International Income Taxation
Chapter 5
Professors Wells
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Structural Options for an **Outbound** Entity:

1) Branch (e.g., a disregarded entity) – current U.S. income taxation & loss deduction availability in U.S.

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

Options for unilateral relief include:

1) A deduction for the foreign tax paid.

2) A (limited) credit for the foreign tax paid.

3) Exemption under a territorial system.
Mitigation of Double Taxation

1. Accomplished unilaterally under domestic law under §901, §902, §903, and §960.
2. Accomplished under a U.S. bilateral income tax treaties under Article 23.
   **Caveat:** U.S. income tax treaties include a “savings clause” that enables the US to assert worldwide tax jurisdiction over U.S. citizens/residents/corporations.

3. Possible shifting of tax liability from source to residence jurisdiction.

**Basic Goal of FTC Regime**

- **Foreign Income**: 1,000x
- **US Tax b/4 FTC (35% rate)**: 350x
- **Foreign Taxes**: 100x
- **US Tax After Credits**: 250x
Fundamental Foreign Tax Credit Issues

1) **Who** is eligible for FTC?

2) **Which** foreign taxes are creditable?

3) The “**direct**” credit regime.

4) The **indirect** or “deemed paid” credit (paid by foreign subsidiaries) regime.

5) Possible **limitations** on foreign tax credit availability.

6) **Foreign currency** translation.
1) Foreign branch of a U.S. corporation.

2) Individuals – U.S. citizens and resident aliens.

3) Individuals and corporations through partnerships and S corporations.

Credit is available for direct taxes, including withholding at source, if the tax is an income tax and imposed on the recipient of the income.
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 purposes?

Guardian Industries Case – p. 283

U.S. corp. has §901 credit for tax paid by “subsidiary” – a disregarded entity for Luxembourg purposes but a regarded entity for US purposes.

* §909 Now Defers FTC Until Income Inclusion
§901(a) identifies income, war profits and excess profits taxes as creditable.

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

Reg. §1.901-2(a)(1) – the tax must be an income tax in the U.S. sense, but exact parallelism to U.S. system not required.
Foreign subnational taxes are creditable.

U.S. subnational taxes are not creditable but only deductible.

Does this create an incentive to base investment in foreign jurisdiction; i.e., what is impact on net after-tax return?

Policy issue: Provide a deduction only for foreign subnational taxes? Provide a credit for U.S. state and local taxes?
Reg. §1.901-2(a)(2)(i) specifies that penalties, fines, interest, customs duties and similar obligations are not taxes.

Tax vs. Royalty: Cf., Rev. Rul. 55-296 & IR-1638. No FTC is available unless the foreign government also obtains an appropriate royalty amount for the production of oil it owns.
### “Dual Capacity” FTC Regulations

Based on Indonesia Rulings

<table>
<thead>
<tr>
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<th>Case One</th>
<th>Case Two</th>
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<td>Income</td>
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<tr>
<td>Net Income</td>
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<td>US Tax Paid</td>
<td>$210</td>
<td>-0-</td>
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**Do not** determine credit on “all or nothing” basis.

Instead: divide the government payment between (i) the creditable tax portion and (ii) the noncreditable (but deductible) royalty portion.

Two methods: (1) facts and circumstances – Reg. §1.901-2A(c)(2), and (2) safe harbor formula – Reg. §1.901-2A(c)(3) and (d) and (e).
\[(A - B - C) \times \frac{D}{(1-D)}\]

A: Gross Receipts
B: Costs
C: Amount paid to government
D: Generally applicable tax rate

$125 \text{ gross receipts}; \$25 \text{ costs}; \$75 \text{ paid to the government}; \text{ tax rate 50\%}$

\[(125 - 25 - 75) \times \frac{50\%}{(1-50\%)} = 25\]

Therefore, amount of the creditable tax is 25. **Check:** \[125-25-50=50\times50\%=25\]

(A-B-C) is simply after-tax net income. From this amount, we are simply finding what is the tax that would have been paid if the general tax rate had applied to the earning of this income.
$1,000 gross receipts; $500 of mining costs; no royalty paid.

Levy of $300 to the foreign government; General tax rate is 33 1/3 percent.

Computation: \((A - B - C) \times \frac{D}{1-D}\)

A: Gross Receipts $1,000
B: Costs $500
C: Amount paid to government $300
D: Generally applicable tax rate 33 1/3 %

\[
\begin{align*}
($1000 - $500 - $300) \times (33\,1/3 / 66\,2/3) &= \frac{200}{0.50} = $100
\end{align*}
\]

Therefore, $100 is creditable. **Confirming check: 1,000-500-200 = 300 \times 33\% = 100**
Tax must reach “net gain” to be creditable. Reg. §1.901-2(a)(3)(i).

“Net gain” test is satisfied if tax meets:

1) The “realization” requirement

2) The “gross receipts” requirement

3) The “net income” requirement
Tax on gross receipts from banking business re interest, etc. and gross profits re sale of currency and notes.

Held: not equivalent to a net income tax.

Issue of whether the other country is attempting to reach some net gain.

Direct tax on gross income is creditable if intended to reach some net gain.
Ontario Minerals Tax is creditable.

Approximation method applied to determine net profit.

“Processing allowance” is held to compensate for disallowed deductions.

This allowance is approximate to or greater than the amount of actual nonrecoverable expenses.
Special foreign tax as a substitute for and not in addition to a generally applicable income tax.

Tax base need not be income tax base.

Why permitted as a creditable tax?

Must satisfy the dual capacity rules and not be a “soak up” tax.
Reg. §1.901-2(c) specifies that a “soak up” tax is not creditable – i.e., a tax conditioned on the availability to the taxpayer to claim a foreign tax credit in its home jurisdiction.

Rev. Ruls. 87-39 (p. 302) and Rev. Rul. 2003-8 (p. 333)

What is the statutory authority for this “soak up” tax / no FTC tax regulation?
Should gross income taxes be creditable?

Foreign gross basis withholding taxes on income such as interest, dividends, rents and royalties – treated as “in lieu of” taxes under Code §903?

Will the withholding tax apply to net gain (e.g., where limited expenses are being incurred) for some taxpayers?
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 and is not creditable.

Separate taxes on dividends, interest and royalties not allowing for deductions.

Equivalent to gross withholding taxes in U.S.? Here, creditability under §901.
Taxpayer must submit receipts showing actual payment of the foreign tax. See Reg. §1.905-2(a)(2).

Must be a compulsory payment, i.e., must exhaust all effective and practical remedies to reduce the foreign tax. See Reg. §1.901-2(e)(5).
Code §901(i) re not taxes if subsidies.

Not a creditable tax if an amount will be credited, refunded, rebated, etc.

See Nissho Iwai American Corp. v. Commissioner (p. 308) – A net loan arrangement; but, a refund was received by the borrower for a portion of tax paid.

Treated as a subsidy when the transactions are integrated; then, no FTC is available.
Nissho has “net loans.” Withholding tax but subsidiary gets a tax refund in part.

Court holding: view the refund and the withholding as a combined event and the net amount is the direct tax.
Amoco Case
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)? Credit claimed by both parties.

Tax Court says Amoco paid the taxes and no indirect subsidy. Egypt Government cannot subsidize itself. Tax burden was on Amoco.
Code §901(j).

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

(i.e., all members of the “Axis of Evil”, plus some others.) Where is Libya?

Previously on the list: South Africa and Vietnam.

Cuba: Including Guantanamo?
Galaxy provides services into Country A and licenses patents for use in certain projects. No generally applicable income tax but (i) a 20 percent withholding tax on gross royalties and (ii) a withholding tax on 25 percent of gross service fees.

No deductions permitted. Galaxy receives royalties and service fees subject to withholding taxes. Creditable taxes?

Royalty – yes; Services – no?
Galaxy provides services into Country A and licenses patents for use in certain projects. But, a generally applicable income tax is imposed (but a gross tax on royalties and gross service fees). Are taxes creditable?

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

This sub pays an 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? No? Why?
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 branch in Country B.

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

FTC available for export tax paid? Yes? An “in lieu of” tax under Code §903; Cf., income tax on other foreigners.
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 subject to generally applicable income tax of 35%.

Cost recovery and tax on net – creditable tax.
Problem 6
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 from the property. Associated expenses are deductible. Creditability? Yes?
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 associated expenses are deductible.

But, diplomatic relations with Country D severed. Creditability? No, §901(j); but, deductibility of the tax paid is permitted.
U.S. citizen earns compensation in Country E. She also owns appreciated shares there.

Net income tax at 25% rate.

Net income definition similar to §63 (but no personal deductions available).

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

Are the 25% and 10% taxes creditable? Yes, for both taxes.
Lunar, U.S. Corp., engaged in manufacturing through a branch.

Under contract with government the tax must be paid equal to the greater of:

(i) $100 per item produced; or,

(ii) The maximum amount creditable by Lunar against its U.S. tax liability.

Lunar exempted from the generally imposed income tax. An “in lieu of” tax; but, dependent upon the U.S. credit.
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 amount creditable by Lunar against its U.S. tax liability.

None of the tax would be imposed solely because of the credit (and entire $100,000 amount would be creditable - §903).
Lunar, U.S. corp., produced 1,000 widgets and would have required to pay a Country D tax of $80,000 under a generally applicable income tax.

None of the tax would be imposed solely because of the $75,000 maximum available credit and the entire $75,000 (not $80,000) would be creditable.
$300,000 of withholding tax on interest payment, but 60% is credited back to the indirect borrowers from prime borrower.

Reg. §1.901-2(e)(3) specifies that this 60% ($180,000 amount) is treated as a “subsidy” and not as a tax.

Remaining $120,000 is creditable as an “in lieu of” tax (since imposed as a substitute for the generally imposed income tax).
$300,000 of withholding tax on interest payment, but 60% is credited back to indirect borrowers.

But, all borrowers are government owned.

Under the Amoco decision is the entire amount (including the $180,000) treated as tax? Government entity is part of the government and, therefore, not a subsidy but a tax (under the Amoco decision).
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 made, is a credit available in the amount of 30%? No, to the extent of the 25%, since not a compulsory payment. Reg. §1.901-2(e)(5) requires a compulsory payment for foreign tax creditability.
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.

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” a generally applicable income tax (i.e., §903).
§905(a) – permits a cash method taxpayer to elect the accrual method for FTC purposes. What potential problem does this accrual method option remedy?

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

What if the foreign tax is contested?

Accrual of tax when the issue is resolved.
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 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.
1) Determine the amount of foreign taxes deemed paid on the distribution.

2) Determine the dividend amount: the dividend as grossed-up is to include the allocated income tax amount (Code §78).

3) Determine the U.S. income tax on the grossed-up amount before and after FTC.

Current Earnings: $1,000
Foreign Income Taxes $ 200
Current Year E&P $ 800

E&P $800 $200
Tax Pool

Dividend: $ 400
§78 Gross-Up* $ 100 [(400/800) * 200]
$ 500 / 175
§902 Deemed Credit $ 100
FTC Pool Rate is 20% [100/500]
1) Determine the amount of foreign taxes deemed paid on the distribution.

2) Determine the dividend amount: the dividend as grossed-up is to include the allocated income tax amount (Code §78).

3) Determine the U.S. income tax on the grossed-up amount before and after FTC.

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**US Parent Calculation**

| Dividend | $200 |
| §78 Gross-Up* | $84 |
| Total | $284 |
| §902 Indirect FTC | $84 |

* FTC Calc: 200/800 * 200 = $100

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**US Parent**

- Dividend: $200
- §78 Gross-Up*: $84
- Total: $284
- §902 Indirect FTC: $84

**Foreign Subsidiary #1**

- Dividend: $200
- US Parent Calculation:
  - Dividend: $200
  - §78 Gross-Up*: $84
  - Total: $284
- §902 Indirect FTC: $84

**Foreign Subsidiary #2**

- Dividend: $200

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<table>
<thead>
<tr>
<th>FS #1</th>
<th>FS #2</th>
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<tr>
<td><strong>Ac. E&amp;P</strong></td>
<td><strong>E&amp;P</strong>\n$800</td>
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<tr>
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<td><strong>Cur. E&amp;P</strong></td>
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<td>$200</td>
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<td><strong>$600</strong></td>
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<tr>
<td>$1,000</td>
<td><strong>$60</strong></td>
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</table>
1) No attribution of *indirect* ownership to obtain the 10% minimum ownership.

2) Determining U.S. corp. ownership when foreign corporate ownership held through:
   a) general partnership (U.S.)
   b) limited partnership (U.S.)
   c) foreign partnership
   d) S corporation (not available)
   e) LLC

See §902(c)(7).
Maryland or Greece as the location?

U.S. corporate tax rate is 35 percent.

Maryland state income tax is 10 percent.

Greece corporate tax is 20% and 10% province tax and 10% withholding tax on dividends.

If a foreign branch, 20% tax on operating profits and 10% province tax, but no withholding taxes on repatriated (branch) profits.

continued
1) Availability of the §901 direct credit for national and subnational taxes paid as foreign income tax, including withholding tax on Greek subsidiary dividends paid;

2) U.S. tax deferral available, if a foreign subsidiary, and availability of the §902 deemed paid credit for foreign taxes, when paid as dividends; and,

3) U.S. subnational taxes are not creditable but are only deductible.
Problem 2
Interest Through Partnership

U.S. corp. and 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).

Rev. Rul. 71-141 applies aggregate theory of partnership taxation and each shareholder is treated as owning 10% of foreign corp.
Problem 3
Interest Held Through an LLC

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

Dividends received on the preferred but no dividends on the voting common.

Eligibility for the §902 credit for the preferred dividend? Yes – see Rev. Rul. 79-74 (p. 340) – since owning 10% of voting (common stock).
§902(b). Six tiers possible eligibility for credit. What is a tier?

Below 3rd tier must be CFC

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

What if needing more tiers?
Distribution of the proportionate amount of post-1986 (1) earnings and (2) foreign taxes to be determined.

See the §902 computation formula – p. 342.

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

What is “accumulated e&p”? 

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

Cf., the prior single year approach, resulting in the “rhythm method” of FTC planning (e.g., fluctuations of income and tax paid: repatriate dividends for only the high foreign tax paid years).
Goodyear G.B. had an operating loss (& carryback and received a substantial refund of U.K. income tax payments).

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

U.S. earnings and profits rules are used, however, to measure the distribution of “accumulated profits” (pre-1987) as a “dividend” for U.S. income tax purposes.
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. Domestic owner subject to zakat.

Dividends not subject to Saudi tax at source.

What was the “accumulated profits” amount allocable to the U.S. shareholder? Is a “special allocation” permitted?
Profits of TVCL  20,902,753
U.S. Shareholders Share (68%)  14,213,872
Saudi Tax (at 48% of U.S. Share)  6,883,191
Dividend  557,924

U.S. Government Position:
557,924 x 6,888,991 = 273,924
20,902,753 – 6,883,191 (tax) (credit)

Taxpayer Position:
557,924 x 6,888,991 = 523,866
14,213,872 – 6,883,191 (credit)
Problem 1
200x Dividend to U.S. Corp.

US Parent Calculation

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<tr>
<th>Foreign Income</th>
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<td>Dividend</td>
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<tr>
<td>§78 Gross-Up</td>
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<td>Total</td>
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<td>§901 Direct FTC</td>
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<td>§902 Indirect FTC</td>
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<td>Total</td>
<td>$130,000</td>
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US Parent

Foreign Person

$200,000 Dividend

$200,000 * 40% = $80,000

40% of $200,000 = $80,000

60% of $200,000 = $120,000

E&P

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<tr>
<th>Year</th>
<th>E&amp;P</th>
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<td></td>
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<td>$300,000</td>
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Ending

$400,000 $200,000

*$902 Calc: 200,000/600,000*300,000 = 100,000
Problem 2 (Vulcan Situation)

Foreign country Y income tax only on the net profits of foreign shareholders (2/3rds of the 900x total). Under current law, this allocation will be disregarded due to Treas. Reg. § 1.902-1(a)(9)(iv) and (10)(ii) in contradiction of Vulcan.

**Partnership Structure Work-Around:**

<table>
<thead>
<tr>
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<th>US Parent Calculation</th>
<th>Foreign Subsidiary #1</th>
<th>Country Y Person</th>
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<tr>
<td><strong>E&amp;P</strong></td>
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<td>Partnership Taxes $300,000</td>
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**US Parent Calculation**
- Foreign Income Dividend: $200,000
- §78 Gross-Up: $200,000
- Total: $400,000 / 140,000
- Taxes: §902 Indirect FTC $200,000

**Foreign Subsidiary #1**
- 66%
- $200,000

**Country Y Person**
- 33%
- $200,000

*902 Calc: 200,000/300,000*300,000=200,000
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% (and 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%.
Three tiers of foreign subsidiaries and dividends paid between various tiers.

US Parent

100% $180

S

100% $140

SS

100% $100

SSS

**US Parent Calculation**

- **Foreign Income Dividend**: $180
- **§78 Gross-Up**: $120
- **Total**: $300 / 105

**Taxes**

- §902 Indirect FTC: $120

**E&P**

- S: $100, $140, $240, <$180>, $60
- SS: $180, $100, $280, <$140>, $140
- SSS: $200, <$100>, $100

**Taxes**

- S: $75, $85, $160*, <$120>, $40
- SS: $120, $50, $170*, <$85>, $50
- SSS: $100, $50, <$50>*

*902 Calc: [Dividend/E&P] * FTC

- S: 180/240 * 160 = 120
- SS: 140/280 * 170 = 85
- SSS: 100/200 * 100 = 50
U.S. corp. owns all stock on FS1.

FS1 owns 20% of voting stock of FS2.

U.S. corp. directly owns 10% of nonvoting common of FS2 and U.S. corp. receives dividends on the nonvoting stock.

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


Code §986(a)(2)(A) – cash method taxpayers – use the exchange rate when the taxes are paid.
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.
Issues re carryforward and carryback of deficits when FTC rules changed in 1986.
### Problem 1

**Historic Transitional Trap for the Unwary**

<table>
<thead>
<tr>
<th>E&amp;P History</th>
<th>Tax Pool</th>
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<tr>
<td>Pre-1987</td>
<td>&lt;200,000&gt;</td>
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<tr>
<td>Post-1986</td>
<td>400,000</td>
</tr>
<tr>
<td>Acc. E&amp;P</td>
<td>200,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Alexandria Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
</tr>
<tr>
<td>§78 Gross-Up</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Distribution of 100k dividend during year.

§902 Credit is: \( \frac{100,000 \text{ dividends}}{200,000 \text{ Acc. E&P}} \times 80,000 \text{ post-1986 taxes} = 40,000 \)

*Note: $50,000 of taxes in the Pre-87 Tax Pool are trapped because there is a pre-1987 deficit. They never get distributed in this scenario.

Extra Thought: How might you unlock the Pre-1987 credits so that they were accessible?
Cosmos Brazil makes a dividend distribution of $200,000 when it has negative accumulated E&P and current year earnings of $200,000.

Impact:
1. Dividend under §316 (so-called nimble dividend)
2. No §902 Indirect Credits. Must have positive accumulated E&P for deemed paid credits.
Possible Reforms
Problem with Eternal Pools

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

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.
Re: Foreign country tax holiday programs.

Under “tax sparing” concept, a tax credit is provided in home country even though foreign country taxes 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 the current U.S. income taxation.

- Treaty allows Brazil to withhold at 25% and guarantees 25% credit whether Brazil imposes a withholding tax.
- Brazil exempts rental from withholding
- Cosmos Corp. receives 25% sparing credit.
- **US rejects tax sparing**
Code §904 – fundamental concepts:

(1) No credit for foreign tax paid against U.S. tax on U.S. sourced income; and,

(2) No averaging of tax rates between different types of income (§904(d)).

Basic FTC limitation formula is:

Applicable fraction (foreign income/worldwide income) \( \times \) U.S. income tax on all income.
FTC §904(a) Limitation Example: 
US Source and Overall Foreign Source Income

Example:

<table>
<thead>
<tr>
<th></th>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Source</td>
<td>$100</td>
<td>$100</td>
<td>$200</td>
</tr>
<tr>
<td>US Tax Rate</td>
<td>x 35%</td>
<td>x 35%</td>
<td>x 35%</td>
</tr>
<tr>
<td>US Tax Before FTC</td>
<td>$ 35</td>
<td>$ 35</td>
<td>$ 70</td>
</tr>
</tbody>
</table>

If $50 of foreign taxes were paid, is the available foreign tax credit amount:

a) $50 FTC Utilized (resulting in a final US tax liability of $20)? Or

b) $35 FTC Utilized (resulting in a final US tax liability of $35 (i.e., $70 - $35 of credits)?

Remaining $15 of FTC is can be carrybacked year and carryforward 10 years.
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.
“Baskets”, Losses and Look Through Rules:

Separate Limitation Categories/Baskets under Code §904(d).

### Income by Basket

<table>
<thead>
<tr>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Source</td>
<td>Foreign Source</td>
<td>Total</td>
</tr>
<tr>
<td>Income</td>
<td>$100</td>
<td>$300</td>
</tr>
<tr>
<td>US Tax Rate</td>
<td>x 35%</td>
<td>x 35%</td>
</tr>
<tr>
<td>US Tax Before FTC</td>
<td>$35</td>
<td>$70</td>
</tr>
</tbody>
</table>

### Taxes by §904(d) Baskets

<table>
<thead>
<tr>
<th>Taxes</th>
<th>Passive</th>
<th>General</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes</td>
<td>$10</td>
<td>$40</td>
<td>$50</td>
</tr>
</tbody>
</table>

Objective: Reduce cross-crediting of excess foreign tax credits against lower-taxed passive income. Useable taxes are $10 passive and $35 of general basket credits. So, no cross crediting of the extra $5 of general basket credits against the residual $25 US tax on passive foreign income.
1) Worldwide – only one limitation fraction. §904(a) limitation only.

2) Separate country limitation.

3) Different “types of income” limitation – Code §904(d).

4) Each item of income limitation.

Fundamental issue: How much “cross-crediting” to allow?

What about losses in some countries or activities? See p. 377
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.
1) Limitation formula 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) Look-through rule applicable (for distributions of post-2002 income).
Code §904(d)(1): Two basket limitation system:

1) **General category income**
   (including shipping income and owner occupied imputed income)

2) **Passive category income (defined as §954(c)– a Chapter 6 concept).**
   (not export financing interest and high-taxed income)
Must use **U.S. rules** concerning sourcing of both income and deductions.

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

This may produce a conflict with the foreign country imposing the tax and asserting it has primary income tax jurisdiction.
Freda performs legal services in U.S. for a Brazilian client for $50,000. U.S. source for U.S. income tax purposes, but Brazil imposes a 15% withholding tax on the payment (i.e., $15,000 of foreign tax).

### Income by Basket

<table>
<thead>
<tr>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Passive</td>
<td>General</td>
</tr>
<tr>
<td>Income</td>
<td>$50,000</td>
<td>$0</td>
</tr>
<tr>
<td>US Tax Rate</td>
<td>x 35%</td>
<td>x 35%</td>
</tr>
<tr>
<td>US Tax Before FTC</td>
<td>$17,500</td>
<td>$0</td>
</tr>
</tbody>
</table>

No foreign tax credit since, for U.S. income tax purposes, income is U.S. sourced and there is no general basket foreign source income.

The numerator of the FTC limitation fraction will be zero.
§904(b) has special rules for capital gains – netting with foreign cap losses.

Further objective: to adjust for capital gain tax rate differentials. §1(h)(11) expiring after 2008 (2010?).

Also, for “dividend rate differentials”.

Relevant for individuals; not relevant for corporations (since no income tax rate differentials).
§904(k) – exemption from foreign tax credit limitation:

1) Limit of $300 ($600 if married)

2) Only qualified passive income (e.g., through a mutual fund or ETF)

3) Elect de minimis rule applicability.
Terry earns the following types of income:

<table>
<thead>
<tr>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US Source</td>
<td></td>
</tr>
<tr>
<td></td>
<td>US Source</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Passive</strong></td>
<td><strong>General</strong></td>
</tr>
<tr>
<td></td>
<td>$904(d)(1)(A)</td>
<td>$904(d)(1)(B)</td>
</tr>
<tr>
<td>Interest Income</td>
<td>$10,000</td>
<td>$0</td>
</tr>
<tr>
<td>US Bus. Income</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>Country C Bus. Income</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>Country D Bus. Income</td>
<td>$40,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$50,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

x  28%  
$14,000  

Taxes by §904(d) Baskets

<table>
<thead>
<tr>
<th>Country C Taxes</th>
<th>Country D Taxes</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passive</td>
<td>General</td>
<td></td>
</tr>
<tr>
<td>$0</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>$20,000</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>$30,000</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

The §904(a) overall limitation is $35,000. The §904(d)(1)(A) Passive Basket Limitation is $3,500. The General Basket Limitation is $25,200. Terry is only able to use $25,200 of General Basket due to §904(d)(1)(B)’s General Basket limitation.
Martha earns $99,500 of U.S. source personal service income and $500 of foreign source dividends (subject to foreign withholding tax of $210).

<table>
<thead>
<tr>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passive</td>
<td>General</td>
<td></td>
</tr>
<tr>
<td>§904(d)(1)(A)</td>
<td>§904(d)(1)(B)</td>
<td></td>
</tr>
<tr>
<td>Interest Income</td>
<td>US Bus. Income</td>
<td></td>
</tr>
<tr>
<td>$0</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>$99,500</td>
<td>$500</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total</td>
<td>x 28%</td>
<td>x 28%</td>
</tr>
<tr>
<td>$14,000</td>
<td>$140</td>
<td>$28,000</td>
</tr>
</tbody>
</table>

Taxes by §904(d) Baskets

<table>
<thead>
<tr>
<th>Passive</th>
<th>General</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$210</td>
<td>$210</td>
</tr>
</tbody>
</table>

The §904(a) overall limitation is $140. The income is initially passive basket income but it gets kick-out per §904(d)(2)(B)(iii)(II) and thus is put in the General Basket. The general rule would be that the General Basket Limitation is $140, so only $140 of credits would be useable. But §904(k)(2) de minimis rule entitles Martha to claim the $210 FTC available (42% tax rate) because all of her income is “qualified passive income” without regard to the high-tax kick-out rule of §904(d)(2)(B)(iii). Election required (see §904(k)(2)(C)).
### Problem 3
#### Gardtrac Problem

Gardtrac earns the following types of income:

<table>
<thead>
<tr>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US Source</td>
<td>Foreign Source</td>
</tr>
<tr>
<td></td>
<td>US Source</td>
<td>Foreign Source</td>
</tr>
<tr>
<td></td>
<td>US Source</td>
<td>Passive</td>
</tr>
<tr>
<td>Apartment</td>
<td>US Source</td>
<td>$100,000</td>
</tr>
<tr>
<td>Braztrac Div. (plus §78 Gross-Up)</td>
<td>US Source</td>
<td>$100,000</td>
</tr>
<tr>
<td>Colombia Branch Income</td>
<td>US Source</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

#### US Operations

<table>
<thead>
<tr>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Operations</td>
<td>US Source</td>
<td>$700,000</td>
</tr>
<tr>
<td>Total</td>
<td>US Source</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

#### Taxes by §904(d) Baskets

<table>
<thead>
<tr>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina Taxes</td>
<td>US Source</td>
<td>$10,000</td>
</tr>
<tr>
<td>Braztrac §902 Credits</td>
<td>US Source</td>
<td>$10,000</td>
</tr>
<tr>
<td>Colombia §901 Credits</td>
<td>US Source</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total</td>
<td>US Source</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

The §904(a) overall limitation is $105,000 ($300,000 x 35%). The §904(d)(1)(A) Passive Basket Limitation is $35,000 so Gardtrac can use all of its $10,000 passive basket credits. The General Basket Limitation is $70,000, so Gardtrac can use $70,000 of its $80,000 of General Basket. So, total Passive plus General basket credits used is $80,000. As to the excess $10,000 of unused General Basket credits, Gardtrac can carryback 1 year and carryforward 10 years.
Problem 4
Apartment Active Income

Gardtrac earns the following types of income:

<table>
<thead>
<tr>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US Source</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Passive</td>
<td>General</td>
</tr>
<tr>
<td></td>
<td>§904(d)(1)(A)</td>
<td>§904(d)(1)(B)</td>
</tr>
<tr>
<td>Apartment</td>
<td>$0</td>
<td>$100,000</td>
</tr>
<tr>
<td>Braztrac Div. (plus §78 Gross-Up)</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Colombia Branch Income</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>US Operations</td>
<td>$700,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Total</td>
<td>$700,000</td>
<td>$105,000</td>
</tr>
<tr>
<td>x 35%</td>
<td>$245,000</td>
<td></td>
</tr>
</tbody>
</table>

**Taxes by §904(d) Basket**

<table>
<thead>
<tr>
<th></th>
<th>Passive</th>
<th>General</th>
<th>Total FTC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina Taxes</td>
<td>$10,000</td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>Braztrac §902 Credits</td>
<td>$35,000</td>
<td>$35,000</td>
<td></td>
</tr>
<tr>
<td>Colombia §901 Credits</td>
<td>$45,000</td>
<td>$45,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$90,000</td>
<td>$90,000</td>
<td></td>
</tr>
</tbody>
</table>

The §904(a) overall limitation is $105,000 ($300,000 x 35%) just as before. There is now no Passive Basket Income or taxes. The **General Basket Limitation is now $105,000**, so Gardtrac can use all of its $90,000 of foreign tax credits since all of those credits are now **General Basket credits**. There is now no excess credits in the General Basket credits.
Problem 5
Look-Through Rule

Gardtrac earns the following types of income:

<table>
<thead>
<tr>
<th></th>
<th>US Source</th>
<th>Foreign Source</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Passive 904(d)(1)(A)</td>
<td>General 904(d)(1)(B)</td>
</tr>
<tr>
<td>Apartment</td>
<td>$100,000</td>
<td>$0</td>
<td>$100,000</td>
</tr>
<tr>
<td>Braztrac Div. (plus §78 Gross-Up)</td>
<td>$20,000</td>
<td>$80,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Colombia Branch Income</td>
<td></td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>US Operations</td>
<td>$700,000</td>
<td>$120,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>$700,000</td>
<td>$180,000</td>
<td></td>
</tr>
<tr>
<td>x 35%</td>
<td>$245,000</td>
<td>$63,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

Taxes by §904(d) Baskets

<table>
<thead>
<tr>
<th></th>
<th>Passive</th>
<th>General</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina Taxes</td>
<td>$10,000</td>
<td></td>
<td>$10,000</td>
</tr>
<tr>
<td>Braztrac §902 Credits</td>
<td>$7,000</td>
<td>$28,000</td>
<td>$35,000</td>
</tr>
<tr>
<td>Colombia §901 Credits</td>
<td></td>
<td>$45,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Total</td>
<td>$17,000</td>
<td>$73,000</td>
<td>$90,000</td>
</tr>
</tbody>
</table>

The §904(a) overall limitation is $105,000 ($300,000 x 35%) is unchanged. The §904(d)(1)(A) Passive Basket Limitation is $42,000 so Gardtrac can use all of its $17,000 passive basket credits. The General Basket Limitation is $63,000, so Gardtrac can use $63,000 of its $73,000 of General Basket credits. So, total credits used is $80,000. As to the excess $10,000 of unused General Basket credits, Gardtrac can carryback 1 year and carryforward 10 years.
IRS Notice 98-5 – possible economic profit test (withdrawn in Notice 2004-19)

IRS Notice 2004-19 – no regs. released
Existing law to be applied; Substance over form; step transaction, etc.

§704(b) (p. 441) – Treas. Reg. §1.704-1(b)(4)(viii)(a) provides that allocations of creditable taxes must be in accordance with the partner’s interest in the partnership or as a safe harbor in accordance with the income to which the credits relate.

See §911(k) & (1) – holding periods.
Foreign Tax Credits disallowed if the foreign tax credits far exceed the economic gain determined on a pre-tax basis.

Discuss the 5 examples in the notice.
Compaq case (reversed by Fifth Circuit) & IES case (reversed by 8th Circuit).

Transaction does have economic substance. p. 409

ADR transaction with foreign dividend and withholding tax stripped.

Capital loss can offset prior realized capital gain.
1. Withdraws Notice 98-5.

2. Announce effort to propose regulations on foreign tax credit splitters. Section 909 eventually enacted to prevent “FTC splitters.”

3. Expansion of Section 901(l) expands disallowance of credits for a variety of minimal holding period transactions.

4. Covered transactions dealt with by new Section 901(m)
Code §901(k) – 15 Day Holding Period Limitation on the dividend stripping transactions.


1. Holding period requirement imposed for various income types to enable FTC.
2. For FTC eligibility purposes, must hold 15 days during a 31 day period.

Code §7701(o) – Health Care and Education Reconciliation Act of 2010

1. Requires the Treasury Department to issue regulations to treat foreign tax credits as an expense for purposes of applying the economic substance doctrine.
2. Effectively reverses the Compaq case.
Zero taxed mfg. income is realized by a foreign country subsidiary.

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

Any limit on FTC availability?

1) Look-through rules (§904(d)(3)) to determine status of royalty payment as general limitation basket income.

2) Challenge to the transaction on tax avoidance, etc. basis?  
Unlikely.
Gross income exclusion is phased up (to $95,100 for 2012). Inflation adjustments to be made. §911(b)(2)(D)(i).

Exclusion available in both (i) high tax foreign country (U.K. or Germany) and (ii) low tax foreign country (e.g., Saudi Arabia).

What tax policy arguments exist both for and against this exclusion from gross income?
Exclusion must be for “foreign earned income” - §911(d)(2)(A)

§911(d)(2)(B) – no more than 30 percent of profits 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.
Consider the sourcing rules to determine the location of the earned income.

No eligibility exists for US Government employees.

Attribution of income to the year earned is required – 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 not eligible for §911.
§911(c) – limited amount – excess of 30% of §911 exclusion amount over 16% of exclusion, or lesser actual expense. Previously, no limit – if reasonable in amount.

Deduction where housing costs not provided by employer. §911(c)(4).

Special treatment if increased cost due to geographical differences. §911(c)(2)(B).
1) Bona fide resident - §911(d)(1)(A).

Consider the Jones case, p. 465

Facts and circumstances test applied to determine “residency” (Cf., §7701(b)).

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

3) Also, must have a “tax home” in the foreign country. Code §911(d)(1).
Treatment of resident aliens under §911(d)(1):

Resident both (1) in U.S. (under Code §7701(b) for U.S. worldwide income taxation and (2) in foreign country (under facts & circumstances test) for §911 purposes – because of application of nondiscrimination article of applicable bilateral income tax treaty.

§911(d)(6) – no “double deductions”; therefore, do not elect §911 in a high tax jurisdiction, but use the FTC.

Tax Computation – 2005 JCT Options paper proposal re bracket effect. Starting tax computation “up the tax bracket ladder”.

TIPRA 2006 – See §911(f).
§911(d)(5) precludes residency status if submitting a statement of non-residency to the U.K. Inland Revenue.

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

If no election re §911, all gross income and no §911 exclusion, but full foreign tax credit is available.
Problem 2 (Jennifer)  
Eligibility?

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.

Compensation in year 2: $140,000 less U.S. source legal service income ($20,000) and less 25,000 from French clients while working in US equals $95,000. Perhaps exclude $10,000 for year 1 legal work performed in France if bona fide resident status existed thus leaving $85,000 for year 2. Less: Exclusion of $80,000? For year 2.
Income received in year 2. When are the author “services” rendered? ½ in each year? And allocated to each year?

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

If received in year 3, only an $80,000 exclusion for year 2 is permitted.

Also, a deduction (not exclusion) for housing costs - §911(c)(3).
Mary Smith

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).

c) 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).

d) Self-employed income of $120,000 and pays $21,000 for housing.

e) Business income of $90,000 and pays $18,000 where capital is material income producing factor.

f) Salary of $135,000 and is furnished housing worth $25,000.

g) Salary of $90,000 and furnish housing worth $70,000.
Basic objective of an income tax treaty is to mitigate double taxation by reducing or eliminating the foreign country treaty partner’s taxes on specified items of income realized by U.S. persons in that foreign country. Article 23 re foreign tax credits.

Remember, however, the “savings clause” in U.S. income tax treaties is applicable to U.S. persons.
U.S. citizen and French resident. Taxpayer spent five days each year in the U.S. on business. Double taxation of U.S. income.

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

Do U.S. Code source of income rules control sourcing for U.S. income tax purposes? US FTC only for foreign tax on foreign income!
U.S. citizen independent oil consultant a resident in a foreign jurisdiction. Engaged to work on Texas problem and spends 30 days in the U.S.

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

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

How much FTC does foreign country allow?