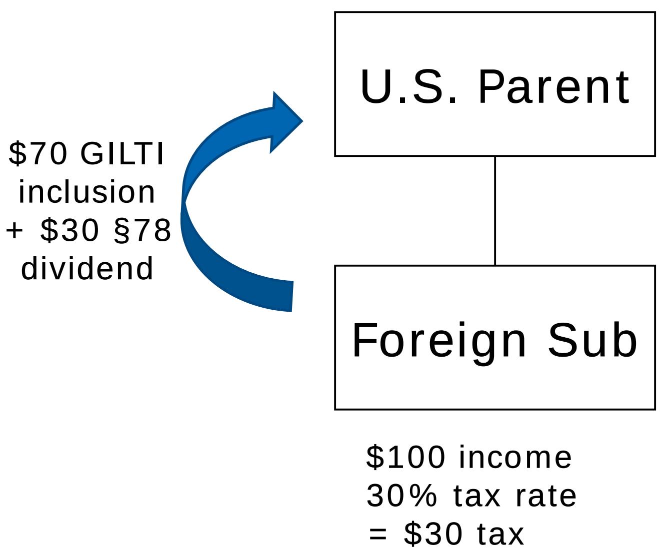



  - Foreign sub has $100 income, all subpart F, and pays $30 (30% tax) to foreign government
  - U.S. Corp must pick up (or "gross up" for) the $30, and include the full $100 in its income
  - Mimics branch result

# Section 78 Gross-Up

Example: Income in GILTI basket

– What happens with 80% FTC limit?




- Foreign sub has $100 income, all tested income, pays $30 (30% tax) to foreign government
- U.S. Corp has GILTI inclusion of $70
- U.S. Corp must pick up (or “gross up” for) the extra $30, and include the full $100 in its income in the GILTI basket
- 50% §250 deduction so $50 included in gross income
- FTC = $30 x .80 or $24
- GILTI tax = 21% x 50 or $10.50
- US tax of $10.50 offset by FTCs so no US tax (assumes no expense allocation)
- Excess credits = $13.50

## Foreign Tax Credit Limitation:

- Section 904
- Excess Credit & Limitation Positions
- Interest Expense Apportionment
- Section 904(b)(4)

# Foreign Tax Credit Limitation – §904

- Section 904(a):Foreign tax credit fraction prevents credits for foreign taxes from offsetting tax on U.S. source income

- The foreign tax credit limitation is expressed as:

$$\frac{Foreign\ taxable\ income}{Worldwide\ taxable\ income} \times Tentative\ U.S.tax$$

- The limitation is also applied separately to each category of §904(d) income or “basket”

# Foreign Tax Credit Limitation – §904

– Section 904(d): Separate income category rules permit blending of high/low taxed foreign source income only within a category:

- General category income
- Passive category income (subject to “high-tax kick-out” – recharacterized as general category)
- Income resourced as foreign under a treaty
  - A separate category is established for each treaty under which income is resourced
- Section 901(j)
- +Foreign branch income
- +Global intangible low-taxed income (GILTI)

# Foreign Tax Credit Limitation – §904

- High taxed passive income (subject to tax in excess of highest US rate) reclassified as general category

- Look-thru rules in §904(d) treat interest, rents, and royalties paid from a related CFC as general basket income except to the extent such amounts are allocable against passive basket income of the CFC; future regulations may extend look-thru to GILTI?

- Section 904(c): Any excess FTCs can be carried back one year, or carried forward up to 10 years, to offset U.S. tax on foreign source income in those years (except for credits in the new GILTI basket)

# Foreign Tax Credit Limitation – §904

## Effects of Tax Reform

- Foreign branch income:
  - U.S. business profits "attributable to" one or more qualified business units (QBUs) in one or more foreign countries
    - The amount of business profits *attributable* to a QBU is to be determined under regulations
    - Is the use of "attributable" similar to "properly attributable?" Similar to the Treaty "attributable?"
  - A QBU is defined under §989(a) and means any separate and clearly defined unit of a trade or business that maintains separate books and records
  - U.S. tax on foreign branch income can only be reduced by foreign taxes paid by foreign branches of the U.S. consolidated group
    - Excess FTCs in the foreign branch income basket cannot be used to reduce U.S. tax on other income

# Foreign Tax Credit Limitation

## Effects of Tax Reform

- GILTI must be currently included in the gross income of a U.S. shareholder of a CFC
  - 50% deduction (subject to taxable income limitation) with result that GILTI is taxed at a lower rate than the 21% corporate rate, i.e., 10.5%
  - Only 80% of the foreign taxes paid allowed as foreign tax credits
  - Result is worldwide effective tax rate of up to 13.125% on GILTI <u>if</u> all GILTI FTCs can be used
  - The practical impact of GILTI will depend significantly on expense allocation to the GILTI basket, which could result in a much higher effective rate
  - Separate basket so no cross-crediting to non-GILTI income
  - No carryback or carryforwards of excess foreign taxes

# Excess Credit Position

- A taxpayer is in an "excess credit" position if available FTCs are greater than its U.S. tax liability on its foreign source income in the relevant basket
- Excess credits may be carried back 1 year and carried forward 10 years, except for excess credits in the GILTI basket where no carryovers are permitted

# Excess Credit Position

## Before and After Tax Reform

### Before TCJA - 35%

| | |
|---|---|
| Net Foreign Source Income | 100 |
| U.S. Tax Rate | 35% |
| U.S. Tax Before Credit | 35 |
| Available FTC | 40 |
| Net US Tax Liability | 0 |
| Excess FTC | 5 |

### After TCJA - 21%

| | |
|---|---|
| Net Foreign Source Income | 100 |
| U.S. Tax Rate | 21% |
| U.S. Tax Before Credit | 21 |
| Available FTC | 40 |
| Net US Tax Liability | 0 |
| Excess FTC | 19 |

# Excess Limitation Position

– A taxpayer is in an “excess limitation” position if its available FTCs are less than the U.S. tax liability on its foreign source income in the relevant basket, i.e., the credits do not completely offset the U.S. tax liability on the foreign source income

# Excess Limitation Position

Before and After Tax Reform

Before TCJA - 35%

| | |
|---|---|
| Net Foreign Source Income | 100 |
| US Tax Rate | 35% |
| US Tax Before Credit | 35 |
| Available FTC | 20 |
| Net US Tax Liability | 15 |

After TCJA - 21%

| | |
|---|---|
| Net Foreign Source Income | 100 |
| US Tax Rate | 21% |
| US Tax Before Credit | 21 |
| Available FTC | 20 |
| Net US Tax Liability | 1 |

# Foreign Tax Credit Limitation

## Example: Before Tax Reform

Taxpayer has $500 in net income, $100 from sources in Country X and $400 from U.S. sources; Country X tax rate is 40%

| | |
|---|---|
| Tentative U.S. tax on $400 U.S. source income: | $140 |
| Tentative U.S. tax on $500 worldwide net income: | $175 |
| Country X tax on $100 Country X income: | $40 |
| Net U.S. tax if full foreign tax credit allowed: | $135 |
| | |
| U.S. tax on non-U.S. source income ($100/$500 x $175): | $35 |
| Foreign tax credits allowed: | $35 |
| U.S. tax due ($175 - $35): | $140 |
| “Excess” foreign tax credits ($40 paid - $35 allowed): | $5 |

# Foreign Tax Credit Limitation

## Example: After Tax Reform

Taxpayer has $500 in net income, $100 from sources in Country X and $400 from U.S. sources; Country X tax rate is 40%

| | |
|---|---|
| Tentative U.S. tax on $400 U.S. source income: | $84 |
| Tentative U.S. tax on $500 worldwide net income: | $105 |
| Country X tax on $100 Country X income: | $40 |
| Net U.S. tax if full foreign tax credit allowed: | $65 |

| | |
|---|---|
| U.S. tax on non-U.S. source income ($100/$500 x $105): | $21 |
| Foreign tax credits allowed: | $21 |
| U.S. tax due ($105 - $21): | $84 |
| “Excess” foreign tax credits ($40 paid - $21 allowed): | $19 |

# INCLUSION MECHANISM COMPARISON

| Order of Application | Step 1: Determine Subpart F income (CFC calculation) | Step 2: Determine GILTI (CFC) (Does not include Subpart F income but no exclusion for §956 amounts) (US SH level calculation) | Step 3: Determine any 956 amounts to be included under §956/951(a)(1)(B) to extent earnings not already taxed under GILTI | Step 4: Determine DRD (Corporations only) Qualifying Distributed Untaxed e&p |
|---|---|---|---|---|
| **FTC Percentage Allowed** | 100% | 80% plus inclusion % haircut/losses – no FTC | Unclear – 100% if any foreign taxes "properly attributable" | None (including withholding taxes) |
| **FTC Basket (General, Passive, GILTI, Foreign Branch, Treaty)** | General or passive | Separate GILTI basket except for passive (FPHCI) | Likely general or treaty (Passive and GILTI come first) | N/A |
| **FTC Basket - Interest expense allocation** | Applies | No express exclusion - Applies unless guidance says otherwise | Applies | Impact under §904(b)(4) |
| **FTC carryover/ carrybacks** | General rule applies - §904(c) (1 year back/10 forward) | None | General rule applies - §904(c) (1 year back/10 forward) | N/A |
| **Timing** | Current | Current | Upon U.S. investment, but proposed §956 regulations reduce inclusion to the extent §245A would apply | Never |
| **Rate** | 21% | 10.5% (or higher if §250 deduction is limited) | 21% | 0% |

# INCLUSION MECHANISM COMPARISON (CONTINUED)

| Order of Application | Step 1: Determine Subpart F income (CFC calculation) | Step 2: Determine GILTI (CFC) (Does not include Subpart F income but no exclusion for §956 amounts) (US SH level calculation) | Step 3: Determine any 956 amounts to be included under §956/951(a)(1)(B) to extent earnings not already taxed under GILTI | Step 4: Determine DRD (Corporations only) Qualifying Distributed Untaxed e&p |
|---|---|---|---|---|
| **Elective High Tax Exception (§954(b)(4)) for FBCI/Insurance Income** | 18.9% (.21 x .90)<br>Not subpart F income if elected | If high tax election, not included as GILTI | e&p from high tax election | e&p from high tax election but no tax on dividends and no FTCs |
| **No election and subject to subpart F** | §78 gross-up applies under §960(a) | §78 gross-up (100%) added to GILTI inclusion (regulations expected to put in GILTI basket) | §78 gross-up applies under §960(a) | No DRD for §78 gross-up dividend |
| **Effect of "loss CFC"** | Chain deficit rule applies to reduce e&p if qualified deficit | Shared to offset tested income of other CFCs<br>Wipes out FTC and QBAI of the loss CFC | No inclusion from CFC without net positive e&p | N/A |

# Foreign Tax Credit Limitation

## Interest Expense Apportionment

- U.S. level expenses are allocated and apportioned to foreign source income, reducing the FTC limitation in the relevant baskets
- Interest expense is often the most significant U.S. expense that reduces foreign source income
- Section 864(e) and §861 Treas. Regs. provide guidance on how interest expense should be apportioned against §904 baskets

# Foreign Tax Credit Limitation

## Interest Expense Apportionment

- Under §864(e)(2), a U.S. Corp is required to use the asset method to apportion interest expense
  - First, have to identify each asset that generates income and value each asset
    - Tax years beginning before January 1, 2018: methodology could be either tax basis or fair market value
    - After January 1, 2018, value must be determined using the tax bases
- Then, characterize the assets according to the type of income that the asset generates and determine source
  - If the asset generates foreign source income, must go in appropriate separate §904 baskets
- Tax-exempt assets are excluded
  - Generally includes assets that give rise to tax-exempt income (e.g., stock on which dividends qualifying for the DRD under §§243 and 245 are paid)
  - Query whether future regulations would extend to the portion of CFC stock eligible for the GILTI §250 deduction. *Compare* §904(b)(4).

# FTC Limit: Interest Expense

Example: STEP 1

**Compute foreign source income (FSI) in accord with U.S. tax principles**

FSI reduced by

(a) expenses directly related; and

(b) a portion of expenses not directly related to any specific income (e.g., interest expense)

| | |
|---|---|
| Foreign source gross income: | $100 |
| Expenses directly related to FSI: | $20 |
| Interest expense: | $60 |

Allocate interest expense based on tax basis of assets; assume:

Foreign: $1,000; Domestic: $1,000

| | | | |
|---|---|---|---|
| **Interest expense allocated to FSI =** | **Foreign Assets : $1000 / Worldwide Assets: $2000 X** | **Interest expense: $60 =** | **$30** |

| | |
|---|---|
| Foreign source gross income: | $100 |
| Expenses directly related: | ($20) |
| Interest expense: | ($30) |
| **Foreign source taxable income:** | **$50** |

# FTC Limit: Interest Expense

## Example: STEP 2

### Determine available FTCs

FTCs are limited to proportion of taxpayer's U.S. tax liability corresponding to the proportion of its worldwide taxable income that is from foreign sources

| | |
|---|---|
| Foreign source taxable income: | $50 |
| Worldwide taxable income: | $120 |
| Tentative U.S. tax liability ($120 x 35%) | $42 |

| | |
|---|---|
| Foreign source taxable income: | $50 |
| Worldwide taxable income: | $120 |
| Tentative U.S. tax liability ($120 x 21%) | $25.20 |

| | | |
|---|---|---|
| Net foreign source income: $50<br>________________________ X<br>Worldwide net income: $120 | Tentative tax liability:<br>$42 =<br>$25.20 = | Foreign tax credit limitation:<br>$17.50<br>$10.50 |

Before TCJA

| | |
|---|---|
| Only $17.50 of $24 is creditable | Only $10.50 of $24 is creditable |
| Remaining $6.50 could be carried back 1 year; forward 10 years, subject to limitations | Remaining $13.50 could be carried back 1 year; forward 10 years, unless in GILTI basket |

After TCJA

# Effect of Expense Allocation on FTC in GILTI Basket

| | With Expenses | Without Expenses |
|---|---|---|
| **Gross GILTI FS Income** | $100* (includes §78 gross-up) | $100 |
| **§250 Deduction** | $50 | $50 |
| **Expenses** | $5 (directly related)+<br>$5 (allocated interest)=<br>$10 Total | $0 |
| **FS Taxable Income** | $40 | $50 |
| **WW Taxable Income** | $40 | $50 |
| **Foreign Taxes** | $13.125 (13.125% rate) | $13.125 (13.125% rate) |
| **Foreign Taxes Available to Credit** | 80% x $13.125 = $10.50 | 80% x $13.125= $10.50 |
| **Tentative U.S. Tax on GILTI Inclusion (No Expenses)** | $50 x .21 = $10.50 | $50 x .21 = $10.50 |
| **§904 Fraction Applied to GILTI/FTCs Allowed**** | $\frac{\$40}{\$100}$ x $21 = $8.40 | $\frac{\$50}{\$100}$ x $21 = $10.50 |
| **U.S. GILTI Outcome** | $2.10 residual US tax; ($10.50 - $8.40) | No U.S. residual tax - no excess credits |
| **WW Tax on GILTI** | $13.125 + $2.10 = $15.225 (or 15.225%) | $13.125 + $0 = $13.125 (or 13.125%) |

*assumes 100% of GILTI inclusion is foreign source
**assumes $60 of U.S. source income before expenses

# Effect of Expense Allocation on FTC in GILTI Basket

- Section 904 limit with expenses = $8.40
- Foreign taxes paid = $13.125
- U.S. residual tax = $2.10
- Excess FTCs = $2.10 ($10.50 - $8.40)
- The worldwide effective tax rate increased from 13.125% to 15.225% due to the residual US tax of $5.25
- Compare this amount to §904 limit of $10.50 when there are no expenses allocated to GILTI basket
- U.S. tax liability= $10.50
  - Could be completely offset by the $10.50 of foreign taxes
- No excess FTCs (though $2.625 ($13.125-$10.50) not creditable due to 80% limitation)
- The worldwide effective tax rate = 13.125%, the foreign tax rate and no U.S. residual tax

# New §904(b)(4) Adjustments for Expenses Allocated to §245A Exempt Dividends

– Section 904(b)(4): In determining both the numerator and the denominator, disregard:
  - the foreign source portion of any dividends received from a 10%-owned foreign corporation;
  - any related deductions NOT allocable to §951(a)(1) or §951A(a) income/stock, i.e., that are allocable to §245A dividends/stock;
  - Result: Deductions allocated to §245A dividends are disregarded for purposes of the numerator and denominator of the §904(a) fraction

## New §904(b)(4) Adjustments for Expenses Allocated to §245A Exempt Dividends

- Prior rules only impacted the numerator and required the subtraction of certain exempt income
  - Tax exempt assets and income from such assets are not taken into account for purposes of apportionment of deductible expenses
  - Deductible expenses are apportioned to remaining taxable assets/income
  - Result is increased apportionment to remaining assets/income with lower FTC limitation resulting
- New §904(b)(4) impacts both the numerator and the denominator
- Expenses allocated to §245A dividends resourced as US source income under §904(h) are also subject to the §904(b)(4) adjustments rule

# New §904(b)(4) Adjustments for Expenses Allocated to §245A Exempt Dividends

| | GILTI | | 245A | | US | | Total |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| Inclusion | 100 | | 50 | | 100 | | |
| | | | | | | | |
| Statutory Deductions | -50 | | -50 | | 0 | | |
| | | | | | | | |
| Allocated/Apportioned Expenses | -20 | | -10 | | -20 | | |
| | | | | | | | |
| Net Taxable Income | 30 | | -10 | | 80 | | 100 |
| | | | | | | | |
| Tentative US Tax (30 x .21) | 6.3 | | N/A | | N/A | | |
| | | | | | | | |
| Available FTCs (10 x .8) | 8 | | N/A | | N/A | | |
| | | | | | | | |
| Tentative Tax Before 904(b)(4) | 0 | | -2.1 | | 16.8 | | 14.7 |
| | | | | | | | |
| 904(b)(4) FSI | 30 | | | | | | |
| 904(b)(4) Total Taxable Income | 110 | | | | | | |
| | | | | | | | |
| Fraction | 0.2727 | | | | | | |
| Tax on Total Net Taxable Income (.21 x 100) | 21 | | | | | | |
| Max FTCs | 5.7273 | | | | | | |
| | | | | | | | |
| FTCs Allowed | 5.7273 | | N/A | | N/A | | |
| | | | | | | | |
| Resulting US Tax After FTCs | 0.5727 | | -2.1 | | 16.8 | | 15.2727273 |
| | | | | | | | |
| Excess GILTI FTCs | 2.2727 | (8 - 5.7273) | | | | | |

# Summary of §904(b)(4) Results

- The §245A dividend is not included in the numerator or the denominator
- Moreover, both the apportioned and allocated expenses attributable to a §245A dividend are disregarded for purposes of the numerator (where relevant) and the denominator
- The result in many cases will be a smaller FTC fraction with a lower limitation on FTCs with higher US tax
- For example, compare the fraction 30/100 if §904(b)(4) did not apply to the fraction 30/110 under §904(b)(4)

# Foreign Tax Credit Limitation – §904(b)(4) Example

| **Taxpayer has the following:** | |
|---|---|
| U.S. source income | $100 |
| Expenses allocable to U.S. source income | ($50) |
| GILTI | $100 |
| Section 250 deduction | ($50) |
| Expenses allocable to GILTI | ($10) |
| Foreign source general basket income | $50 |
| Expenses allocable to foreign source general basket income | ($20) |
| **Expenses allocable to QBAI return giving rise to general basket §245A dividends** | **($20)** |
| **Taxable income** | **$100** |
| **Tentative U.S. tax ($100×21%)** | **$21** |

| **FTC limit before §904(b)(4):** | | **FTC limit after §904(b)(4):** | |
|---|---|---|---|
| Net U.S. source income ($100–$50) | $50 | Net U.S. source income | $50 |
| Net GILTI basket income ($100–$50–$10) | $40 | Net GILTI basket income | $40 |
| Net general basket income ($50–$20–$20) | $10 | Net general basket income ($10**+$20**) | **$30** |
| Net worldwide income ($50+$40+$10) | $100 | Net worldwide income ($100**+$20**) | **$120** |
| **GILTI FTC limit ($\frac{\$40}{\$100}$×$21)** | **$8.40** | **GILTI FTC limit ($\frac{\$40}{\$120}$×$21)** | **$7.00** |
| **General basket FTC limit ($\frac{\$10}{\$100}$×$21)** | **$2.10** | **General basket FTC limit ($\frac{\$30}{\$120}$×$21)** | **$5.25** |

# Effect of Losses on Foreign Tax Credit Limitation

- Complicated regime concerning overall foreign losses (OFL) and overall domestic losses (ODL)
- Rules for OFLs and ODLs similar
- Ordering rules require foreign losses to offset other separate limitation categories prior to offsetting U.S. source income
- Recapture provisions recharacterize income to the extent that prior losses offset U.S. or foreign income
- Pre-2018 ODLs – may elect to recapture up to 100% under §904(g)(5) under the TCJA (vs. general rule of 50% recapture)

# Excess GILTI Basket FTC Considerations

## Foreign Tax Considerations

# Excess GILTI Basket FTCs

## General Considerations

- Many taxpayers will find themselves with substantial excess FTCs in the GILTI basket in most years
  - Depends in part on expense allocation rules and whether §904 look-thru is extended to the GILTI basket
- Because FTCs in the GILTI basket cannot be carried back or forward, such excess FTCs are essentially a wasted tax attribute
  - Accordingly, companies should seek to minimize their foreign taxes related to tested income
- Even taxpayers that typically have excess GILTI basket FTCs should seek to maximize the potential FTC benefit from the foreign taxes they do pay, because in certain years they may all be valuable

# Value of Excess GILTI Basket FTCs in a Disposition

- The optimal result in a taxable disposition often will be that the recognized gain is characterized as GILTI income so that the income is subject to the reduced GILTI rate rather than the full 21% corporate tax rate
- If there are sufficient GILTI basket FTCs available to cover the gain generated on the disposition, it may be possible to reduce or eliminate the U.S. tax cost of the disposition assuming that no or minimal foreign taxes are imposed on the disposition gain

# Use of Excess GILTI Credits for Disposition

- Assume facts of prior example with GILTI income of $30
- Assume that the disposition of an asset by a CFC results in net taxable gain of $60 ($30 net GILTI after §250 deduction)
- Section 904(a) fraction becomes $60/$140 or .42857
- Compare to fraction of $30/$110 or .2727
- The excess credits of $2.27 may now be used
- Tentative tax on $130 = $27.30
- 60/140 x $27.30 = $11.70 so excess credits of $2.27 will be used
- Note that if foreign tax at a rate of 13.125% or higher were imposed on the gain, the preexisting excess credits could not be used

# Excess GILTI Basket FTC Considerations

| Factors Potentially Increasing Value of Excess GILTI Basket FTCs | |
|---|---|
| **Growth** | Disproportionate growth in low-tax jurisdictions would reduce excess GILTI basket FTCs |
| **Disposition in Future** | A large foreign disposition could generate substantial GILTI without local taxes, providing an opportunity to utilize otherwise excess GILTI FTCs for that same taxable year |
| **Audit Protection** | Significant excess GILTI basket FTCs may reduce the incentive for the IRS to propose certain adjustments, including increasing the royalty if royalties are treated as GILTI, valuation issues, or challenging transactions that are intended to be non-taxable |
| **Rate Increase** | GILTI effective rate will increase to 16.4% in 2025, meaning the capacity to use GILTI basket FTCs will increase, and GILTI effective rate may also be increased through legislation |
| **Expense Allocation** | In addition to the potential for a change to the expense allocation rules, a significant taxable acquisition in the U.S. could reduce the expenses allocated to the GILTI basket, creating capacity to use additional GILTI basket FTCs |

# Maximizing Future GILTI Basket FTCs in an Acquisition

- A key consideration in planning and structuring an acquisition is the value to Acquiror of generating net excess FTCs in the GILTI basket
  - The amount of GILTI basket net excess FTCs generated by a target post-acquisition depends primarily on:
    - the effective rate of the target and,
    - for a company with intangibles,
      - where those intangibles are held in the group
      - whether amortization is available for U.S. and local tax purposes on the intangibles and/or goodwill
      - whether §901(m) applies to any U.S. step-up on the intangibles and/or goodwill
  - In many cases, there will be GILTI basket net excess FTCs because of the low GILTI rate
- If Acquiror already has significant excess GILTI basket FTCs before taking into account any additional excess GILTI basket FTCs related to a target, the value of such incremental excess FTCs may be minimal, unless, possibly, there is a change in circumstances

# Foreign Tax Considerations

- Minimizing local tax on operations continues to be important, as it was in most cases prior to TCJA in light of deferral, because taxes imposed on GILTI are only creditable up to 80%, and as noted excess GILTI basket FTCs have limited value
- The importance of minimizing foreign taxes, which historically could often be fully credited, is increased following tax reform, and acquisition structures should take this into account (e.g., through financing structures or amortization of intangibles)
- FTCs for withholding taxes on GILTI PTI would provide limited benefit to the extent the company generally has significant excess GILTI basket FTCs
  - Because GILTI basket FTCs cannot be carried forward, if the FTCs are not used in the year paid or deemed paid, they have no value
- FTCs for withholding taxes are partially disallowed on distributions of §965 PTI
- No FTCs are allowed for foreign taxes imposed on §245A dividends, including hybrid dividends under §245A(e)
- Because holding company structures are no longer required for FTC planning or deferral purposes, historic structures should be reviewed

# Section 905(c) Adjustments

## Section 905(c) Background

- Section 905(c) provides rules for taking into account foreign tax redeterminations – when the amount of foreign tax ultimately paid differs from the FTCs accrued or the foreign tax is not paid within two years of the accrual
- Historically, required amended returns for changes to §901 "direct" FTCs, but foreign tax redeterminations with respect to CFCs were generally just taken into account in the §902 earnings and FTC pools in the year the redetermination occurred

# Changes to Section 905(c)

- Section 902 pooling repealed
- Section 905(c) adjustments to all foreign taxes will apparently require filing an amended return for the year with respect to which the adjustment is made
- What to do about closed years pre-2018?
  - TCJA effectively retroactively changes the rules for these years
  - Raises statute of limitations issues for CFC foreign tax audits related to years before 2008
- For ongoing lengthy foreign audits, file protective returns to keep statute of limitations open so return can be amended?

# Summary of Changes After TCJA

# Summary of Changes After TCJA

What's New:

- Two new baskets – GILTI and foreign branch income (QBUs)
- Section 904(b)(4) pulls expenses allocable or apportioned to §245A stock/dividends out of §904 computation
- FMV apportionment of interest expense not allowed – tax bases of assets required
- FTCs for withholding taxes on CFC dividends often restricted
- No pooling of taxes (only current year relevant) and no §902
- New inventory manufacture/production source rule: if production in the US, 100% US source even if sales outside the US

# Summary of Changes After TCJA

## What's Unclear Under TCJA Changes:

- Does look-through apply to GILTI? If so, how?
- Allocation of expenses to the GILTI basket
- Characterization of CFC stock for expense apportionment and §904(b)(4) purposes where §245A applies
- How are "business profits" of a foreign branch determined?
- Interaction of Financial Services and the Foreign Branch Basket
- Interaction of Foreign Branch Basket and new production source rule
- Any FTCs ever allowed with respect to §956 inclusions?
- Transition Rules, e.g., carryover credits earned in pre-2018 years

# Other Statutory and Regulatory Limits

Taxes Not Considered Paid – Subsidies

Holding Periods – Sections 901(k) and (l)

Covered Asset Acquisitions – Section 901(m)

Splitter Arrangements - Section 909

# Taxes Not Considered Paid - Subsidies

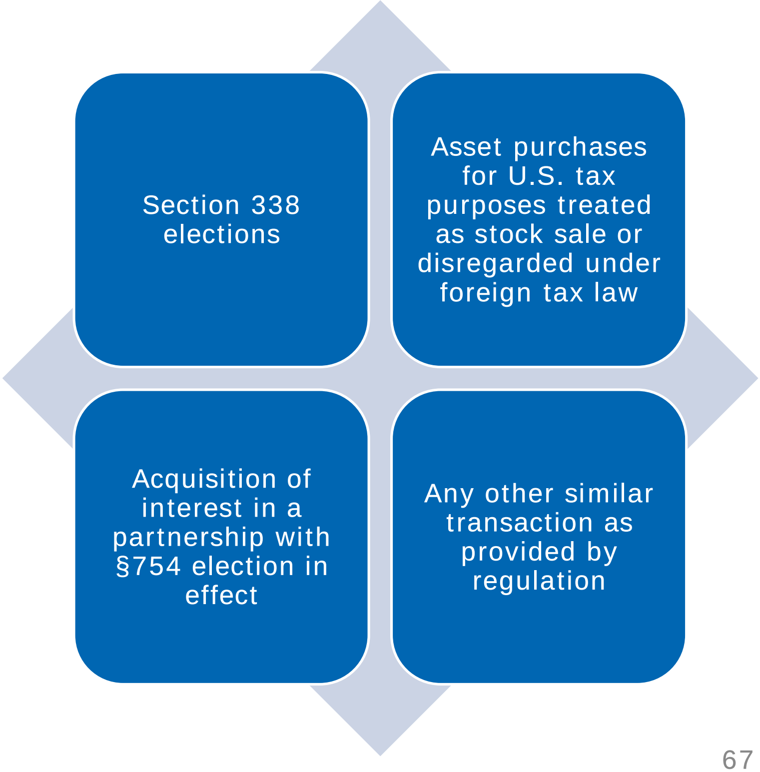
- No FTC if foreign tax has not effectively been paid
  - There must be an actual net economic outlay
- Not treated as paid if there is a "subsidy"
  - Taxpayer receives a direct or indirect benefit from foreign government measured by reference to the tax or tax base
  - Example:
    - USVI subsidiary of a U.S. corporation receives 75% of USVI taxes it paid under the VI Industrial Incentive Program
    - See Rev. Rul. 69-433

# Holding Periods – Sections 901(k) and (l)

- Both sections:
  - Apply to withholding taxes
  - Require a minimum holding period
  - Prohibit an obligation to make related payments re: positions in substantially similar property
    - Exception for dealers in stock or securities
  - Deny a FTC but allow a deduction for such taxes
- Section 901(k) applies to dividends and deemed paid taxes under §960
- Section 901(l) applies to withholding taxes on gain and income other than dividends

# Covered Asset Acquisitions – Section 901(m)

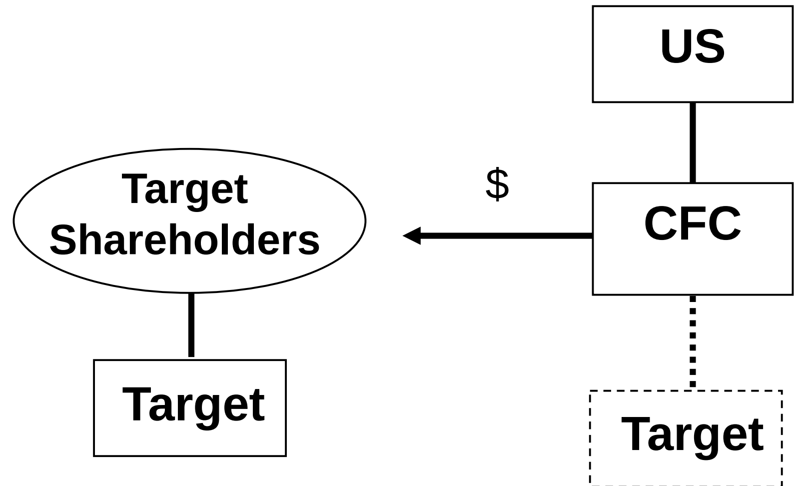
- Section 901(m) disallows a FTC for foreign taxes paid that relate to certain basis step-ups for U.S. tax purposes without a taxable transaction under foreign law
  - Permanently disallowed FTC but allows for a deduction
- Applies to “covered asset acquisition” or “CAA”
  - Statute includes list of CAAs
  - Temporary and proposed regulations issued 12/7/2016 T.D. 9800



# Covered Asset Acquisitions – Section 901(m)

## Example: Denial of FTCs in the Case of CAA

CFC acquisition of Target stock in a qualified stock purchase with §338 election




CFC purchases Target after 31 December 2010 and makes a §338(g) election
Total stepped-up basis is $1,500,000 (all assets have a 15-year life)
Basis immediately prior to acquisition was 0, so “basis difference” is $1,500,000
Pre-tax Target foreign income for year 1 is $1 million and foreign tax is $300,000

Disqualified portion of year 1 tax:

$$\frac{\$100{,}000\ [\$1{,}500{,}000 \div 15]}{\$1{,}000{,}000\ [\text{foreign income}]} \times \$300{,}000\ [\text{foreign taxes}] = \$30{,}000 \text{ disallowed tax}$$

# Splitter Arrangements – Section 909

- Section 909 was designed to address situations that arbitrage U.S./foreign tax law where, from U.S. tax perspective, foreign taxes are "split" from the income on which the foreign taxes were imposed
- Section prevents claim of FTCs without recognition of income in U.S. that caused foreign tax
- Applies a matching principle to foreign taxes and foreign income (as seen from U.S. tax perspective)

# Splitter Arrangements – Section 909

- In general, §909 defers consideration of foreign taxes for FTC purposes at the level of the payor until the income on which the foreign taxes were imposed is taken into account by the payor or a U.S. shareholder of the payor
- Once “related income” is taken into account, the suspended tax is taken into account
  - Translate taxes to year tax is paid/accrued
  - Interaction with elimination of pooling unclear
- Section 909 regulations list the only “splitting” events
  - Reverse hybrid arrangements
  - Loss sharing arrangements
  - Hybrid instrument arrangements
    - U.S. equity hybrid arrangements
    - U.S. debt hybrid arrangements
  - Partnership inter-branch payment arrangements

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