The Future of the Foreign Tax Credit

University of Chicago Law School
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Panelists

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- Marjorie Rollinson, Associate Chief Counsel International, Internal Revenue Service
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- Kevin Dolan, Shearman & Sterling LLP
- Tim McDonald, Proctor & Gamble
Credit at the Crossroads
Policies of the Foreign Tax Credit
Challenges in Administering the FTC System
International Tax Reform
Selected Topics
- Section 901(m)
- Foreign Tax Credit Splitting
- Section 901 and the Scope of Creditable Taxes
- The Noncompulsory Payment Rule
Credit at the Crossroads

- Existing foreign tax credit system is already strained given the complexity of current law
- Tax reform in the United States will almost certainly include the adoption of some form of a territorial tax system
- Evolving global landscape trending towards higher taxation?
  - Increases in the types of foreign taxes and the relative balance of foreign taxes that are being used to raise revenue
    - Increase in asset based taxes
    - Puerto Rico manufacturing excise tax
    - Diverted profits taxes
  - Increase in the overall foreign tax burden
    - BEPS
    - Transfer pricing enforcement
    - UN Transfer Pricing Guidelines and the developing world
Why the foreign tax credit matters

2013 U.S. Corporation Returns with a Foreign Tax Credit -- Form 1118
(dollar amounts in thousands of dollars)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of returns</th>
<th>U.S. income tax before credits</th>
<th>Foreign tax credit claimed</th>
<th>General business credit</th>
<th>U.S. income tax after credits</th>
<th>FTCs as a % of Pre-credit US income tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>All industries</td>
<td>6,542</td>
<td>329,389,198</td>
<td>118,285,306</td>
<td>20,586,842</td>
<td>189,172,697</td>
<td>35.9%</td>
</tr>
<tr>
<td>Mining</td>
<td>200</td>
<td>7,875,675</td>
<td>4,456,496</td>
<td>84,094</td>
<td>3,156,184</td>
<td>56.6%</td>
</tr>
<tr>
<td>Construction</td>
<td>183</td>
<td>774,358</td>
<td>155,795</td>
<td>11,992</td>
<td>606,198</td>
<td>20.1%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>1,174</td>
<td>142,059,429</td>
<td>68,627,970</td>
<td>6,737,715</td>
<td>66,513,000</td>
<td>48.3%</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>948</td>
<td>44,526,740</td>
<td>7,023,586</td>
<td>2,100,829</td>
<td>35,278,333</td>
<td>15.8%</td>
</tr>
<tr>
<td>Transportation and warehousing</td>
<td>131</td>
<td>6,522,881</td>
<td>482,505</td>
<td>92,784</td>
<td>5,946,329</td>
<td>7.4%</td>
</tr>
<tr>
<td>Information</td>
<td>541</td>
<td>28,337,365</td>
<td>7,843,595</td>
<td>1,524,802</td>
<td>18,960,885</td>
<td>27.7%</td>
</tr>
<tr>
<td>Finance, insurance, real estate, and rental and leasing</td>
<td>1,089</td>
<td>39,946,532</td>
<td>6,447,763</td>
<td>1,823,225</td>
<td>31,063,255</td>
<td>16.1%</td>
</tr>
<tr>
<td>Services</td>
<td>1,984</td>
<td>59,059,009</td>
<td>23,232,468</td>
<td>8,173,099</td>
<td>27,415,056</td>
<td>39.3%</td>
</tr>
<tr>
<td>All other industries</td>
<td>294</td>
<td>287,210</td>
<td>15,128</td>
<td>38,303</td>
<td>233,456</td>
<td>5.3%</td>
</tr>
</tbody>
</table>

Options for the Future

What to do if tax reform passes?
- Changes to the foreign tax credit as part of the legislation (or as technical corrections)
- Administrative guidance on issues both old and new
  - Dispensation from the “2 old regs for 1 new reg” rule if tax reform happens, or perhaps we will not need it?

What to do if tax reform fails? Or more appropriately, prioritizing what to do as the wait continues?
- Smaller legislative changes, reforms, simplifications (I know, so 20th century)
- Administrative guidance priorities for
  - easing the burdens of the current system
  - curbing abuse
  - and how politics will fit into all of this
Policies of the Foreign Tax Credit

You can't know where you are going until you know where you have been
Policies of the Foreign Tax Credit

- Section 901 (and sections 902 and 960)
  - To eliminate double taxation of income
    - “the primary design of the provision was to mitigate the evil of double taxation” -- Burnet v. Chicago Portrait Co., 285 U.S. 1, 7 (1932)
  - Contrast with the alternative approach used in most other countries:
    - Territorial tax system – often implemented through a participation exemption
    - Neutralizing the impact of any foreign tax burden v. exempting foreign income
    - Capital export neutrality v. capital import neutrality

- Section 902 and 960
  - Credit available for taxes “deemed paid” by a foreign corporation
  - Provides branch-sub parity

- Section 903 provides a credit for taxes in lieu of income taxes
Policies of the Foreign Tax Credit

- Section 904(a) – Overall Foreign Tax Credit Limitation
  - Enacted as part of the Revenue Act of 1921
  - Prevents foreign tax credits from offsetting U.S. tax on U.S. source income
  - The birth of complexity
  - Need to determine foreign source net income
    - Source income, allocate deduction

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>Foreign</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>100</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>Pre-credit US tax</td>
<td>35</td>
<td>35</td>
<td>70</td>
</tr>
<tr>
<td>FTCs</td>
<td>0</td>
<td>70</td>
<td>70 (w/o 904)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>35 (w/ 904)</td>
</tr>
<tr>
<td>Post-credit US tax</td>
<td>35</td>
<td>(35) or 0</td>
<td>0 (w/o 904)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>35 (w/ 904)</td>
</tr>
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</table>
Policies of the Foreign Tax Credit

- Section 904(d) – Foreign tax credit separate limitations or “baskets”
  - Expanded from interest to 8 baskets as part of the Tax Reform Act of 1986
    - Baskets reduced from 8 to 2 in 2004, but provides limited simplification
  - Limits cross-crediting – allowing foreign tax credits on high-taxed foreign income to offset the U.S. residual tax on low-taxed foreign income
    - Passive basket to avoid shifting investment income offshore to generate additional foreign tax credit limitation

<table>
<thead>
<tr>
<th>Polices of the Foreign Tax Credit</th>
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</table>
| Earnings of a foreign branch from its operations in a foreign country are subject to tax in both the foreign and U.S. countries. The foreign tax credit (FTC) is a mechanism to reduce the tax liability in the U.S. due to the foreign taxes paid. The FTC is subject to separate limitations or “baskets” for different types of income.

**Example:**

- **US Co.**
  - 100 US income
  - 35% US tax rate

- **Foreign Branch**
  - 70% foreign income
  - 0% foreign tax rate
  - 70 foreign tax paid

**Active Income**
- 100 Foreign income
- 70 Foreign tax paid

**Passive Income**
- 100 Foreign income
- 0 Foreign tax rate

**Income**
- 100 US income
- 100 foreign income
- 100 total income

**Pre-credit US tax**
- 35 US tax
- 35 foreign tax
- 35 total tax

**FTCs**
- 0 US FTC
- 70 foreign FTC
- 0 total FTC

**Post-credit US tax**
- 35 US tax
- (35) or 0
- 0 or 35
- 35 (w/o 904(d))
- 70 (w/ 904(d))

**Total**
- 70 (w/o 904(d))
- 35 (w/ 904(d))

**Table:**

<table>
<thead>
<tr>
<th>Income</th>
<th>US</th>
<th>Foreign Active</th>
<th>Foreign Passive</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-credit US tax</td>
<td>35</td>
<td>35</td>
<td>35</td>
<td>105</td>
</tr>
<tr>
<td>FTCs</td>
<td>0</td>
<td>70</td>
<td>0</td>
<td>70 (w/o 904(d))</td>
</tr>
<tr>
<td>Post-credit US tax</td>
<td>35</td>
<td>(35) or 0</td>
<td>0 or 35</td>
<td>35 (w/o 904(d))</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td>200</td>
</tr>
</tbody>
</table>
Challenges Administering the Foreign Tax Credit System
Challenges with the Foreign Tax Credit – Unique Economics

- Dollar-for-dollar credit
  - Section 901 regulations requiring taxpayers to contest foreign taxes
  - Section 704 rules and the allocation of creditable foreign tax expenditures (“CFTEs”) – the only tax item that lacks “substantial economic effect”

- The tax shelter rules and application of economic profits tests:
  - *Compaq* and *IES* cases
  - *Pritired*, the pendulum swings back (if only temporarily)
  - STARS – a structured transaction (and what taxpayers are seeing)

- But the courts use of economic substance has helped to sort out the underlying issue, nor has the government
  - Notice 98-5, and its withdrawal
  - Section 7701(o) – codification of the economic substance doctrine and regulatory authority to treat taxes as expense
  - Tax generator regulations
Challenges with the Foreign Tax Credit – Unique Economics

- Alternative “second best” approaches
  - Section 901(k) and (l)
  - Exposure to economic risk as a surrogate to determine entitlement to a foreign tax credit

- Bolder (more extreme) proposals
  - “The Case Against Foreign Tax Credits” by Daniel Shaviro
  - Throwing “sand in the gears”
    - Obama Administration’s “Framework for Business Tax Reform” (April 2016 Update)
    - Haircut the credit by 15%
    - Done in the context of a 19% minimum tax v. 28% US rate
    - Total tax burden ranges from 19% to 21.85%

<table>
<thead>
<tr>
<th>Foreign tax rate</th>
<th>0%</th>
<th>5%</th>
<th>10%</th>
<th>15%</th>
<th>19%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Tax Burden (U.S. and Foreign)</td>
<td>19.00%</td>
<td>19.75%</td>
<td>20.50%</td>
<td>21.25%</td>
<td>21.85%</td>
</tr>
</tbody>
</table>
Challenges with the Foreign Tax Credit – Complexity

- Definition of a creditable foreign tax
- Who paid the tax and the technical taxpayer rule
- Sourcing rules for income
- Interest expense allocation rules
  - Netting rule
  - Section 904(i) and forced consolidation
- Separate baskets
- Overall foreign loss rules
- Separate limitation losses
- Overall domestic loss rules
- Pooling v. layers
- Foreign tax redeterminations
- Section 704 regulations allocating creditable foreign expenditures earned through partnerships
- Section 909 – foreign tax credit splitting arrangements
- Section 901(m) – covered asset acquisitions
- Section 960(c) – haircut of deemed paid taxes on section 956 inclusions

Enough said . . .
Challenges with the Foreign Tax Credit – Lack of Consolidation

- US tax system generally uses a consolidation approach for domestic corporations, but foreign corporations do not consolidate with
  - U.S. companies or
  - Other foreign corporations
- Introduces costs and provides opportunities for taxpayers
- Increased complexity arising from (often reasonable) government attempts to apply quasi-consolidation solutions
  - Foreign tax credit approaches
    - Section 909 and foreign tax credit splitting
    - Rep. Rangel proposed legislative approach pooling taxes across all CFCs
      - “Cross-crediting to prevent cross-crediting”
  - The foreign tax credit is not special; issue for all international tax rules
    - Leveraged distributions (Illinois Tool Works litigation)
    - Sections 304 and 956 anti-abuse rules
    - CFC chain deficit rule under section 952(c)
Challenges with the Foreign Tax Credit – **Deferral + Planning**

- The tax credit system functions in a world where a significant portion of the foreign income is entitled to deferral
  - APB 23 referencing in excess of $2 trillion in offshore earnings
- The combination of
  - deconsolidated foreign subsidiaries, and
  - taxpayer selectivity of both
    - which foreign earnings are repatriated, and
    - when these earnings are repatriated
  - provides planning flexibility to maximize the use of the credit
- And these planning opportunities are not aggressive tax shelters, but primarily the careful application of the existing rules
- The world has evolved and is not what was envisioned in 1919
A Brave New World
Foreign Tax Credits and International Tax Reform

_The report of my death was an exaggeration._ *
— Mark Twain

*The famous quote by Twain was in response to an incorrect report of his death in a newspaper. Although there appears to be no debate about the origin of the quotation (helped no doubt by the very limited number of people afforded an opportunity to comment publicly on such a newspaper account), the precise wording of the quote is less clear, and therefore this variation may differ slightly from one’s own recollections. See discussion at http://answers.google.com/answers/threadview?id=191570 (containing a detailed discussion about the origin of the quote and the various formulations that are now ubiquitous). The version above is from a website that includes the full quotation, “The report of my illness grew out of his illness [in this case, his cousin], the report of my death was an exaggeration,” and accompanies this version with a scan of the (alleged) letter where it originally appeared. http://www.twainquotes.com/Death.html.
Reform of the U.S. International Tax System

- Tax Reform – is 2017 (or 2018) the year??
  - If tax reform legislation moves this year, then reform of the international tax system – and the adoption of some form of a territorial system – seems inevitable.
- Numerous plans have been floated, but as with most things, the details will matter enormously.
  - The Big 6 “Unified Framework for Fixing Our Broken Tax Code,” released on September 27th (the “Framework”)
  - Camp Bill from December 2014
  - Other proposals
- **Tax Reform is not the end of the credit, but it is a significant inflection point**
- Intersection with domestic tax proposals
  - Reduction in the corporate tax rate
  - Limitation on interest deductibility
  - Senate’s partial integration proposal and a dividends paid deduction
- Intersection with global developments
  - Increased foreign taxation from BEPS, country-by-country reporting and transfer pricing enforcement, EU proposals, diverted profits taxes, etc.
Likely Components of a Reformed U.S. International Tax System

- **Shift to a territorial tax system**
  - Implemented through a dividends received deduction (100% in the Framework)
  - Eliminates the complexity of repatriating cash
  - Eliminates high-taxed income from the US tax system, and with it, excess foreign tax credits
  - No mention of branch taxation in the Framework
    - Parity of tax treatment with foreign subsidiaries
    - Revenue concerns from cherry-picking
      - Loss operations
      - Transfer pricing between gain and loss operations
      - High-taxed foreign operations
    - Transition issues if branches are included in the proposal
- Individuals not invited to the party
Reform of the U.S. International Tax System

- Expanded Subpart F rules to address base erosion
  - Focus on low-taxed income
    - Exemption coupled with the “end of deferral”
    - Income is either immediately taxed or exempt
  - Anti-round tripping rules
  - Use of foreign effective tax rate to define subpart F income, including if there is minimum tax on foreign earnings
    - Likely tied to US creditable foreign taxes
    - High-taxed exception to subpart F under section 954(b)(5)

- Changes to the Foreign Tax Credit
  - No 902 credit – dividends are exempt
  - Section 960 credit on subpart F income
  - No credit for withholding taxes on exempt dividends
    - But what about PTI and 960(a)(3) credits?
  - If a minimum tax included, then will it use section 904(b) to address the US and foreign rate differential??
  - Very little high-taxed income, and a great deal of low-taxed income

- Transition
  - Repatriation of foreign earnings (and taxes)
Rate Differential Adjustments under Section 904(b)

Case 1
Taxpayer has 100 of foreign source capital gain income taxed at 20%

\[
FTC\ Limit = \frac{Foreign\ income}{WW\ income} \times Pre-credit\ USTax
\]

\[
FTC\ Limit = \frac{100}{100} \times 20 = 20
\]

Case 2
Taxpayer has 100 of foreign source capital gains taxed at 20% AND 100 of US source ordinary income taxed at 35%

Without section 904(b) adjustments

\[
FTC\ Limit = \frac{100}{200} \times 55 = 27.5 \quad (\text{and not 20})
\]

With section 904(b) adjustments

\[
FTC\ Limit = \frac{100(20\%)}{100 + 100(20\%)} \quad \text{or} \quad \frac{57.14}{157.14} \times 550 = 20
\]

Case 2A- amounts reversed
100 of US source capital gains taxed AND 100 of foreign source ordinary income

\[
FTC\ Limit = \frac{100(20\%)}{100(20\%) + 100} \quad \text{or} \quad \frac{100}{157.14} \times 55 = 35
\]
## Overview of US Tax System (not to scale)

<table>
<thead>
<tr>
<th></th>
<th>U.S. Source Income</th>
<th>Foreign Source Income</th>
</tr>
</thead>
</table>
|                         | “Most” domestic activity | “U.S. Income” 
- Export Sales 
- Royalties | High-Taxed Income | Low-Taxed Income Subpart F | Low-Taxed Income Deferred / Exempt |
| Pre-Reform              | Income             | Foreign Taxes         | Tax Cost/ Benefit |
|                         | Immediate inclusion| None                  | Max U.S. rate    |
|                         |                    |                       | Low-taxed -- US rate less FTCs |
|                         |                    |                       | Negative Tax Rate |
|                         |                    |                       | Significant U.S. residual tax |
|                         | Deferred           | Little or no          | Effectively exempt |
| Post-Reform             | Income             | Foreign Taxes         | Tax Cost/ Benefit |
|                         | Immediate inclusion| None                  | Max U.S. rate    |
|                         |                    |                       | Max U.S. Rate    |
|                         | Exempt             | Creditable            | Exempt           |
|                         | Immediate inclusion| Excluded              | Not Creditable   |
|                         |                    |                       | Residual US tax  |
|                         | Exempt             |                       | Exempt           |
| Change in Tax Cost/Benefit from Tax Reform | Savings | Cost?? | Cost | Cost | Even / Savings |
|                         | Drop in the US rate| Loss of FTC sheltering outweighs lower rate (Depends on treatment of branch income) | No longer excess credits | Significant increase in scope, partially offset by reduced rate and potentially increasing FTCs | Assuming that the income is permanently deferred; but sub F is scaled back so more income qualifies

**Notes:**
- FTC: Foreign Tax Credit
- Sub F: Subpart F of the Internal Revenue Code
What to do if we have Tax Reform?

- Reconsider the foreign tax credit limitation under section 904(d)
  - Depending on the structural decisions made in reform, likely to become significantly less relevant
  - How much, if any, high-taxed income will remain in the U.S. tax system
    - Treatment of branches
  - Significant decrease in FTC because the related income is exempt
  - Significant increase in limitation
    - Expansion of subpart F income
    - Elimination of expense allocation
    - Offset to some extent by possible repeal of section 863(b) and export sales
- But the foreign tax credit limitation has many components
  - Sourcing rules
  - Expense allocation
  - OFLs, ODLs, sections 901(m), 909, etc.
Possible Reforms – Simplification of the FTC Limitation

Eliminate the foreign tax credit limitation entirely

Eliminate the baskets, primarily passive

Eliminate expense allocation

Eliminate the “netting rule”

Eliminate OFL rules

Does it matter if the rules exist as opposed to whether to create them?
- Comparisons with other countries, for example, on expense allocation

Does it matter if you keep them around for individuals? (16 billion of FTCs in 2011)
- Or do you rethink the balance of costs and benefits?
- While it may have made sense to extend corporate rules to individuals, will it make sense to keep rules for corporations just to be consistent with individuals?
Problems that Remain

- Some are straightforward – Section 960(c)
  - Haircuts the section 902/960 credit on a section 956 inclusion
  - In a territorial system, there are no deferred earnings, and thus no need for section 956
  - Without section 956, section 960(c) can go
  - Did it make sense in the first place?

- But many issues are more complex because they affect more than just the FTC limitation
  - Expense Allocation
    - Framework has a 100% DRD, so there is no haircut, which is often viewed as a surrogate for expense allocation
    - Magnitude of the problem from US borrowing to fund foreign operations
    - Sufficiently addressed by other base erosion measures on financing costs?
    - Other expenses?

- Tax shelter transactions?
  - Still a theoretical issue if there is significant excess limitation
  - Sufficiently addressed by the courts and the tax credit generator regulations?
Section 901(m)

Foreign Taxes on Tax Exempt Income
Section 901(m) Base Case

- U.S. Buyer acquires Foreign Target from unrelated Foreign Seller for $100
- Section 338 election made for Foreign Target
- Foreign Target has one asset with 50 of built-in gain for US tax purposes
- Basis difference = 50 (100 – 50 A/B)
- Foreign Target sells the asset for 100
  - US gain = 0 (100 – 100 A/B)
  - Foreign gain = 50 (100 – 50 A/B)
  - 50 of gain never taxed in US system
- Foreign tax credit results
  - Assume foreign tax on the gain (and thus credit) is 17.50 (30% foreign tax rate)
  - US tax on gain is 0
  - Section 901(m) would disallow a credit all 17.50 of the foreign taxes
Policy of Section 901(m)

- Denies a credit for foreign taxes attributable to the basis “step-up” for U.S. tax purposes in certain transactions
  - Taxpayers are permitted a deduction for the disallowed taxes and no section 78 gross-up
- Policy of the foreign tax credit – eliminate double taxation
- What about income that is exempt for U.S. tax purposes?
  - Service litigated this issue in the past
  - Not about disparity between U.S. and foreign tax basis (though correlated)
    - Rules apply to the U.S. basis differences before and after the transaction
    - Foreign tax basis is not relevant under the statute (except for an election under the regulations)
  - Not about the “hyped” foreign tax rate
  - Concern is a credit for taxes on exempt income
    - In this case concern arises from effectively assuming the foreign tax liability of another person – the seller
Future of Section 901(m)

- Should a credit still be available for taxes related to the US basis step-up?
  - Is the case more compelling after tax reform?
  - Are the rules too complex to justify the policy?
  - Should the current rules be simplified even without reform?

- What does a disallowance mean for the foreign ETR under a subpart F or other similar rule?
  - Issue under current law for rules that depend on the foreign ETR
    - Subpart F high-tax exception
    - Section 904 high-tax kick-out
Section 909
Foreign Tax Credit Splitting
Does foreign tax credit splitting remain an issue? Has it become even more significant?

- Old problem: taxes on deferred income being included on the US return without the related foreign income (because of deferral)
- New problem: taxes on exempt income being included on the US return without the related foreign income (because exempt under a territorial system)

How do you determine whether foreign taxes relate to tax exempt income and thus are not creditable in a territorial system?

- Some type of tracing rule for related taxes
  - Section 904 regulations for allocating taxes to baskets
  - More mechanical / formulaic approach (consider 901(m))
- Certainty v. Complexity

Impact of foreign tax rate test – Who paid the tax?
Background on Section 909

- Enacted in 2010
- Covers situations where foreign taxes are paid by one person on income earned by a related person – when foreign taxes are split from the related income
- Taxes are not denied, just suspended until matched with the related income
- Regulations limit the rules to specific situations
  - Reverse hybrids
  - Hybrid instrument
  - Foreign loss sharing regimes (e.g., UK group relief)
  - State Aid cases
- In the example,
  - US Co is treated as the technical taxpayer of the 40 of foreign tax (as the owner of Foreign DE
  - But cannot claim a credit (or deduction) under section 909 until the 100 of income is paid as a dividend
CFC would be highly taxed except that it is a reverse hybrid and thus US Co is legally liable for the taxes on CFC’s income.

CFC has 0 tax on 100 of income even though Country X imposes income tax at a 40% rate.

CFC has 0 tax on 100 of income or 0% tax rate.

Can US Co, claim a 40 credit for the taxes on CFC’s income?

How does this affect the foreign effective tax rate for subpart F purposes?

Pre-909 proposed regs would have pushed the taxes down to CFC.
CFC1 is low-taxed, and would generate subpart F income under the reformed minimum tax rules.

CFC2 would be highly taxed except that it is a reverse hybrid and thus CFC1 is legally liable for the taxes on CFC2’s income.

CFC1 has 50 tax on 100 of income or a 50% effective tax rate.

CFC2 has 0 tax on 100 of income or 0% effective tax rate.

Can CFC1 claim a 40 credit for the taxes on CFC2’s income?

How does this affect the foreign effective tax rate for subpart F purposes?

If you do not correct, is US Co worse off? Does it depend if France is an active CFC?
Section 901

Which taxes are (or should be) creditable?
Which taxes are creditable?

- Section 901 provides a credit for income, war profits and excess profits taxes (collectively, “income taxes” or “section 901 taxes”)
- Section 903 provides that a creditable tax include a tax paid in lieu of an income, war profits and excess profits tax (and “in lieu of tax” or a “section 903 tax”)
  - Substitution requirement, the tax must be imposed in lieu of an income tax or a series of income taxes
- Income tax treaties also identify certain taxes that are entitled to a credit for U.S. federal income tax purposes
  - Generally this includes taxes that are already creditable taxes
  - But some treaties include additional taxes
Which taxes are creditable?

- Income tax is a creditable tax if:
  - It is a “tax” – “a compulsory payment pursuant to the authority of a foreign country to levy taxes”
  - “the predominant character of that tax is that of an income tax in the U.S. sense”
- The section 901 regulations impose three requirements:
  - **Realization requirement**: Imposes tax at the same time as the U.S. system, . . . or later, . . . or earlier
  - **Gross receipts requirement**: imposed on gross receipts, or a method that is likely produce an amount that is not greater than gross receipts
  - **Net income requirement**: permits the recovery of significant costs and expenses
- The tax cannot be:
  - A soak-up tax – a tax imposed only if it will be creditable in the other jurisdiction
  - A refund or credit
  - Used, directly or indirectly, to provide a subsidy to the taxpayer
  - A noncompulsory amount
- What taxes are not creditable:
  - *Ad valorem* taxes, sales taxes, VATs, real estate taxes, excise taxes
  - Would a border adjusted tax be creditable?
Which taxes are creditable?

- Language of section 901(b) is essentially unchanged since the original enactment (in 1919) of the foreign tax credit in the Revenue Act of 1918
  - Revenue Act of 1918
    
    *In the case of a citizen of the United States, the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States; and*
  
  - Current Section 901
    
    *In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States*

- Does tax reform change what it means to be an income tax in the U.S. sense?
  - If we eliminate or substantially limit the deduction for interest?
  - If we adopt a border adjusted mechanism or destination-base tax?
Which taxes should be creditable?

- In light of global developments, do we need more guidance as it seems like the question is getting harder?
  - Italian IRAP
    - News Release (Mar. 31, 1998) (creditable for approximately 10 years until the treaty entered into force)
  - Mexican IETU
    - Notice 2008-3 (under study, IRS will not challenge creditability)
  - Puerto Rican Manufacturing Excise Tax
    - Notice 2011-29 (under study, IRS will not challenge creditability)
  - Recent EU State Aid assessments
    - Notice 2016-52 (no position on creditability, but if they are, then it is a splitter and you need to include the related deferred income to receive a credit)
  - UK Diverted Profits Tax
    - No word yet
  - Other taxes
As part of reform, or just under current law, should the concept of an income tax be expanded?

- Form of taxation does not seem to change the reality that income is subject to double taxation
- Otherwise, the foreign tax credit will not fully neutralize location decisions and protect the competitiveness of U.S. companies
- Used to be simple, but the world is evolving

If so, how should this be implemented?

- Global approach (through statutory amendment or revision to the regulations)
- Individualized approach (influencing the policy decision when negotiating income tax treaties, and thus perhaps a win-win for the government and taxpayers)
Noncompulsory Payment Rule

Is it time to close Pandora’s box?
Noncompulsory Payment Rule

- General rule: “An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax.”
- Situation required (and received) regulations that were practical
  - Requires a taxpayer to contest the foreign tax by pursuing
    - “all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax”
    - “A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success”
  - Permits to use of options or elections, even if they shift income taxes between years, but do not increase the overall taxes paid
    - For example, election to use a longer depreciable life
    - Time value of money is not relevant in the decision
      - What if higher tax, but lower under time value of money principles?
  - Ordinary Course Exception
    - “A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax.”
    - Although helpful, no guidance identifying examples or elaborating on scope
Noncompulsory Payment Rule

- Government has taken the position that the tax is paid on a taxpayer-by-taxpayer basis
  - See Treas. Reg. § 1.901-2(f) definition of a taxpayer, which deviates from the general definition of a taxpayer under section 7701 for (possibly all) other tax purposes
  - Used the regulation to address foreign tax credit splitting prior to the enactment of section 909
- But . . .
  - Does the punishment fit the crime – section 909 defers taxes when they are split from the related income; the noncompulsory payment rule *denies* the credit entirely
  - Creates issues with foreign tax consolidation and similar systems (UK group relief) where taxes are effectively determined by aggregating income and losses of multiple “taxpayers”
  - Similar issue when trading audit adjustments on different taxpayers within the same foreign consolidated group
Although foreign consolidation and group relief regimes have been available for years, no guidance addressed the application of the noncompulsory payment rule to foreign groups prior to 2007

- Treas. Reg. § 1.901-2(f) defines the taxpayer for section 901 purposes as “the person on whom foreign law imposes legal liability for such tax”

Unpublished guidance has applied the noncompulsory payment rule on a separate entity basis in two situations

- TAM 200807015 (Feb. 15, 2008) – addressing a structured lending transaction that used a hybrid instrument and the sharing of a loss with an unrelated company
- CCA 200920051 (May 15, 2009) – addressing a foreign tax credit splitting arrangement involving two CFCs that elected fiscal transparency for Italian tax purposes, thus producing results similar to a reverse hybrid: earnings at the CFC level while the related foreign taxes imposed at the shareholder level

CCA 200920051—Italian CCA Example

- US Co
- Foreign DE
- Reverse Hybrid
- 100 Income
- 20 Foreign tax
Government has issued proposed regulation to address these complexities by permitting the application of the noncompulsory payment rule across a group of foreign entities

- Requires 80% common ownership by the US owner
- Appears to (and must) be a safe harbor, thus leaving uncertainty when outside of the 80% group rule
- Proposed in March of 2017 as part of the tax credit generator regulations
- Separated from those regulations and have never been finalized

The proposed regulations should be finalized, addressing some of the issue presented by the 80%-owned group approach

Should the rules be scaled back further?
- Enactment of section 909 – better tool, including the proper remedy
Clarification of the US-owned Group as a Safe Harbor

- If Unrelated Foreign Co **owns 20% or less**, then the Proposed Regulations permit UK Sub 2 to share the loss with UK Sub 1
- But if Unrelated Foreign Co **owns more than 20%**, then UK Sub 1 and UK Sub 2 are not members of a US-owned Group
  - Does sharing the loss give rise to a noncompulsory payment?
  - See Proposed Regulations, Example 2, concluding that the foreign companies are not members of the same group
  - But are the taxes creditable?
Inclusion of US Persons in the US-owned Group

**Base Case**

- US Co
  - 100%
- CFC
  - 100% 20 Foreign tax
- Reverse Hybrid
  - 100% Income

**Italian CCA**

- US Co
  - 100%
- Foreign DE
  - 100% 20 Foreign tax
- Reverse Hybrid
  - 100% Income

**Direct Ownership**

- US Co
  - 100%
- Reverse Hybrid
  - 100% Income
  - 20 Foreign tax
Address Joint Venture Situations

- **Satisfies the Prop. Reg.**
  - US Co
    - UK Sub 1 (80%)
      - UK Sub 2 (20%)
    - Satisfies the Prop. Reg.

- **Does not satisfy the Prop. Reg.**
  - US Co
    - UK Sub 1 (79% or 21%)
      - UK Sub 2 (21% or 99%)
      - Does not satisfy the Prop. Reg. (but should—why does ownership matter here?)
    - US Co
      - UK Sub 1 (100% or 79.5%)
        - UK Sub 2 (79% or 21%)
        - Does not satisfy the Prop. Reg.