

Chapter 5

Foreign Tax Credit p.302

Tax structural options for an outbound U.S. enterprise in (1) the foreign destination country and (2) any conduit country:

- 1) Branch (e.g., a disregarded entity) -
current U.S. income taxation on profits &
loss deduction availability in the U.S.
- 2) Foreign organized corporate subsidiary -
income tax deferral of U.S. income tax &
no possible U.S. loss utilization

Is the entity decision controlled by (1) tax planning
or (2) non-tax business considerations?

Mitigating Possible Double National Level Taxation

Possible double taxation exposure exists (1) since the U.S. income tax is imposed on a worldwide basis & (2) assuming foreign country income tax.

Options for unilateral relief (as provided by U.S.):

- 1) a tax deduction for the foreign tax paid (not completely eliminating double taxation); or
- 2) a (limited) credit for the foreign tax paid (primarily used by U.S.); limited to offsetting the U.S. tax on taxpayer's foreign income; or
- 3) exemption under a territorial system (only source country tax), but (usually) not in U.S.

Bilateral (i.e., Income Tax Treaty) Relief p.306

Double tax relief accomplished under a U.S. bilateral income tax treaty. See U.S. Model, Article 23 (2016) (double tax relief).

- possible shifting of the primary income tax liability away from source location to residence jurisdiction.
- but, a U.S. income tax treaty does include a “savings clause” (Art. 1(4)) - enabling the continuing worldwide tax jurisdiction of U.S. citizens, U.S. residents & U.S. corporations.

Fundamental U.S. Foreign Tax Credit Issues P.307

- 1) Who is eligible for the FTC?
- 2) Which foreign taxes are creditable?
- 3) The “direct credit” regime.
- 4) The indirect or “deemed paid” credit regime (tax paid by foreign subsidiaries & branch equivalency treatment); timing for the credit?
- 5) Possible limitations on foreign tax credit availability.
- 6) Foreign currency translation (taxes are paid in foreign currency; how determine US\$ credit?)

Eligible Taxpayers for the Direct FTC p.308-9

§901(a) & (b) - credit availability for taxes paid by:

- 1) Foreign branch of a U.S. corporation.
- 2) Individuals - U.S. citizens and resident aliens.
- 3) Individuals and corporations operating/investing through partnerships & (for individuals) S corporations.

A credit is available for direct taxes paid, including for withholding at source, if the tax is an income tax & the tax is imposed on the recipient of the income.

“Hybrid Entities”

p.310

**Who is the taxpayer? Reg. §1.901-2(f)(1)
prescribes the “technical taxpayer rule.”**

**Inquiry: Who has the “legal liability” for the
foreign income tax under applicable foreign
law when a flow-through occurs for foreign tax
(but foreign entity is a corp. for U.S. tax)?**

**Consider the “reverse hybrid” entity – a corp. for
U.S. tax, but a flow-thru for foreign tax.**

**Under foreign tax law the U.S. taxpayer has the
legal liability for the foreign tax. But, foreign
corp. has its income deferred for U.S. tax.**

“Hybrid Entities”

p.310

Guardian Industries case – p. 311

- U.S. corp. has a §901 credit for tax paid by “subsidiary” - a disregarded entity for U.S. tax purposes but a corp. for foreign tax. The disregarded entity had the tax obligation for U.S. tax purposes and the tax was treated as paid by U.S. corp.**
- See change to the technical taxpayer rule in Reg. §1.901-2(f) & § 909 (next slide).**

IRC §909 Enactment

p.312

See Code §909 re “splitter” transactions as enacted in 2010.

A “matching rule” is imposed: A foreign tax credit is not available to the U.S. taxpayer until the related income on which the foreign tax was paid is included in the U.S. tax base.

Final regulations issued in 2012.

“Creditable” Taxes

Code §§901 & 903 p.313

§901(a) identifies income, war profits and excess profits taxes as creditable for U.S. income tax – to prevent/minimize double income taxation.

Must be a tax on income; cannot be an excise tax, sales tax, VAT, capital or net worth taxes.

Reg. §1.901-2(a)(1) - the tax must be an income tax in the U.S. sense, but exact parallelism to the U.S. system is not (& should not be) required. Should be a tax imposed on “net profits.”

Might be an “in lieu of” tax; §903 enables a substitution tax to enable a foreign tax credit.

Subnational Taxes p.314



Foreign subnational income taxes are creditable.

U.S. subnational (i.e., state and local) income taxes are not creditable, but are only deductible.

Does this difference create an incentive to locate investment in a foreign jurisdiction; i.e., what is the impact on the net after-tax return when having a tax credit rather than only a tax deduction?

Policy issue: Provide a tax deduction only for foreign subnational taxes? Or, provide a tax credit for both U.S. state & local taxes?

Is the Foreign Levy a “Tax” (or a Benefit)? p.315

A tax is a compulsory payment under foreign country’s authority to impose a tax.

Reg. §1.901-2(a)(2)(i) specifies that penalties, fines, interest, customs duties and similar obligations are not taxes for FTC purposes.

Tax vs. Royalty: Cf., Rev. Rul. 55-296 (p.316) & IR-1638 (p. 321). No FTC is available unless the foreign government also obtains an appropriate royalty amount for the production of oil which it owns, calculated separately from the tax amount.

“Dual Capacity” FTC Regulations

p.323

Regulations provide for not determining foreign tax credit amount on an “all or nothing” basis.

Divide the amount paid between (i) the creditable tax portion and (ii) the noncreditable (but deductible) royalty amount paid to govt.-owner.

How demonstrate that portion which is the payment for the creditable tax?

Two methods: (1) facts & circumstances - Reg. §1.901-2A(c)(2), and (2) a safe harbor formula - Reg. §1.901-2A(c)(3) & (d) & (e).

Problem re Dual Capacity Taxpayer

p.324

\$1,000 gross receipts and \$500 of mining costs; no royalty is paid to the foreign government.

Levy of \$300 is paid to the foreign government.

Generally applicable income tax rate is $33 \frac{1}{3}\%$.

Computation: gross receipts (1000) less mining costs (500) less the levy (300) = 200

times tax rate ($33 \frac{1}{3}$ percent)

$66 \frac{2}{3}$ percent (or 1.0 less $\frac{1}{3}$ rd tax rate)

Therefore, 100 is the creditable tax amount.

If usual tax: $1000 - 500 - 200$ (expense) = 300 income.

“Income Tax in the U.S. Sense”?

p.324

Tax must reach “net gain” to be a creditable tax.
Reg. §1.901-2(a)(3)(i).

“Net gain” test is satisfied if the tax paid meets:

- 1) the “realization” requirement – what is a “realization event”? Cf., § 1001 & Haig/Simons.
- 2) the “gross receipts” requirement – actual receipts.
- 3) the “net income” requirement – recovery of actual expenses must be allowed to offset the gross receipts amount.

Bank of America case

p.326

Tax on gross receipts from banking business re (1) interest, etc. and (b) gross profits re sale of foreign currency and promissory notes.

Held: taxes imposed here were not equivalent to a net income tax. No deductions were allowed.

The issue is whether the other country is attempting to reach some net gain. Must be able to deduct associated costs (when expenses are relevant).

A direct tax on gross income is creditable if intended to reach some net gain.

Texasgulf, Inc. case

p. 330

Ontario Minerals Tax is creditable (since meeting the “net income” test).

An approximation method was applied to determine expenses & the net profit amount.

A “processing allowance” was held to compensate for the disallowed specific deductions.

This allowance is approximate to or greater than the amount of actual non-recoverable expenses.

Similarly, Exxon case, p. 330 (re allowances permitted for UK PRT purposes).

Code §903 “In Lieu of” Foreign Tax Credit p.331

FTC is available for a special foreign tax imposed as (i) a substitute for, and (ii) not in addition to, a generally applicable income tax.

Tax base need not be the income tax base.

Why permitted as a creditable tax? Difficulty in imposing an income tax on the taxpayer's particular industry (e.g., mining or petroleum)?

But, the “in lieu of” tax must (1) satisfy the dual capacity rules and (2) not be a “soak-up tax”.

“Soak-up” Taxes

p. 331

Reg. §1.901-2(c) specifies that a “soak-up” tax is not creditable – i.e., a foreign country tax which is conditioned on the availability to the taxpayer of a foreign tax credit in its home jurisdiction.

Rev. Ruls. 87-39 (p. 332) & 2003-8 (p. 333)

Not creditable under either direct credit provision (§901) or in lieu of tax provision (§903).

What is the statutory authority for this soak-up tax/no FTC tax regulation? Note 2, p. 333. No supporting Code language exists.

Gross Income Taxes & Withholding Tax

p.333

Should gross income taxes imposed by withholding at source be creditable?

Foreign gross basis withholding taxes on income such as interest, dividends, rents and royalties – are to be treated as "in lieu of" taxes under Code §903, rather than foreign income tax under §901?

Will withholding tax apply to net gain (e.g., where limited expenses incurred) for some taxpayers?

See Rev. Rul. 78-234 (*next slide*).

Withholding Tax at Source



Withholding tax on dividends, interest, royalties and management fees.

Gross tax on management or professional fees is not the equivalent of a U.S. income tax & is not creditable for U.S. tax under §901 (or §903?).

Separate taxes on dividends, interest and royalties also not allowing for deductions. But, equivalent to gross withholding taxes in U.S.? Here, creditability under §901 (or §903?).

Actual foreign tax payment required

p.336

Taxpayer must submit receipts showing actual payment of the foreign tax. Reg. §1.905-2(a)(2).

What if a foreign tax receipt is not available?

Must be a compulsory payment, i.e., must exhaust all effective and practical remedies to reduce the foreign tax before the foreign tax credit is available. No FTC if not required to pay the foreign country tax. Reg. §1.901-2(e)(5).

Then a business expense/charitable contribution?

Refunds, Rebates & Subsidies

p.338

See Code §901(i) re not being “taxes” if subsidies.

Not a creditable tax if an amount will be credited, refunded, rebated, etc., to taxpayer (or another?).

See Nissho Iwai American Corp. v. Commissioner (p. 338) - A net loan arrangement; interest based on LIBOR. Why “net loan” deals?

But, a refund was received by the borrower for a portion of the tax paid by lender to Brazil.

Treated as a subsidy when the transactions are integrated; therefore, no FTC is available (for refunded amount).

Amoco case (7th Cir) p.347

Was a Tax Subsidy Available?

U.S. oil company and an instrumentality of Egypt government (i.e., a wholly owned government corporation; cf., Pemex).

How structure the payment of taxes under a production sharing agreement so taxes are treated as paid by AMOCO (for FTC purposes)? Here tax credit was claimed by both parties.

Tax Court says Amoco paid the taxes & no indirect subsidy. Egypt Govt. cannot subsidize itself.
Tax burden was economically on Amoco.

Denial of FTC for Political Purposes

p.361

Code §901(j).

FTC denial re: Cuba, Iran, Iraq (not from 1982 to 1990 & not after 2004), North Korea, Sudan & Syria.

(i.e., all members of the Bush II “Axis of Evil,” plus some others). Where is Libya? A 2004 Presidential Determination of “national interest” was made.

Previously on the list: South Africa (apartheid issue) and Vietnam (war enemy).

Cuba: including Guantanamo?

But, non-creditable taxes are deductible. §164(a).

Problem 1

p.362

Withholding Taxes at Source

Galaxy provides services into Country A and licenses patents for use in certain projects. No generally applicable income tax, but (i) a 20% withholding tax on gross royalties, and (ii) a withholding tax of 25% on gross service fees. Therefore, no “in lieu of” credit. But, §901?

No deductions are permitted. Galaxy receives (1) royalties and (2) service fees subject to withholding taxes. Are these taxes creditable?

Royalty – yes (assuming no expenses); services tax – no (tax applies even if a loss is incurred).

Problem 2

p.363

“In lieu of” Taxes



Galaxy (1) provides services into Country A and (2) licenses patents for use in certain projects. A generally applicable income tax is imposed (but a gross tax is imposed on royalties & gross service fees). Are these taxes on royalties & services creditable?

Yes: the withholding taxes on (1) the service fees and (2) royalties are both “in lieu of” taxes (under Code §903).

Problem 3

p.363

Local Country Subsidiary

Foreign government imposes income tax of 30 percent on net income realized within foreign country by foreign persons engaged in business there.

Domestic persons are not subject to income tax.

U.S. corporation is engaged in mining and exporting copper ore through an export subsidiary organized in that foreign country (i.e., a domestic corp.).

This sub pays export tax of \$1,000 per ton of copper ore. No portion paid for specific economic benefit.

Is FTC available for the export tax paid? Not §901 (not reaching net income); Not §903 in lieu of tax (since no other tax is applicable to others in FC).

Problem 4

p.363

Operation through a Branch

Foreign government imposes income tax of 30 percent on net income realized within foreign country by foreign persons engaged in business there.

Domestic persons are not subject to income tax.

U.S. corporation is engaged in mining and exporting copper ore through a branch in Country B.

Branch pays export tax of \$1,000 per ton of copper ore. No portion paid for specific economic benefit.

Is FTC available for the export tax paid? Yes.

An “in lieu of” tax under Code §903; cf., the foreign country income tax is imposed on other foreigners.

Problem 5

p.363

Assumed Gross Income

Orbit established Country C branch office coordinating export sales. No foreign branch revenue reported; only expenses.

C has a generally applicable income tax.

Branch is taxed on basis that gross income will equal 120% of the expenses. Assumed income less expenses is subject to generally applicable income tax of 35%. Is this a net income tax?

Cost recovery & a tax on net – i.e., a creditable §901 tax (?) & not a §903 “in lieu of” tax.

Problem 6

p.363

Imputed Rental Income

U.S. corporation owns undeveloped land in Country D, but is not engaged in trade or business there and has no income there.

Country D has generally applicable net income tax imposed at rate of 30 percent.

Under Country D law an owner of real estate is deemed to realize the imputed rental income from the property. Associated expenses are deductible. Creditability under §901?

Yes, even though imputed income?

Problem 7

p.364

Evil Country Exception

Same facts as Problem 6: U.S. corporation owns undeveloped land in, but is not engaged in, trade or business there and has no income there. Generally applicable net income tax is imposed at rate of 30%.

Imputed rental income from the property and the associated expenses are deductible.

But, diplomatic relations with Country D has been severed. Creditability? No, §901(j); but, deductibility of tax paid is permitted. §164(a)(3).

Problem 8

p.364

Individual Tax Exposure

U.S. citizen earns compensation in Country E. She owns appreciated shares there. Net 25% income tax. “Net income” definition satisfied? Similar to §63 (but no personal deductions available).

Accrued appreciation in the stock is subject to a 10% tax and the adjusted tax basis is increased.

Are 25% and 10% taxes creditable? Yes - for both taxes under §901. Even if no deductions?

For stock – tax on a “pre-realization” event, but the tax basis adjustment mitigates the effect (& the “realization test” is deemed met).

Problem 9

p.364

Reg. §1.903-1(b)(2)

Lunar, U.S. Corp, is engaged in manufacturing through a branch. Under contract with govt. tax is equal to greater of: (i) \$100 per item produced (50x); or, (ii) max. amount creditable by Lunar against U.S. income tax.

Lunar is exempted from the generally imposed income tax. An “in lieu of” tax is imposed; but, the tax is dependent upon the U.S. credit.

Answer: 50 of 75 is creditable under §903 (“in lieu of” tax); 25x is dependent upon credit availability and, therefore, is not creditable.

Problem 10

p.364

No Tax Credit Dependency?

Lunar, U.S. Corp, produced 1,000 widgets and was required to pay a Country D tax of \$100,000. This amount exceeded the \$75,000 creditable by Lunar against U.S. tax liability.

None of the tax would be imposed solely because the “credit is available.”

All foreign tax is attributable to the actual production by Lunar.

Therefore, the entire \$100,000 amount would be creditable as an “in lieu of” tax under §903).

Problem 11

p.365

Comparison to Regular Tax

Lunar, U.S. Corp, produced 1,000 widgets and would have been required to pay a Country D income tax of \$80,000 under a generally imposed income tax in Country D.

None of the tax would be imposed solely because of the \$75,000 maximum available U.S. credit.

The entire \$75,000 tax actually paid (not \$80,000) would be creditable.

Problem 12

p.365

Withholding Tax on Interest

\$300,000 of withholding tax on interest payment, but 60% is credited back to indirect borrowers from the prime (Dev. Bank) borrower.

Reg. §1.901-2(e)(3) specifies that this 60% (\$180,000 amount of \$300,000) is treated as a “subsidy” and not as a tax since the received amount is provided to a party to a related transaction.

The remaining \$120,000 is creditable as a § 903 “in lieu of” tax (since it is imposed as a substitute for a generally imposed income tax).

Problem 13

p.365

Foreign Government Borrower

\$300,000 of withholding tax on interest payment,
but 60% credited back to indirect borrowers.

But, each of the borrowers is government owned.

Under the Amoco decision is the entire amount
(including the \$180,000) treated as tax paid?

Government entity is a part of the government
and, therefore, amount transferred is not a
subsidy - but a tax (the government then
distributes the funds to various government
entities)?

Problem 14

p.365

Compulsory Tax Payment?

Foreign country withholding at source on interest is at 30% but the income tax treaty rate is 5%. The excess 25% can be retrieved by making a refund claim.

If no refund claim is made, is a credit available in the amount of 30%? No, to the extent of the 25% (of the total 30%), since the total amount is not a compulsory payment.

Reg. §1.901-2(e)(5) requires a compulsory payment to enable foreign tax creditability.

What timing issues re (1) claiming FTC, (2) filing refund claim, and (3) revising FTC?

Doubt re tax refund success

Eligibility for reduced tax rate on interest (under tax treaty) is uncertain since contingent interest is dependent upon profits.

No pursuit of refund claim since not a realistic chance of succeeding to obtain refund.

See Reg. §1.901-2(e)(5)(i) indicating that the remedy must be effective and practical to require pursuit of the refund.

Creditable – as an “in lieu of” (the generally applicable income) tax (i.e., a §903 tax).

Election and Accounting Rules

p.366

§905(a) - permits a cash method taxpayer to elect accrual method for FTC purposes.

What potential problem does this accrual method option remedy? I.e., to match accrued foreign tax for the same year when U.S. tax on income.

§905(c) – an accrual basis taxpayer must make adjustments when the accrued tax amount changes or where the foreign taxes are not actually paid within two years after tax year.

What if the foreign tax is contested? Accrual of tax only when the issue is resolved. But, a ten year S/L to avoid credit limitation issues.

Indirect “Deemed Paid” Credit Availability §902

Objective: A branch of a U.S. corporation and a foreign subsidiary of a U.S. corp. are to be treated similarly with respect to the availability of the U.S. foreign tax credit.

U.S. tax treatment: A 10% or greater corporate shareholder is deemed to have paid a proportionate share of the foreign corporation's post-1986 foreign income taxes. Cf., the §243(a) DRD. Why a 10% minimum ownership in the foreign sub. to enable indirect credit eligibility?

Indirect Credit – P.368

Calculating the Amount

- 1) Determine the amount of foreign taxes deemed paid on the foreign corp. distribution:
 - (a) all or only a partial E&P distribution?
 - (b) allocations to multiple shareholders?
- 2) Determine the includible dividend amount: the dividend as grossed-up is to include the allocated income tax amount (Code §78) (otherwise both a deduction & a tax credit is available).
- 3) Determine the U.S. income tax on the grossed-up amount (a) before & (b) after the FTC.

Indirect Credit – p.371

Determining Ownership

- 1) No attribution of indirect ownership to obtain the 10% minimum ownership status.
- 2) Determining U.S. corp. ownership when foreign corporate ownership held thru:
 - a) a general partnership (US)
 - b) a limited partnership (US)
 - c) a foreign partnership
 - d) an S corporation? (not available)
 - e) LLC (tax status?) See §902(c)(7).

Manufacturing Plant

Problem 1

p.372

Maryland or Greece as the mfg. location?

U.S. corporate income tax rate is 35 percent.

Maryland corp. state income tax is 10 percent.

Greece corporate tax is 20% & a 10% provincial tax
& a 10% withholding tax on dividends paid.

If a foreign branch, a 20% tax is imposed on
operating profits & a 10% provincial tax, but no
withholding taxes on repatriated (branch) profits.
continued

Problem 1, cont.

Alternative Considerations

- 1) Availability of the §901 direct credit for national and subnational taxes paid directly as foreign income tax, including the withholding tax on the Greek subsidiary dividends paid;
- 2) U.S. tax deferral is available, if a foreign subsidiary, and then later availability of the §902 deemed paid credit for foreign taxes, when profits are paid as dividends; and,
- 3) U.S. subnational taxes are not creditable, but are only deductible.

Problem 2

p.372

Interest Through Partnership

U.S. corp & U.S. citizen own 50% interests in a U.S. general partnership. The partnership owns a 20% interest in a foreign corporation.

Is an indirect credit available to the shareholders? Yes, to corporation (only). Not available to individuals (even thru ptnshp.).

Rev. Rul. 71-141 applies aggregate theory of partnership taxation and each shareholder is treated as owning 10% of the foreign corp.

Problem 3

p.373

Interest Held Through an LLC



U.S. corp. & U.S. individual own 50% interests in a U.S. limited liability company (treated as a partnership for U.S. tax). The LLC owns a 20% interest in a foreign corporation.

Should indirect credits be available here?

Concern re complicated allocation provisions and structures? Note: §902(c)(7) - as enacted in 2004 Jobs Act.

Problem 4

p.373

Dividends on Preferred Only

U.S. corp. owns 10% of voting stock and 5% of nonvoting preferred stock of foreign corp.

Dividends are received on the preferred stock but no dividends paid on the voting common.

Eligibility for the §902 credit for tax paid by corp. attributable to the distributed preferred dividend? Yes - see Rev. Rul. 79-74 (p. 373) – since Y Corp. then owning 10% of the foreign corporation's voting (common) stock.

Indirect credit through multiple tiers

p.373

§902(b). Six ownership tiers for enabling possible eligibility for foreign tax credit.

Ten percent direct ownership (by the owner sub) and 5 percent indirect ownership (by the U.S. parent) for each lower tier is required.

Below the 3rd tier – must be CFCs. §902(b)(2).

What if needing more ownership tiers?

Why need even more than one tier after the “choice of entity” rules (i.e., disregarded entities)?

Possible answer: Hi-tax/low-tax companies?

Subpart F planning - to come.

Determination of Earnings, Foreign Taxes and Dividends

Distribution of the proportionate amount of post-1986: (1) earnings and (2) foreign taxes to be determined.

See the §902 computation formula - p. 375.

What is a “dividend?” The Code §316 definition applies: either (i) current e&p (“nimble dividend” rule), or (ii) accumulated e&p.

What is “accumulated e&p”?

What is E&P? §312(k) re S.L. depreciation.

The Perpetual Pool System (i.e., not year-by-year) p.376

§ 902(c)(1) perpetual pool of post-1986 earnings,
starting in 1987. p.376

§ 902(c)(2) continuing pool of foreign taxes,
starting in 1987. p.377.

Pooling only when a 10% or + voting interest.

Cf., the prior single year approach, resulting in
the “rhythm method” of FTC planning (e.g.,
arrange fluctuations of income and tax paid:
repatriate dividends for only the high foreign
tax payment years).

Goodyear Tire & Rubber - U.S. E&P Rules Applicable p.381

Goodyear G.B. had an operating loss (& carryback and received a substantial refund of U.K. income tax payments). No U.S. income tax change.

Code §905(c) requires a redetermination of FTC when foreign tax previously paid is refunded.

U.S. “earnings and profits” rules (not foreign country tax law) are to be used, however, to measure the distribution of “accumulated profits” (pre-1987) as being “dividends” for U.S. income tax purposes.

Vulcan Materials

“Mixed Corporation”

p.388

Vulcan, a U.S. corporation, was a shareholder of a Saudi corporation (TVCL).

Saudi income tax on a "mixed corporation" is imposed on only that portion of the profits attributable to the foreign ownership interest. The domestic owner is subject to the “zakat.”

Dividends are not subject to Saudi tax at source.

What was the “accumulated profits” amount allocable to the U.S. corporate shareholder? Is a “special allocation” permitted here? *Next slide*

Vulcan Materials Computation

p.388
1st Year

Profits of TVCL	20,902,753
U.S. Shareholders share (68%)	14,213,872
Saudi tax (at 48% on U.S. share)	6,883,191
<u>Dividend</u>	<u>557,924</u>

What foreign tax credit amount?

1) *USGovt. position:*

$$\underline{557,924} \times 6,888,991 = 273,924$$

$$20,902,753 - 6,883,191 \text{ (tax)} \quad \text{(credit)}$$

2) *Taxpayer position:*

$$\underline{557,924} \times 6,888,991 = 523,866$$

$$14,213,872 - 6,883,191 \quad \text{(credit)}$$

Problem 1

p.395

200x Dividend to U.S. Corp.

ABC Mfg. (US corp.) owns 40% of FC, Inc.

1) Direct credit - 30x (15% “in lieu of” tax).

2) Indirect credit to ABC:

Dividend (200x) x 300k tax = 100x FTC

Earnings (600x [i.e., 900 less 300 tax])

Dividend of 300x is included in ABC’s GI;

(note: gross-up of 200x dividend by the 100x tax).

Indirect FTC credit is available in the U.S. for
the amount of 100x.

Problem 2

(Vulcan type situation) p.396

Facts: Country Y income tax is only on the net profits which are attributable to non-Y shareholders (tax of 300x is imposed on 600x)?

Can % allocation (only 200x) be disregarded?

If “special” allocation (e.g., Vulcan) is accepted:

Dividend (200x) $\times$ 300x tax = 200x credit

Undistributed earnings (300x; 600x less 300x tax)

Income gross-up of 200x dividend by 200x tax.

Dividend of 400x is to be included in GI.

Indirect credit totals 200x (50% tax rate).

Problem 3 Foreign Tax Rate Manipulation

p.396

Dividend of \$700,000 is to be distributed from \$1 million profits.

Option One: Foreign Country has 22% corporate tax rate and 10% dividends withholding rate.

Option Two: Corporate tax rate is raised to 25% (& a 10% div. withholding rate).

Option Three: Assume the dividend withholding tax rate is increased to 15% and the corporate tax rate is only 22%.

Problem 4

p.396

Sub-sub-sub Problem



Three tiers of foreign subsidiaries and dividends
paid between various tiers.

Problem 5 Problem re:

Voting-nonvoting stock

US Corp owns all stock of FS1.

FS1 owns 20% of voting stock of FS2.

US Corp directly owns 10% of nonvoting common of FS2 & US Corp receives dividends on the nonvoting stock.

Issue: US Corp eligibility for §902 credit for FS2 taxes?

Rev. Rul. 74-459 says no; U.S. corp. owned only nonvoting stock in 2nd tier corp.

§902 is dependent upon voting stock ownership of the corporations in the chain.

Foreign currency conversion

p.397

Issue: Conversion of both (1) foreign earnings and (2) foreign taxes paid into U.S. dollars for determining the FTC amount.

Code §986(a)(1)(A) - accrual basis taxpayers - use an average exchange rate.

Code §986(a)(2)(A) - cash method taxpayers - use the exchange rate when the taxes are actually paid.

Impact of Deficits on the FTC Computation

p.397

Interrelated complications:

- 1) “Nimble dividend” rule, although deficit E&P.**
- 2) Foreign country does not have NOL carryback or carryforward system.**
- 3) Carryback of post-1986 or carryforward of pre-1987 deficits.**

Notice 87-54

p.399

**Issues re carryforward and carryback of deficits
when FTC rules changed in 1986.**

Problem 1

p.401

100 % owned foreign sub

Pre-1987 200,000 deficit and 50,000 taxes

Post-1986 undistributed earnings of \$400,000 and foreign taxes of \$80,000

Distribution of 100x dividend during year.

Deemed paid credit computation is:

100x dividends x 80,000 post 1986 tax = 40x

200,000 earnings (400x less (200x) - pre-1986)

100,000 dividend grossed up by 40x deemed paid and total dividend of 140,000

Indirect credit of 40,000

Problem 2

p.402

Impact of Earlier Losses

Re: Impact of the inconsistency between Code §316 & §902.

Cosmos Brazil (a foreign subsidiary) has a loss of 200x in year one and a loss of 100x in year two. In year three foreign subsidiary has earnings of 400x, paying tax of 200x and making a distribution of 200x.

continued

Problem 2 continued

p.402

200x of undistributed earnings for year three
(400x less 200x tax) is less than the
accumulated loss (300x).

“Pool of earnings” is in deficit, i.e., (100x).

Foreign tax pool will be +200x.

Entire distribution will be a dividend under the
“nimble dividend” rule - although a deficit
exists in the foreign earnings pool.

No deemed paid credit? $200x/(100x) = 0$

Possible Reforms p.402

Problem with Eternal Pools

Issue: Dealing with the complexity of the present structure for calculating indirect foreign tax credits for U.S. corp. shareholders.

Options:

- 1) Moving pools, rather than “eternal pools.”
- 2) Limit on years in the eternal pools.
- 3) Year by year method but a general anti-abuse rule.

“Tax Sparing” Credits p.403

U.S. Position - “No”

Re: Foreign country tax holiday programs.

Under the "tax sparing" concept a tax credit is provided in the home country even though foreign country taxes are not actually paid.

U.S. rule: Uncollected foreign taxes are not creditable for U.S. income tax purposes.

For U.S. tax planning: use a foreign country subsidiary and achieve deferral of (1) the local country tax and (2) current U.S. income tax.

Foreign Tax Credit & Possible Limitations p.406

Code §904 - fundamental concepts:

- (1) no credit allowed for foreign tax paid against U.S. tax on U.S. sourced income; and,
- (2) no averaging of foreign country tax rates between different types of income (§904(d)).

The basic FTC limitation formula is:

Applicable fraction (foreign income/worldwide income) times U.S. income tax on all the income of the taxpayer.

FTC Limitation Example: Two Income Items Only

Assume U.S. taxpayer:

- 1) 100 U.S. source income taxed at 40% = 40
- 2) 100 foreign source income taxed at 70% = 70

Result: 200 total income - U.S. tax is imposed at 40% = 80 U.S. tax (before FTC applicability)

Is the available foreign tax credit determined:

- a) 80 less 70 (i.e., net 10 U.S. income tax)? or
- b) 80 less 40 (i.e., net 40 U.S. income tax) & total 110 tax (i.e., 40 US + 70 foreign tax - of which 40 is creditable)?

Foreign Tax Credit p.408

Excess Credit Carryover

Code §904(c) – Excess foreign tax credits – carryback one year and carryforward for ten years.

Pre-2004 rule: Carryback two years and carryforward five years.

Cf., §172 NOL carryback & carryforward rules & periods.

Planning objective: develop low taxed foreign source income to enable total FTC absorption.

Foreign Tax Credit Limitations

p.409

“Baskets”, Losses and Look-Through Rules:
Separate Limitation Categories/Baskets under
Code §904(d).

Objective: To reduce *cross-crediting* of excess
foreign tax credits against tax on other income
subject to lesser foreign income tax rates.

E.g., manufacturing income taxed at high rate
vs. low taxed interest (passive) income.

Possible Types of FTC Limitation Formulas

1. Worldwide - only one limitation fraction.
2. Separate country limitation fraction.
3. Different “types of income” limitation - Code §904(d).
4. Each item of income has separate limitation.

Fundamental issue: how much “cross-crediting” should be allowed?

What about losses in some countries or activities?
Offset foreign income with foreign losses?

FTC Limitation Baskets –

Prior §904(d)(1) p.414

- 1) Passive income (FPCI income)**
- 2) High withholding tax interest - 5%+**
- 3) Financial services income**
- 4) 10-50 corporation dividends**
- 5) Overall/residual basket (“I” basket).**

Must determine for each basket:

(a) gross income, (b) deductions, and (c) the foreign tax amount.

10-50 Corp. Dividends - Limitation Choices p.418

- 1) Limitation formula to be applied on a corporation by corporation basis (i.e., separate calculations)?
- 2) Combination: Treat all as one §902 corporation (the rule for post 2002 distributions from pre-2003 E&P)?
- 3) Current rule: Look-through rule is applicable (for distributions of post-2002 income), with income from corporations placed into separate baskets.

Post 2006 Tax Years - 2004 Jobs Act Rules p.419

Code §904(d)(1): Two basket limitation system:

- 1) General category income (including shipping income & owner occupied imputed income)
- 2) Passive category income – FPHC income (e.g., dividends, interest, rents, royalties); not export financing interest (incentive for exports) & high-taxed passive income (“high-taxed kick-out”).

Substantially increased “cross-crediting” opportunities under these revised (2004) rules.

2010 Tax Legislation

Technical Changes p.423

- 1) Code §909: Re splitting income from the credit.**
- 2) Code §901(m): Re “covered asset acquisition” – no foreign tax credit for foreign income not taxed in U.S. when, e.g., a §338 transaction basis step-up occurs in corporate transaction.**
- 3) Code §904(d)(6) – separate limitation when foreign sourced income under tax treaty.**
- 4) Code §960(c): Special subpart F limitation.**
- 5) Interest expense/corporate affiliation rules.**
- 6) Terminate 80/20 U.S. corp/foreign source rule.**

Income & Deduction Sourcing Rules

p.424

Must use U.S. rules concerning sourcing of both income and deductions for FTC limitation.

Numerator and denominator of the FTC limitation formula are based on amounts determined under U.S. sourcing rules.

This may produce a conflict with:

- 1) the foreign country imposing tax & asserting it has primary income tax jurisdiction, and
- 2) the amount of income (& tax) in foreign country.

Problem

p.426

Divergent Income Sourcing

Legal services performed in U.S. for foreign client

1) U.S. source income for U.S. income tax purposes, but

2) foreign source income for foreign tax purposes (per foreign tax authorities).

No foreign tax credit since, for U.S. income tax purposes, income is U.S. sourced (to the place where the services are rendered).

The numerator of the FTC limitation fraction will be zero (and, therefore, no FTC available).

Capital Gains

p.426

§904(b)(2)

§904(b) has special rules for capital gains –
netting gains with foreign capital losses.

Further objective: to adjust for capital gain tax
rate differentials (20% for individuals). §1(h).

Similar adjustment required for “dividend rate
differentials”. §1(h)(11) (dividends taxed at
20% cap gain rate). See §1(h)(11)(c)(iv).

Relevant for individuals; not relevant for
corporations (since no income tax rate
differentials for corporations).

De Minimis Exemption

p.427

**§904(j) (redesignated from §904(k) in 2013) –
exemption from foreign tax credit limitation
for individuals:**

- 1) Limit of \$300 of creditable tax (\$600 if
married & joint return)**
- 2) Applies only to qualified passive income
(e.g., thru a mutual fund or an ETF)**
- 3) Elect for this “de minimis” rule to apply.**

Problem 1

FTC Limitation

p.428

Total income - 150,000 (including 50,000 U.S. sales income)

	<u>Income</u>	<u>Tax</u>
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Country D <u>int.</u> income	10,000	-0-
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§904(d)(1)(A)

Country C <u>bus.</u> income	50,000	10,000 (20%)
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§904(d)(1)(B)

Country D <u>bus.</u> income	40,000	<u>20,000</u> (50%)
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§904(d)(1)(B)

Continued foreign totals: 100,000 30,000

Problem 1, cont., p.428

Total pre-credit U.S. tax is \$42,000

(\$150,000 @ 28% assumed U.S. tax rate)

1) Code §904(d)(1)(A) (passive income) limitation:

10,000 times 42,000 equals 2,800 limit

150,000 (but, no foreign tax is actually paid)

2) Code §904(d)(1)(B) (formerly I) limitation:

90,000 times 42,000 equals 25,200 limit

150,000 Net credit amount? \$25,200 (not 30x paid).

But, is a carryback or carry-forward possible?

Problem 2

p.429

De minimis rule - §904(j)

U.S. citizen with \$99,500 U.S. personal service income and \$500 foreign source dividends (subject to foreign withholding tax of \$210).

§904(d)(1)(A) limitation: & 28% tax rate

$$\frac{\underline{500}}{100,000} \text{ times } 28,000 = \$140$$

But, if §904(j) de minimis rule is applicable (and election made), then \$210 FTC is available (42% tax rate). Election required for de minimis rule.

Problem 3 Gardtrac problem

p.429

<u>Country and Income</u>	<u>Amount</u>	<u>Tax Paid</u>
Argentina branch §904(d)(1)(A)	100,000	10,000
Brazil <u>sub</u> (gross-up)* §904(d)(1)(B) (look-through)	100,000	35,000
Colombian <u>branch</u> §904(d)(1)(B)	100,000	45,000
	Total tax	90,000

* gross-up: $65,000 / 325,000 \times 175,000$ foreign tax =
\$35,000 (plus \$65,000 dividend) *continued*

Gardtrac Problem, continued

35% U.S. tax rate; \$1 mil. total worldwide income

<u>Country</u>		<u>Limit</u>	<u>Actual Tax</u>
Argentina	A basket	35,000	10,000
Brazil	B basket		35,000
Columbia	B basket		45,000
Total/limit re B basket		70,000	90,000 total
		<u>$(200/1000 \times 350,000 = 70,000)$</u>	

Credit amount: 10,000 plus 70,000 equals 80,000.
but, total actual foreign tax paid is 90,000;
10x carryback/over?

Problem 4

p.429

Apartment & active income

1) Code §904(d)(1)(B) limitation computation:

$$\frac{300,000}{1,000,000} \text{ times } 350,000 = 105,000 \text{ FTC limit}$$

2) Credit is available of \$105,000; all same basket

35,000 of Brazilian tax (B basket)

10,000 tax to Argentina (B basket)

45,000 tax to Columbia (B basket)

Result: Blending for FTC limit & total 90,000 tax paid is creditable for U.S. tax purposes.

Problem 5

p.429

Look-through rule

Look-through rule (§904(d)(4)) requires sourcing of income to the underlying (Braztrac) income.

80% of 100,000 Braztrac income would be “B” basket income; 20% for “A” passive limitation.

A basket 120,000 x 350,000 = 42,000

1,000,000 (tax paid is 17,000; i.e., 10x
Argentina & 7x from Brazil)

B basket 180,000 x 350,000 = 63,000

1,000,000 (actual tax paid is 73,000)
(Col. 45x + Brazil 28x)

Anti-Abuse Rules **p.430**

Cross border tax arbitrage

**IRS Notice 98-5 - possible economic profit test
when FTC generating arrangements**

**Withdrawn in Notice 2004-19 (p.437) - no regs.
released. Existing law to be applied:
Substance over form; step transaction; etc.**

**§704(b) regs. (p.440) - no special allocations of
creditable foreign taxes – any allocation will
not have substantial economic effect (except
when proportionate to interests in Ptnship).**

See §901(k) (1997) & (l) (2004) – holding periods.

Judicial Doctrines

p.441

Compaq case (2001, reversed by Fifth Circuit) & IES case (reversed by 8th Circuit). Transaction does have economic substance.

ADR transaction with foreign dividend and withholding tax – dividend stripped after the ADR purchase and before the ADR sale:

- 1) Capital loss can be used to offset prior realized capital gain from stock disposition by Compaq;
- 2) A foreign tax credit is obtained (& net dividend is received after at source tax withholding).

Statutory Anti-Abuse Provisions

p.450

Code §901(k) (1997) – Limitation on the FTC stripping transaction. Holding period requirement for enabling the FTC re stock. Similar to the requirement for the dividends received deduction (DRD).

Code §901(l) – 2004 Jobs Act

Holding period requirement imposed for various other (non-dividend) income types to enable FTC eligibility - must hold property 15 days during a 31 day period.

Statutory Anti-Abuse Provisions, continued p.451

Code §901(m) (2010) – Disallowance of FTC for taxes attributable to a “covered asset acquisition.”

Code §909 (2010) – Deferral of FTC eligibility until related income included in U.S. gross income (i.e., “splitter transactions”).

Code §7701(o) (2010) – Codification of the “economic substance doctrine.” Transaction has this purpose only if: (1) transaction meaningfully changes the taxpayer’s economic position, and (2) substantial non-tax purpose exists for the transaction.

Problem

p.452

Atlas mfg. income is realized by a foreign country subsidiary – tax-free in the foreign country & no withholding tax in that country.

Acquire foreign country patent – to be used by foreign country sub. Royalty payment to be subject to 40% withholding at source.

Any limit on FTC availability for foreign tax?

- 1) Look-thru rules (§904(d)(3)) to determine status of royalty as general limitation basket income.
- 2) Challenge to the transaction on tax avoidance, etc. basis? Unlikely. Sufficient economic benefit to Atlas for the use of the patent for its life.

Code §911 Foreign Earned Income Exclusion p.453

Gross income exclusion is phased up (to \$102,100 for 2017). Inflation adjustments are to be made. §911(b)(2)(D)(i). Rev. Proc. 2016-55 (for 2017 adjustments). A quasi-territorial approach.

Exclusion is available for income in both:

- (i) a high tax foreign country (U.K. or Germany), &
- (ii) a low tax foreign country (e.g., Saudi Arabia).

What tax policy arguments exist both: (1) for and (2) against this earned income exclusion from gross income? P.454.

Defining “Foreign Earned Income”

p. 457

Exclusion must be for “foreign earned income” - §911(d)(2)(A).

§911(d)(2)(B) - no more than 30 percent of profits of a business may be treated as foreign earned income when “capital is a material producing item”.

Rousku, p. 458 Auto body repair business - was capital a “material producing factor”? Yes, in this situation.

§911 requirements, cont.

p. 460

Defining earner income – artists; sculptors?

Consider the sourcing rules to determine the location of the earned income.

No eligibility exists for US Govt. employees.

Attribution required of income to the year when income is earned - Code §911(b)(2)(B).

Payment is required by the end of the year following the year in which income earned (i.e., no eligibility for deferred comp.).

Pension/annuity income is not eligible for §911.

Exclusion for Housing Costs

§911(a)(2) p.462

§911(c) – limited amount – Up to 30% of §911 exclusion amount over 16% of this exclusion, or the lesser actual expense. Previously, no limit - if reasonable in amount. Possible adjustment upwards for high cost housing situations. §911(c)(2)(B). See IRS Form 2555 Instructions for this listing.

Deduction where housing costs are not provided by the employer. §911(c)(4). E.g., proprietor.

What about the §119 exclusion for meals and lodging?

Eligibility for earned income exclusion

p.464

1) Bona fide foreign country resident - §911(d)(1)(A). Jones case.

Facts and circumstances test are applied to determine "residency" (cf. §7701(b)); i.e., not a "day-counting" test. And, no statement permitted that not a resident in foreign country. §911(d)(5).

2) Physical presence test - 330 days in any consecutive 12 months. §911(d)(1)(B).

3) Also, must have a "tax home" in the foreign country. Code §911(d)(1) & 911(d)(3).

Tax Treaty Impact

p.474, part 3.

Treatment of resident aliens under §911(d)(1):

Resident both:

- 1) in U.S. (under Code §7701(b)) for U.S. worldwide income taxation (e.g., Greencard), and
- 2) in foreign country (under facts & circumstances test) for §911 purposes – because of the application of the nondiscrimination article of an applicable bilateral income tax treaty. Rev. Rul. 91-58.
(or under the “physical presence” test?)

Other §911 Special Eligibility Requirements p.474, 4&5.

§911(d)(4) - concerning waiver of eligibility requirement when danger exists. Pakistan, but not Iraq! Haiti (2005). Other Middle –Eastern countries. Rev. Proc 2007-28: East Timor, Lebanon, Nepal; Rev. Proc. 2009-22: Chad, Serbia & Yemen; Rev. Proc 2010-17: Madagascar & Guinea; Rev. Proc. 2011-20, Haiti & Ivory Cst.; Rev. Proc. 2012-21: Egypt, Libya, Syria.

§911(d)(8) - no qualification where travel restrictions are in effect. Cuba (but not Guantanamo – Notice 2006-84). Rev. Rul. 2005-3 – list of numerous countries (Iran, North Korea, Syria, Sudan), but Iraq – no limit (ended 2004).

§911 Benefit – Income Tax Computations

p.475

§911(d)(6) - no “double deductions”;

therefore, do not elect §911 in a high tax jurisdiction, but use the foreign tax credit.

Income tax computation – see 2005 JCT Options paper proposal re bracket effect. Starting this tax computation “up the tax bracket ladder.”

TIPRA 2006 – See §911(f) – starting at a higher plateau on the bracket ladder, i.e., a “stacking rule.”

Problem 1 (Clemens)

page 475

§911(d)(5) precludes residency status if submitting a statement of non-residency to the U.K. Inland Revenue.

But, can qualify for §911 even if not a resident if satisfying the “physical presence” test.

If no election re §911, all gross income (including bonus and housing allowance) and no §911 exclusion, but a full foreign tax credit is available (subject to FTC limits).

If §911 election: exclusion of statutory amount, plus housing allowance amount.

Problem 2 (Jennifer)

Eligibility?

page 476

- 1) Satisfying the “tax home” requirement?
Probably; no “abode” in Miami?
- 2) Physical presence test? Only satisfied during a limited period?
- 3) Bona fide residence test satisfied? Probably; enabling a greater exclusion period. Pro-rate the §911 exclusion for years one and three.

Jennifer, cont (p. 476); how much § 911 exclusion?

Compensation in year 2 - \$140,000, less U.S. source income - 20,000 (US) and 25,000 (US).

Equals: \$95,000

Less: \$10,000 for year 1 (partial exclusion, if bona fide resident status)

Equals: \$85,000 for year 2.

Less: exclusion of \$80,000? for year 2.

Problem 3

Jones the author

p.477

Income entirely received in year 2. When are the author's "services" rendered? 1/2 in each year? & allocated to each year?

If so, exclusion of \$80,000(?) for each year.

If received in year three, only an \$80,000 exclusion for year two is permitted.

Also, a deduction (not an exclusion) for housing costs is permitted - §911(c)(3).

Problem 4

Mary Smith

p.477

Eligible for exclusion as a bona fide resident of Brazil.

- a) Exclude \$65,000 salary and \$13,000 rental value (equals \$78,000).**
- b) Foreign earned income of \$90,000. Excludable housing amount is determined under §911(c)(1).**

Problem 4c

Mary Smith

p. 478

Foreign earned income of \$90,000 (but limited exclusion).

Housing cost of \$23,000 less base housing subtraction amount. Not a deduction (since not an employer provided amount, but an exclusion is permitted).

Problem 4

Mary Smith

p. 478



Problems d, e, f &g

[to come]

Role of Tax Treaties in Mitigating Double Taxation of U.S. Persons

Basic objective of an income tax treaty is to mitigate double taxation by (in outbound context) reducing or eliminating the foreign country treaty partner's taxes on specified items of income realized by U.S. persons in that foreign country.

Remember, however, the “savings clause” in U.S. income tax treaties is applicable to U.S. persons – causing continuing U.S. income tax jurisdiction.

See Treaty Article 23 re foreign tax credits as being available (even if not creditable under Code).

Filler v. Commissioner

page 480

U.S. citizen and French resident. Taxpayer spent five days each year in the U.S. on business. Double income taxation of U.S. earned income.

U.S. Tax Court says income is subject to U.S. income taxation and that the French taxing authorities should withdraw.

Do U.S. income tax code “source of income” rules (§861(a)(3)) control the sourcing for U.S. income tax purposes? US FTC is only available for foreign tax paid on foreign income!

Problem

p.484

Savings Clause Issue

U.S. citizen independent oil consultant is a resident in a foreign jurisdiction. Engaged to work on Texas problem and spends 30 days in the U.S. But, resident in a foreign country. Article 4 status.

Will a U.S. income tax liability arise? Yes.

“Savings clause” is applicable to the U.S. citizen - Treaty Art. 1(4) - as a foreign country resident.

Real question: How much FTC does the foreign country allow for its income tax? How much U.S. tax when dependent on UK granting a FTC?