



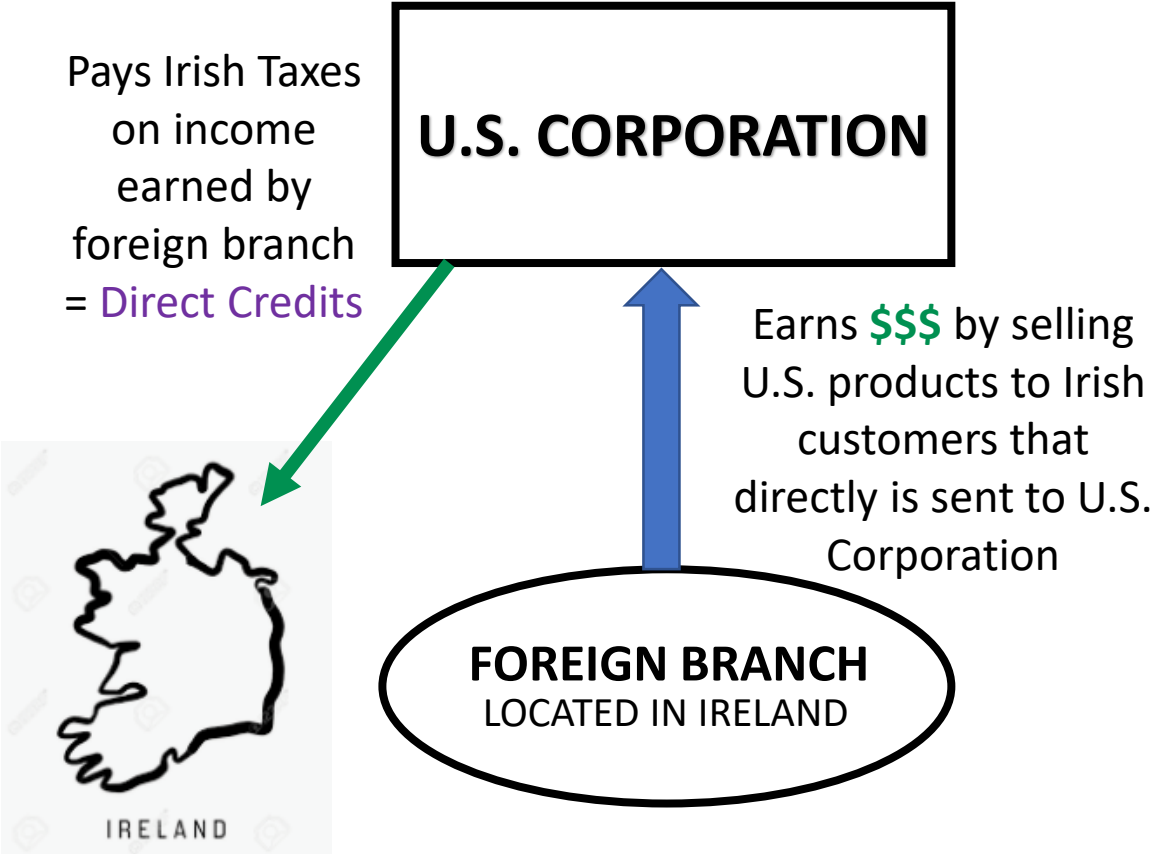
# U.S. AND GLOBAL TAXATION

- 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. tax purposes
- Ireland taxes the foreign branch's income
  - U.S. Corporation pays the Irish taxes on the foreign branch's income
  - **Remember:** U.S. Corporation must also pay U.S. tax on the foreign branch's **Irish** income

# 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
- Generally, a dollar of foreign tax credit offsets a dollar of U.S. tax on the foreign branch's income
  - Thus, if the foreign tax rate is **higher** than the U.S. rate, then U.S. does not impose additional tax on the foreign branch's income
- **BUT**, if the foreign tax rate is **lower** than U.S. tax rate, then U.S. Corporation must pay U.S. tax on the foreign branch's income to **EQUAL** what the U.S. tax on it would be

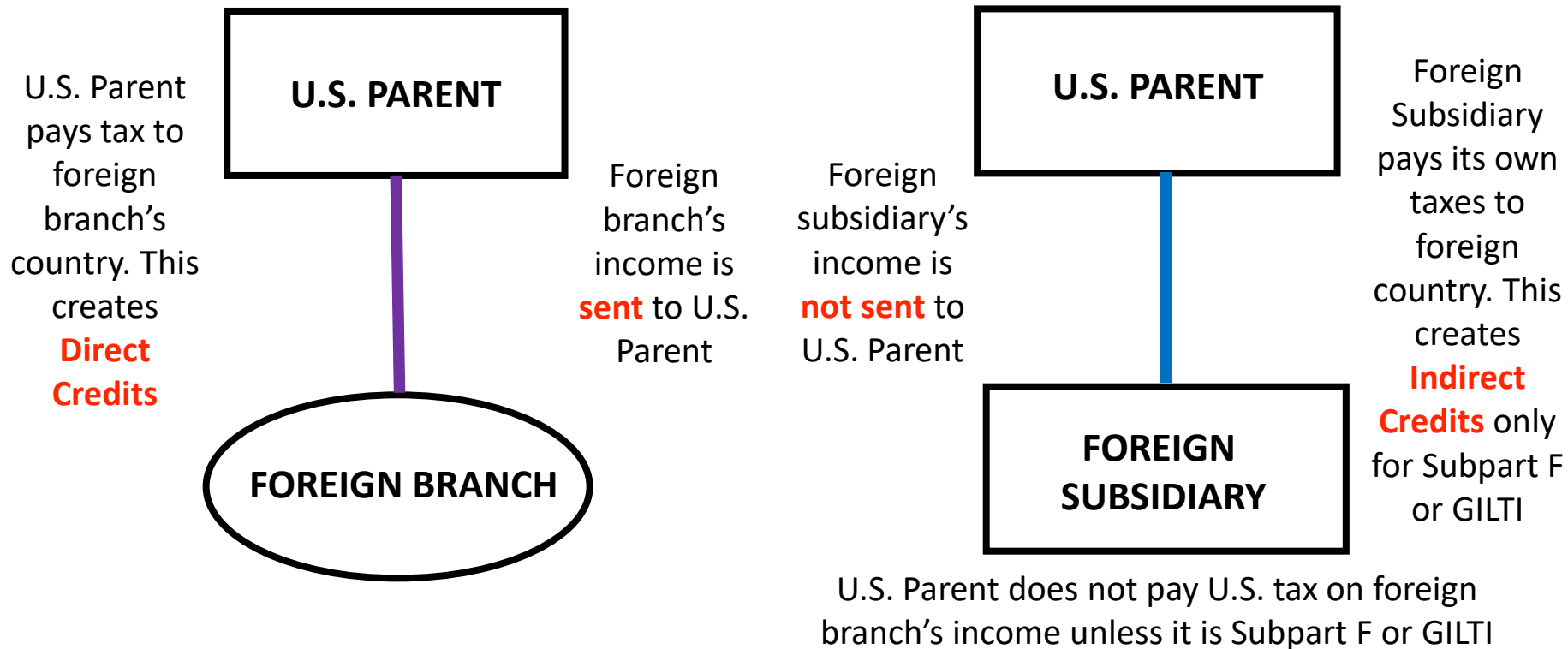
# POINT OF FOREIGN TAX CREDITS

- Foreign Income = \$1,000
  - U.S. Tax before FTC (at 21% rate) = \$210
  - Foreign Taxes (at 10%) = \$100
  - U.S. Tax after Credits = \$110
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- The diagram illustrates the calculation of total tax paid on foreign income. It shows that the U.S. tax before foreign tax credits (FTC) is \$210. This amount is equal to the sum of foreign taxes (\$100) and the U.S. tax after credits (\$110). A blue arrow points from the \$210 U.S. tax before FTC to the \$210 total tax after credits. A red bracket groups the \$100 foreign taxes and the \$110 U.S. tax after credits, with an arrow pointing to the \$210 total tax.

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)



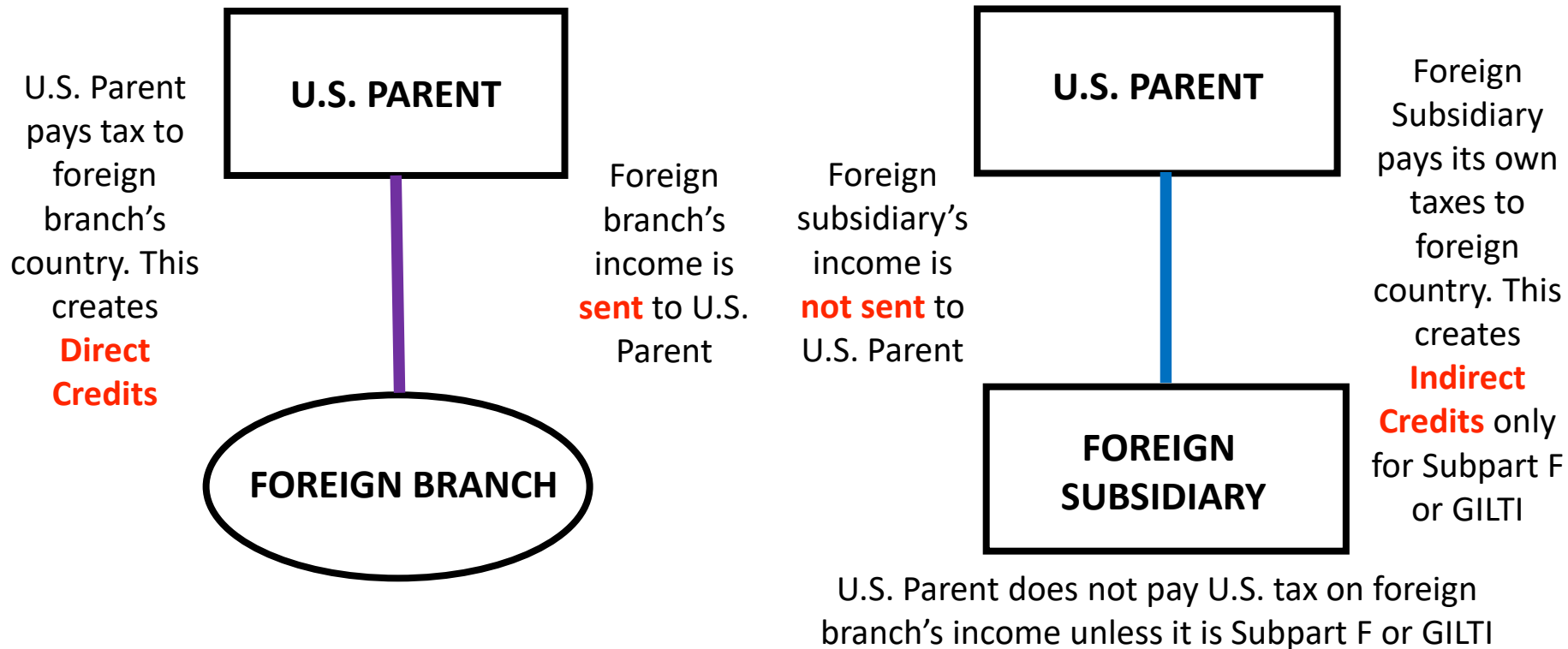


## 2 TYPES OF FOREIGN TAX CREDITS

- *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** – **BUT** principles still apply to § 960
    - Subpart F income entitles U.S. shareholder to 100% FTCs
    - Global Intangible Low Taxed Income inclusion entitles U.S. shareholder to 80% FTCs

# FUNDAMENTAL FOREIGN TAX CREDIT QUESTIONS

- Who is the payor of the tax and is it eligible for FTC?
- Are the foreign taxes are creditable? If yes, what amount?
- Which entity qualifies for DIRECT credits? Which entity qualifies for INDIRECT credits?
- Are there any limitations on FTCs?
- Foreign currency issues?



# 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 SYSTEM IS 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)

# INTENT OF FOREIGN TAX CREDIT FINAL REGULATIONS

- In 2020, FTC regulations were proposed with the intent to limit the creditability of certain “**novel extraterritorial taxes**”
  - Novel extraterritorial taxes assert taxing jurisdiction based on factors such as destination, customers and market access
  - Like the gross-basis **digital services** taxes (DSTs) that have been introduced in European and emerging-market jurisdictions
- So many expected the Final Regulations to pull back the proposed regulations’ scope to prevent the denial of FTCs for the withholding taxes commonly imposed around the world on royalties and service fees
  - But the Treasury and the IRS kept broad scope in the Final Regulations
- Now, taxpayers are faced with **analyzing various foreign taxes** for which they previously claimed FTCs to determine whether the FTCs are still available under the Final Regulations

# 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 country and the taxpayer's activities or investments in the foreign country
  - Treas. Reg. §1.901-2(b)(5)



# 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 (*i.e.*, the country's transfer pricing rules) must be determined **under arm's length principles**
  - Final Regulations specify that allocations of income under the foreign tax must not "tak[e] into account as a significant factor the location of customers, users, or any other destination-based criteria"
  - Treas. Reg. §1.901-2(b)(5)

# FTC FINAL REGULATIONS

## NEW ATTRIBUTION REQUIREMENT

- For *nonresidents* the attribution requirement is incorporated into the net gain requirement
- The attribution requirement is **met** for the foreign income tax *only if one of these three standards is met*:
  1. Activities-Based Attribution
  2. Source-Based Attribution
  3. Property-Situs Attribution

# 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. § 1.901-2(B)(5)(I)(B)

- The gross income or gross receipts (other than from sales or other dispositions of property) that are included in the foreign tax base on a source-basis are:
  - Limited to gross income arising from sources within the foreign country imposing the tax
  - Determined based on sourcing rules that are reasonably similar to those that apply under the Code
- if foreign law and US law characterize gross income or gross receipts differently, the foreign law characterization governs
  - BUT for a sale of a copyrighted article, a foreign tax satisfies the attribution requirement only if the transaction is treated as a sale of tangible property and not as a license of intangible property
  - BUT services income must be sourced based on where the services are performed, while royalty income must be sourced based on the place of use of, or the right to use, the intangible property
  - BUT for intangible property the Final Regulations clarifies that they do not require the foreign law to reach the same conclusion as US law
- Gross income or gross receipts from sales or other dispositions of property (including copyrighted articles) must be included in the foreign tax base via the Activities-Based Attribution or Property-Situs Attribution standards
- In the absence of a specific statutory source rule in the Code, the Preamble notes that the foreign law source rule satisfies the attribution requirement if it is reasonably similar to the US source rule that applies by closest analogy

# 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

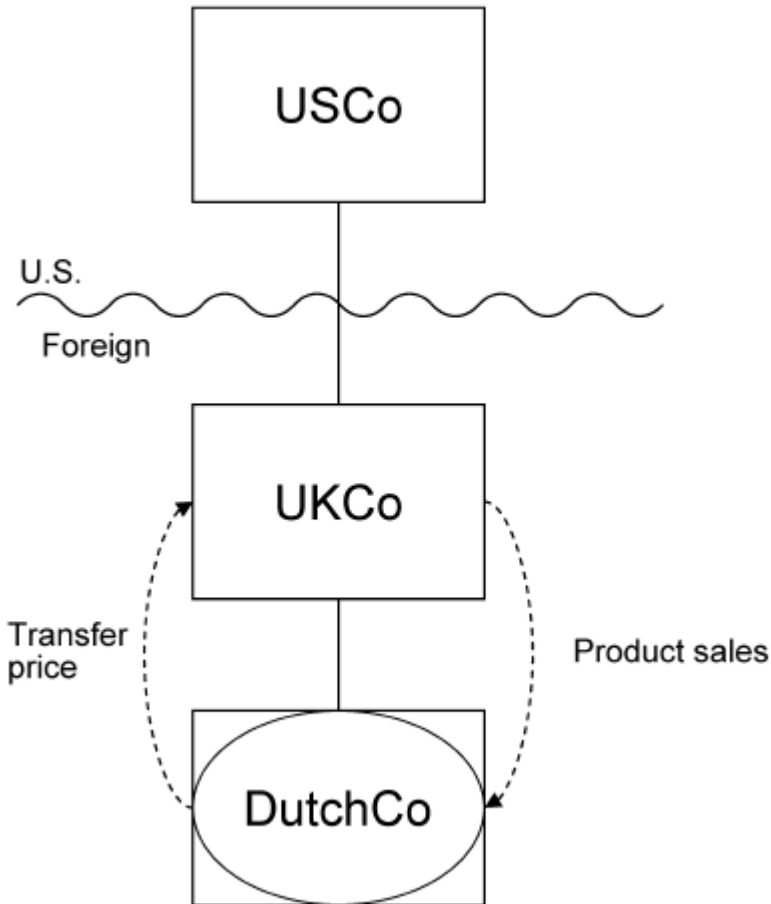
# CREDITABLE FOREIGN TAXES

- Foreign tax must be an income tax or **a tax in lieu of an income tax** to be “**creditable**” for U.S. credit purposes
- Foreign **levy** is a **tax in lieu of an income tax** if it requires a *compulsory payment based on authority of a foreign country* determined by *U.S. law* **not** foreign law
  - Penalties, fines, interest, custom duties and/or similar obligations are **not** taxes

# 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. A payment in exchange for a *specific economic benefit*
    - Payments for specific economic benefits are **NOT** considered a levy of tax. Treas. Reg. §1.901-2(a)(2)(i)

# 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 actually "withheld" at source) that is imposed on non-residents of the foreign country
3. Tested tax must satisfy a non-duplication standard similar to the one in the 4 tests
4. Must satisfy Source-Based Attribution requirement under the sufficient nexus standard for creditability

# FTC FINAL REGULATIONS SUBSTITUTION REQUIREMENT FOUR REQUIRED TESTS

1. Existence of a Generally Imposed Net Income Tax
2. Non-duplication
3. Close Connection to Excluded Income
4. Jurisdiction to Tax Excluded Income

# 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
  - Thus, if the generally-imposed net income tax, or a hypothetical new tax that is a separate levy relative to the generally-imposed net income tax, were **actually applied to the excluded income**, the generally-imposed net income tax or separate levy would satisfy the new attribution requirement

# 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
- Final rules will have far-reaching implications for U.S. taxpayers across all industries operating globally