FOREIGN TAX CREDITS
2022 UPDATE

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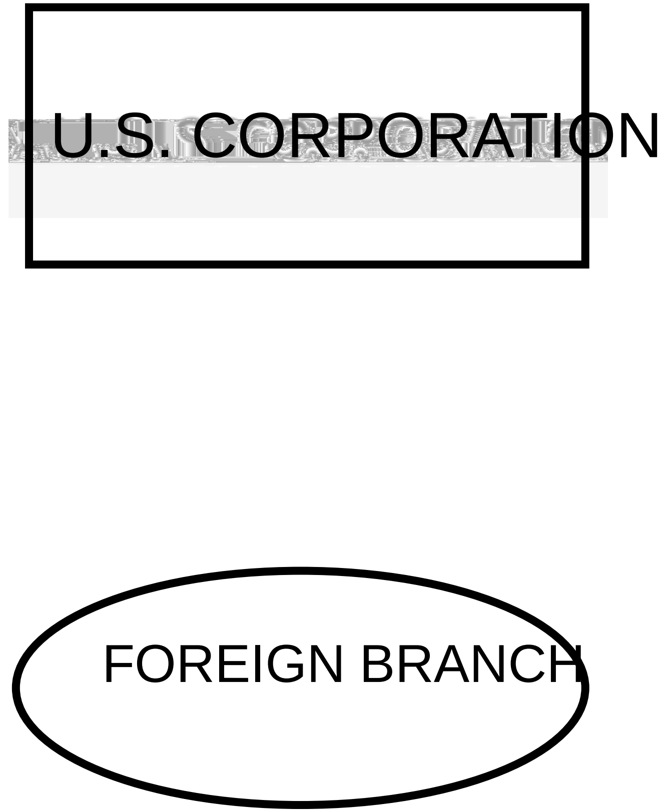
U.S. and Global Taxation

- U.S. tax is generally imposed on its citizens/residents' WORLDWIDE INCOME that includes their foreign earned income
- This creates Double Taxation exposure
  - Payment of foreign taxes on the foreign income
  - Payment of U.S. taxes on the *same* foreign income

Foreign Tax Credit System

- U.S. created a system to give its citizens/residents relief from double taxation
- Options for U.S. citizens/residents:
    1. A deduction for the foreign tax paid
    2. A (limited) tax credit for the foreign tax paid, or
    3. Exemption under a territorial system

How Does the Foreign Tax Credit Work?



How Does the Foreign Tax Credit Work?

- U.S. Corporation does business in Ireland and earns income through its foreign branch
  - A foreign branch is the business operations of a US company in a foreign country
  - Foreign branch's income goes directly to U.S. Corporation and is consolidated with U.S. Corporation's income for U.S.

How Does the Foreign Tax Credit Work?

- So, when U.S. Corporation files its federal tax return, it can elect to receive a foreign tax credit for each dollar of the direct taxes it paid to Ireland
  - If the tax is an INCOME TAX (like U.S. income tax) imposed on U.S. Corporation
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Point of Foreign Tax Credits

- Foreign Income = $1,000
- U.S. Tax before FTC (at 21% rate) = $210

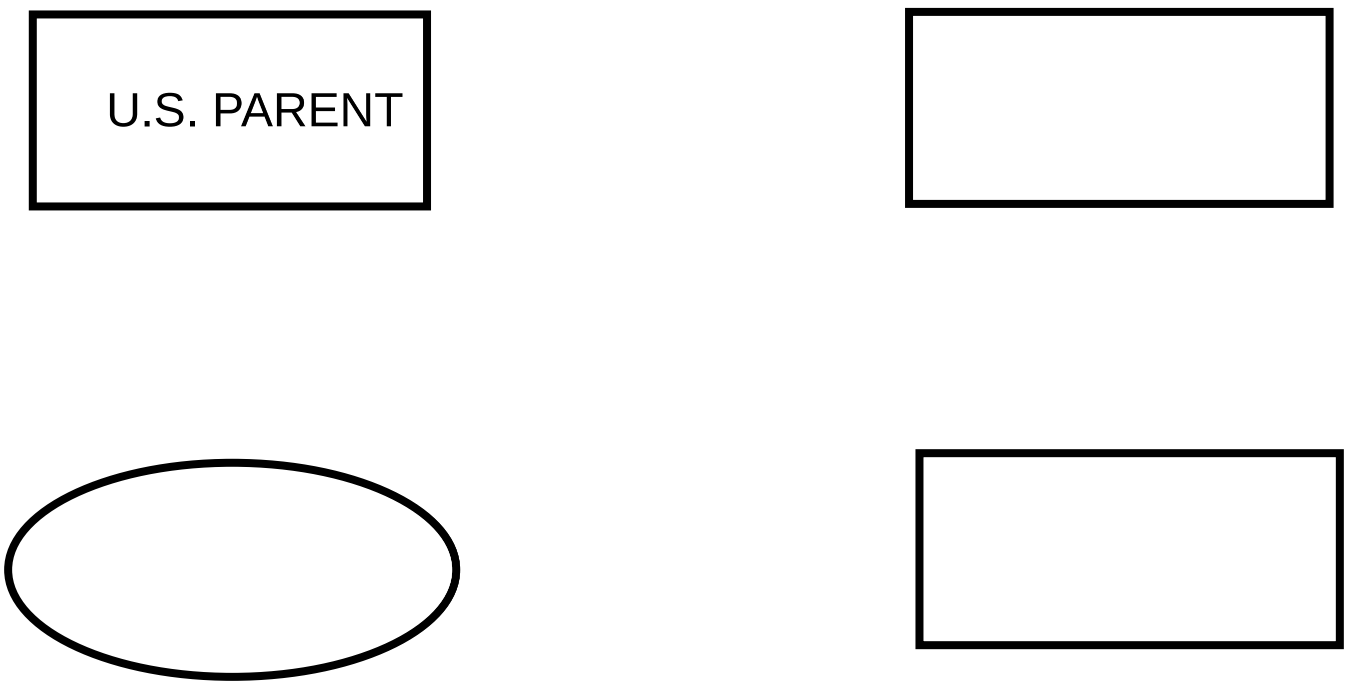
- Foreign Taxes (at 10%) = $100
- U.S. Tax after Credits = $110

$210

Total tax paid on foreign income must = U.S. tax rate of 21%

U.S. PARENT CORPORATION DOING BUSINESS IN FOREIGN COUNTRY

- Two Scenarios
  - As a Foreign Branch or
  - As a Foreign Subsidiary (a separate legal entity)



2 Types of Foreign Tax Credits

- *Direct* credits are for taxes withheld or taxes paid on the foreign branch's income
- *Indirect* or deemed paid credits are for taxes paid by foreign subsidiaries with 10% U.S. shareholders – REPEALED – BUT717.96 -0 0 27876l2.2 (e)-31r5

Fundamental Foreign Tax Credit Questions

FTC System is Extremely Complex

- Not every payment to a foreign country is considered to be a ”tax” for U.S. tax purposes
- The payment must creditable to be a tax
- There are many detailed requirements that must be met for the payment of a foreign tax to be eligible to be a creditable foreign tax credit under U.S. tax law

FTC Systems Extremely Complex

- Generally, all of these four tests must be met for any payment of a foreign tax to qualify to be creditable for the foreign tax credit:
  - The tax must be imposed on the taxpayer
  - Taxpayer must have paid or accrued the tax
  - Tax must be the legal and actual foreign tax liability, AND
  - *Tax must be an income tax or a tax in lieu of an income tax*

CREDITABLE FOREIGN TAXES

- Foreign tax must be an income tax or a tax in lieu of an income tax to be "creditable" for U.S. credit purposes
- Requirements to be creditable:
  1. The foreign tax must be paid to a foreign country (*it is a compulsory payment*), AND
  2. It must be a tax on income; cannot be an excise tax, sales tax, VAT, capital or net worth taxes (deduct those as *business expenses*), AND
  3. The foreign tax must be an income tax in the U.S. sense
  - See §901(a) and Treas. Reg. §1.901-2(a)(1)

FTC Final Regulations Issued December 2021

- Extensive changes to the requirements that a foreign tax must satisfy *for the tax to be creditable*
- *Most significant change* is that a foreign tax must satisfy a new "attribution requirement" (aka as the "*jurisdictional nexus requirement*" in the proposed regulations) under IRC §§ 901 or 903
- Attribution requirement (and other provisions) applies to foreign income taxes when paid or accrued in tax years beginning *on or after December 28, 2021*
  - (T.D. 9959)

FTC Final Regulations
New Attribution Requirement

- Under the new attribution requirement, foreign taxes will be generally creditable if the foreign tax law requires a sufficient nexus between the foreign

FTC Final Regulations
New Attribution Requirement

- Attribution Requirement is applied differently to a tax on *residents of the country* imposing the tax versus a tax on *nonresidents*
- For *residents,* allocations of income among taxpayer and its related parties (

FTC Final Regulations
New Attribution Rule

ACTIVITIES-BASED ATTRIBUTION STANDARD TREAS. REG. § 1.901-2(B)(5)(I)(A)

- The gross receipts and costs that are contained in the foreign tax base are limited to those attributable, under reasonable principles, to the nonresident's activities within the foreign country (including functions, assets, and risks)
- Using foreign law, these amounts may not use the following significant factors:
  - The location of customers, users or other similar destination-based criteria or
  - The location of persons from whom the nonresident makes purchases in the foreign country
- A foreign country that attributes income under rules similar to those for determining effectively connected income under IRC Section 864(c) will meet the Activities-Based Attribution standard
- This standard is not met if the foreign law deems the existence of a trade or business or permanent establishment, or attributes gross receipts or costs, to a nonresident based on the activities of another person (with limited exceptions for agency and pass-through entities)

Source-Based Attribution Standard Treas. Reg

PROPERTY-SITUS ATTRIBUTION STANDARD TREAS. REG. § 1.901-2(B)(5)(I)(C)

- The gross receipts from sales or dispositions of property that are included in the foreign tax base include only gains from the disposition of:
  - Real property located in the foreign country, or an interest in a resident corporation or other entity that owns such real property, under rules reasonably similar to those under the FIRPTA of IRC § 897 OR
  - Property that is part of the business property creating a taxable presence in the foreign country (including interests in a partnership or other pass-through entity attributable to that property), under rules similar to those for determining effectively connected income under IRC § 864(c)
- For a foreign tax imposed on residents of the foreign country, the worldwide gross receipts of a resident can be included in the foreign tax base but require any profit allocation to be arm's length under transfer pricing rules, without taking customers, users or other destination-based criteria into account as significant factors

CREDITABLE FOREIGN TAXES

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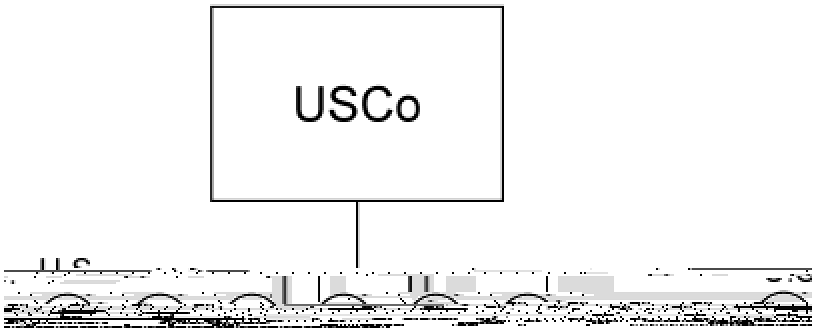
Creditable Foreign Taxes

- If person/entity subject to foreign levy receives or will receive directly or indirectly a specific economic benefit, then the payment is not a tax
- Sometimes there's 2 parts to a foreign levy:
  1. *A compulsory payment AND*
  2.

CREDITABLE FOREIGN TAX EXAMPLE



- USCo owns UKCo that owns DutchCo (a disregarded entity for U.S. taxes)
- Dutch Tax Authority (like IRS) assesses additional Dutch taxes against DutchCo's income.
- DutchCo hires Dutch counsel who opines that it would be impossible to reduce Dutch tax by appealing the assessment, which would involve competent authority.
- DutchCo pays the assessment; is this payment eligible for U.S. FTCs?

FTC Final Regulations Issued December 2021

- Now, to qualify as an in-lieu-of tax, a foreign levy must be considered a foreign tax AND satisfy a *substitution requirement*
  - Treas. Reg. §1.903-1
- Substitution requirement is satisfied IF:
  - Tested tax is a covered withholding tax, *OR*
  - All *Four Tests* are met, based on foreign country's law

SUBSTITUTION REQUIREMENT COVERED WITHHOLDING TAX REQUIREMENTS

1. In addition to the tested tax at issue, the foreign country must also apply a generally-imposed net income tax
2. Tested tax must be a gross basis tax (whether or not it is

FTC Final Regulations
Substitution Requirement
Four Required Tests

1. Existence of a Generally Imposed Net Income Tax
2. Non

Substitution Requirement Test 1

- *Existence of a generally-imposed net income tax*:
- The foreign country imposing the tested tax must also have a "generally-imposed net income tax"

Substitution Requirement Test 2

- *Non-duplication*
- The generally-imposed net income tax and any other separate net income tax imposed by the same foreign country *does not apply* to income related to the base of the tested tax
  - This income is excluded
  - For example, a tested tax based on gross sales or units of production related to the property sold would fail this requirement if gains from the sales were subject to a net income tax

SUBSTITUTION REQUIREMENT TEST 3

- *Close connection to excluded income*
- This requirement is satisfied only if a taxpayer establishes that a "close connection" exists between the foreign country's imposition of the tested tax and its failure to impose the generally-imposed net income tax
- A close connection must be established with proof:
  - Based on the contemporaneous enactment of the tested tax and enactment or amendment of the generally-imposed net income tax OR
  - Based on legislative history showing that the foreign country made a "cognizant and deliberate choice" to impose the separate tax

Substitution Requirement Test 4

- *Jurisdiction to tax excluded income*
- This requirement requires the foreign country have the jurisdiction to tax the excluded income covered by the tested tax but not subject it to the generally imposed net income tax

New Attribution Requirement Takeaways

- Taxpayers have to carefully analyze how the the attribution requirement determines creditable foreign taxes
  - Because this directly affects taxpayers' ability to claim a credit for foreign taxes paid to foreign countries
- The scope of the Final Regulations is far broader than expected, even though they were formulated in response to novel foreign taxes
  - Unfortunately, current taxes that are less novel—particularly withholding taxes imposed on royalties and services—may not be creditable under the Final Regulations, specifically withholding taxes imposed in many emerging markets where there may be no double tax treaty relief yet