A Note From the Editor-in-Chief

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The Foreign Tax Credit Mine Field

Beware of hidden limits on a corporation’s ability to claim foreign taxes as a credit. Under multiple complex rules—some recently added to the Code—a credit for foreign taxes paid on ordinary business transactions can be delayed, or worse, permanently denied. And the IRS is actively auditing foreign tax credit claims.

A U.S. company generally is entitled to claim a credit against U.S. taxes on foreign source income for foreign taxes it pays or accrues. A credit also is available for taxes paid by a foreign subsidiary when the earnings bearing the tax become subject to U.S. taxation, either when distributed as a dividend or included in income under subpart F.1

To be creditable, a foreign tax must be an “income” tax or an “in-lieu-of” tax.2 Generally, foreign taxes imposed on “net income” and withholding taxes imposed on gross payments can be claimed as a credit. However, certain countries have modified their rules to impose tax on a base other than net income. Even if the tax is intended to replace the income tax, IRS guidance may be necessary to support creditability. Examples include the Italian IRAP, the Puerto Rico excise tax and the Mexican IETU, and while the U.S. government will not challenge a credit for such taxes, it has not said that these taxes meet the creditability criteria.3 Lesson—confirm that foreign taxes are income taxes or in-lieu-of taxes under U.S. principles.4

In addition, a foreign tax must be compulsory to be creditable. If there is some question concerning whether foreign law requires a company to pay a tax, the taxpayer must exhaust its effective remedies to reduce the tax.5 A court denied a credit for Japanese withholding taxes because the taxpayer failed to show that it had exhausted its remedies in Japan, but allowed a credit for Korean withholding taxes based on a letter from Korean counsel opining that the royalty payments were subject to the withholding tax.6 The compulsory issue can arise when a country asserts a local taxable presence (i.e., permanent establishment), or proposes a transfer pricing adjustment (e.g., between two foreign subsidiaries). Recently, the IRS questioned the appropriateness of China imposing a capital gains tax on indirect transfers of stock in a Chinese company, and indicated that it may deny a credit unless the taxpayer pursues competent authority. Lesson—be sure foreign law requires the payment of taxes, and pursue all practical and effective remedies when a foreign country proposes a tax adjustment on audit.
A person liable for taxes under foreign law generally is entitled to claim a credit. Recent legislation and regulations, however, can treat foreign taxes as paid by another taxpayer or suspend the credits (sometimes indefinitely). For example, foreign taxes paid by a member of a foreign consolidated group may be treated as paid by another member of the group if attributable to such other member’s income. In addition, while taxes normally are treated as accruing at the end of an entity’s year, certain mid-year transactions can require allocation of the taxes between two entities (e.g., the sale of interests in a disregarded entity). Furthermore, under so-called splitter rules, certain taxes paid by a company without the corresponding income are suspended. For example, partners generally are liable for taxes paid on income of a foreign partnership. If the partnership is classified as a corporation for U.S. purposes, such taxes are not creditable to the partners until the associated earnings of the partnership are distributed, and under regulations all earnings must be distributed before all of the credits are freed up. Lesson—be aware of the special rules that can apply when taxes are paid by one corporation on income of another corporation.

Another new rule denies a credit for certain otherwise creditable foreign taxes paid on operating income. The rule generally applies to transactions that are treated as acquisitions of stock (or are disregarded) for foreign tax purposes but that are treated as asset acquisitions for U.S. tax purposes (e.g., a Code Sec. 338 election is made, or the target is a disregarded entity or a partnership). Such transactions can result in additional U.S. deductions for depreciation and amortization attributable to the stepped up basis of the foreign target’s assets without affecting the amount of taxable income or taxes for foreign law purposes. Under Code Sec. 901(m), future foreign taxes paid by the target are denied as a credit to the extent paid on the amount of its foreign income that is unreduced by the additional U.S. deductions. The denial of credits applies equally to internal transactions. Lesson—be aware of the rules that disallow a credit for foreign taxes paid on foreign income to the extent it exceeds U.S. income as a result of a transaction.

To be entitled to a credit for foreign taxes associated with dividends received from a foreign subsidiary, a U.S. shareholder must own directly 10 percent of the voting stock of the distributing corporation (the same rule applies for subpart F inclusions). Unfortunately, this rule has been applied rigidly to U.S. consolidated groups. For example, assume a consolidated group owns in the aggregate all of the stock of a foreign subsidiary, but one domestic subsidiary owns eight percent directly. The deemed paid taxes otherwise accompanying a dividend paid to the eight-percent owner are not allowed as a credit (and they disappear). Lesson—carefully monitor the 10-percent ownership rules.

Another trap is the tier limitation. A U.S. shareholder is entitled to claim a deemed paid foreign tax credit only for taxes paid by controlled foreign corporations (CFCs) that are no more than six tiers below the U.S. owner. It is not uncommon for ownership structures to inadvertently end up with more than six tiers, e.g., with acquisitions or internal reorganizations. Foreign taxes paid by a seventh tier subsidiary are not creditable. Lesson—monitor the foreign ownership structure to avoid CFCs below six tiers, and restructure to eliminate too many tiers (e.g., using disregarded entity elections for intermediate entities).

There are numerous other limitations on the ability to use foreign tax credits. For example, credits are allowed on a basket-by-basket basis, requiring separately tracking the different baskets. Moreover, the U.S. interest expense allocation rules can significantly reduce or eliminate foreign source income and create an overall foreign loss account, which prevents or limits utilization of foreign tax credits, even when the U.S. taxpayer derives substantial foreign source income. In addition, the rules are uncertain and complex concerning the treatment of foreign taxes in dispute.

With much talk in Washington concerning a territorial tax system, it may be that the future U.S. tax system will not fundamentally rely on the foreign tax credit rules to eliminate double taxation of cross-border profits, and that would be good.

ENDNOTES

1 Code Secs. 901(a), 902(a).
2 Reg. §1.901-2(a)(3), (b); Code Sec. 903.
4 Recently, one circuit court held that the U.K. Windfall Tax was creditable (Entergy Corp., CA-5, 2012-1 ustc ¶50,386), but another court circuit court held that the U.K. tax was not creditable because it was not imposed on net income (PPL Corp., CA-3, 2012-1 ustc ¶50,115, 665 F3d 60).
5 Reg. §1.901-2(a)(2)(i), (e)(5)(i).
7 Reg. §1.901-2(f).
8 Code Sec. 909 and temporary regulations issued pursuant thereto.
9 First Chicago NBD Corp., CA-7, 98-1 ustc ¶50,169, 135 F3d 457.
10 This issue can arise with cross-chain transactions under Code Secs. 304 or 368(a)(1)(D) that give rise to dividends.