

FDU: U.S. International Corporate Tax

- 93 **Foreign Tax Credit**
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- Credit allowed for foreign income taxes
 - Limited to portion of current year tax generated by foreign source taxable income
 - Excess credits carried over
 - Back 1 year
 - Forward 10 years
- 95 **Credit vs. Deduction**
- Choice every year
 - Can change your mind for 10 years
 - §6511(d)
 - Choice applies to regular tax and AMT
 - Coordination of credit carryovers in deduction years
- 96 **Creditable Taxes**
- Foreign taxes imposed on
 - Net Income or equivalent, under US concepts
 - OR Foreign tax in lieu of income tax
- 97 **What is a Foreign Income Tax?**
- IRS has issued rulings on many taxes
 - Must be imposed on net income or a reasonable approximation thereof
 - Excludes capital taxes, stamp taxes, etc.
 - Example: Swiss tax has income & capital components
 - Income part is creditable
 - Capital part is not
 - Duck test
- 98 **Amount of FTC**
- Amount paid or accrued
 - Translated at rate on date of payment
 - Adjustment procedure: §905
 - Must notify IRS of change in US\$ amount in 180 days
 - Must file amended return if tax affected
 - Separate rules for deemed paid credits & pools of CFC tax
 - Interest applies to any resulting underpayment
- 99 **Translating Foreign Taxes**
- §986(a)
 - Average rate for year
 - But use spot rate on payment date if paid before year or after 2nd following year
 - Refunds: rate on initial payment
 - Upward adjustment: rate on date paid

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100 Adjustments to Foreign Tax

– §905(a), Reg. §§1.905-3T, -4T

- **Taxpayers must notify IRS of adjustment**
 - File 1040X or 1120X if adjustment results in negative pools or change in direct tax
 - Otherwise adjust pools
 - Within 180 days after redetermination
- **Pay additional US tax on IRS notice & demand**
 - Interest accrues from original due date till payment

101 Adjustments to Foreign Tax

- **Applies to changes to foreign tax that affect US tax liability**
 - Refunds
 - Exchange differences
 - Accrued vs. paid
- **Does not apply to adjustments to pools for deemed paid taxes unless change reduces pool below zero**

102 Deemed Paid Foreign Tax Credit

103 Deemed Paid Credits

– §902 & regs

- **Credit for taxes paid by 10% or more subsidiary of US corp.**
- **Credits flow with dividends or Subpart F inclusions**
- **Income is grossed up for tax**
 - Effectively puts corp s/h on pretax basis
- **6 tier limit**
- **10% / 5% ownership requirements**

104 902: 6 Tier Limit

- **Deemed paid FTC limited to credit for taxes paid by first three tiers**
- **Dividends from lower tier subsidiaries bring tax up chain**
- **6 Tier limit may be avoided by using partnerships or hybrids as intermediaries**
- **Below 3rd tier must be CFC**

105 Deemed Paid Credit

- **Deemed paid credits determined based on pools of E&P and taxes**
- **Post-86 pool**
 - Includes only post-acquisition taxes
- **Pre-87: year by year pool**
 - Last in first out

106 Deemed Paid Credit

- **Amount of tax deemed paid by shareholder =**

$$\text{Tax in pool} \times \frac{\text{Part of dividend from pool}}{\text{Total E\&P in pool}}$$

107 Gross-up

– §78

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- Dividends are “grossed up” for taxes deemed paid
- Puts shareholder on pre-tax basis
- Applies only if foreign tax credit chosen for year
- Applies only to §902 taxes (i.e., foreign corp.)

108 **902: Trapped Taxes**

- No taxes deemed paid if E&P in pool is zero or deficit
- Thus taxes can be “trapped”
 - Especially in pre-86

109 **902: Translation to Dollars**

- Taxes for years after 1997: average rate for year to which they relate: §986(a)
- Taxes on post-86, pre-98 E&P: spot rate on date of payment: §986(a) prior to 97 act
- Taxes on pre-87 E&P: spot rate on date of distribution of E&P
 - Bon Ami, 39 BTA 825 (1939)

110 **902 & 905: Adjustments to Taxes**

- Requires adjustment of pools
 - But if adjustment reduces pool below zero, must amend returns reflecting dividends
- Translation:
 - Payments:
 - Up to 2 years after accrual: accrual rate
 - Later: spot rate on date of payment
 - Refunds: rate used on original tax

111 **902: Deficits in E&P**

- Carryover & carryback determined at time of dividend
- Post-86 current deficits first reduce post-86 pool
- Post-86 deficits carried back on LIFO basis
 - Carryback limited to pre-87 E&P
- Pre-87 deficits in a year carried forward only

112 **902: Tiering Up**

- Taxes flow up with earnings
- No grossup: would result in double counting
- Pre-87 E&P and tax counted with post-86 after distribution up chain

113 **902: Direct Ownership**

- 10% ownership must be direct, without attribution other than thru partnership
- No 902 credit in example shown:
 - First Chicago, 96 TC 421 (1991)

114 **902 Exercise**

- Tiering up E&P & tax

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115 Foreign Tax Credit Limitation

116 Foreign Tax Credit: Limitation

– §904

- **Credit Limit =**
Foreign Source
Taxable Income
----- X Current Year Tax
Worldwide Taxable Income before Credits
- **Credit limit computed separately for each basket**

117 Foreign Tax Credit: Baskets

– §904(d): major changes effective after 2006

- **Passive income**
 - Interest
 - Dividends
 - Rents & royalties
 - Note: high tax & financial services kickouts
- **General limitation**
- **Look through dividends, interest, rents & royalties from CFCs**

118 Prior Baskets

The following no longer have applicability on current returns (but may apply to pre-2007 open years):

- High withholding tax interest
- Dividends from noncontrolled 902 corporations
- Shipping income
- FSC income

119 High Tax Kickout

- **Passive income subject to foreign tax in excess of top US tax rate**
- **Treated as general basket**
- **Computed on net FSTI for group of items after allocating & apportioning expenses**
- **Look thru CFC dividends and QBU income to apply passive & grouping**
- **Rents & royalties aggregated with expenses**

120 Passive Income

- **Interest**
- **Dividends**
- **Rents**
- **Royalties**
- **Gains on assets producing passive income**
- **FX gains as discussed later**

121 General Limitation

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- **Everything else**

122 **Basket Exercise**

123 **Look Thru Rules**

– §904(d)(3), Reg. §1.904-5

- **Passive income from CFC in which taxpayer is US shareholder treated as general limitation, except as provided**
 - CFC
 - US Shareholder
- **Applies to Subpart F inclusions also**