How to Lose a Foreign Tax Credit, Part I: Disregarded Transactions of a CFC

*By Brian Jenn**

The Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") are in the midst of an ongoing process of building out the post-TCJA foreign tax credit regulatory infrastructure to accommodate the new pillars of the U.S. international tax system: the Code Sec. 951A Global Intangible Low-Taxed Income Regime ("GILTI") regime, the Code Sec. 245A dividends-received deduction ("DRD"), and the new Code Sec. 904 category for foreign branch income.[1] Starting with proposed regulations published in December 2018, this effort has so far produced four major packages of proposed regulations, two of which have also been the subject of final regulations.

The new regulatory infrastructure features extraordinary (but perhaps necessary) complexity and many opportunities to "lose" a foreign tax credit a U.S. taxpayer might have expected to be able to claim. The risk of losing a foreign tax credit is particularly great when foreign taxes are imposed on transactions of a controlled foreign corporation (CFC) that result in income recognition for foreign law purposes where there is no analogous U.S. recognition event in the same year. In this vein, this article focuses on fact patterns involving foreign taxes imposed on transactions of a CFC that are disregarded for U.S. federal income tax purposes. A forthcoming article will focus on foreign taxes imposed as a result of transactions of a CFC that are regarded for U.S. federal income tax purposes but are treated differently for U.S. and foreign purposes, for example, because a transaction is a nonrecognition transaction for U.S. purposes but is a taxable transaction for foreign purposes.

The New Statutory Framework: Code Secs. 960 and 245A(d)

In general, under the new regime, a U.S. person may claim a foreign tax credit under Code Sec. 901 for a foreign tax that person pays or accrues, except that Code Sec. 245A(d) denies a credit for a tax imposed with respect to a dividend to the U.S. person for which a Code Sec. 245A DRD is available. Under proposed Code Sec. 245A(d) regulations, a foreign tax credit is also disallowed for foreign taxes imposed with respect to certain distributions to

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a U.S. person of previously taxed earnings and profits ("PTEP") described in Code Sec. 959 and certain foreign taxes imposed on a distribution to a U.S. person that is a Code Sec. 301(c)(2) return of basis for U.S. federal income tax purposes.[2]

The conditions under which a U.S. person may claim a foreign tax credit for a foreign tax paid or accrued by a CFC described in Code Sec. 957 are far more limited, particularly compared to the availability of a foreign tax credit in such circumstances under former Code Sec. 902. In general, a Code Sec. 951(b) United States shareholder ("U.S. shareholder") of a CFC may claim a full foreign tax credit under Code Sec. 960(a) for foreign taxes "properly attributable" to the CFC's Subpart F income included by the U.S. shareholder under Code Sec. 951(a) and a partial foreign tax credit under Code Sec. 960(d) for foreign taxes "properly attributable to" the CFC's tested income included by the U.S. shareholder under Code Sec. 951A(a).[3]

In addition, in the last vestige of the old Code Sec. 902 foreign tax credit "pooling" concept, a U.S. shareholder may claim a foreign tax credit under Code Sec. 960(b) for foreign taxes paid or accrued by a CFC and "properly attributable to" PTEP distributed from one CFC to another that is ultimately distributed to the U.S. shareholder.[4] As in the case of foreign taxes on certain distributions to a U.S. shareholder, however, the proposed Code Sec. 245A(d) regulations may disallow a foreign tax credit for otherwise creditable taxes paid or accrued by a CFC with respect to certain PTEP and return of basis distributions.

A New General Regulatory Framework for Categorizing Foreign Taxes: Reg. §1.861-20

The need to determine what income of a CFC's foreign taxes paid by the CFC is "properly attributable to" accounts for much of the complexity of the new foreign tax credit infrastructure. To meet this need, Treasury and the IRS established a new general framework under Reg. §1.861-20 for allocating and apportioning foreign taxes to separate categories. Other new, and newly revised, sections of regulations apply the general rules of Reg. §1.861-20 in specific circumstances. In particular, Reg. §1.904-6 provides that the rules of Reg. §1.861-20 apply to allocate and apportion foreign income taxes to Code Sec. 904 categories (general category income and passive category income, in the case of a CFC). Additionally, Reg. §1.960-1 applies the rules of Reg. §1.861-20 to allocate and apportion foreign taxes to income groups (Subpart F income groups, tested income groups, PTEP groups, and the residual income group) within such Code Sec. 904 categories.[5]

Applying Reg. §1.861-20 to allocate and apportion foreign taxes is rarely a straightforward exercise, but in cases where a foreign tax is imposed on an item of income recognized for U.S. and foreign tax purposes in the same year, it might at least be called a manageable one. In that case, the regulations generally require identifying the item of income recognized for foreign purposes, which is referred to as "foreign gross income" (or "FGI") on which foreign tax is imposed.[6] The tax is then allocated and apportioned to the same category or categories that a "corresponding U.S. item" (or "CUSI") is assigned. The CUSI definition has its subtleties, but at a high level, it refers to the item of gross income that is recognized for U.S. federal income tax purposes and that arises from the same transaction or realization event from which an item of FGI arises.[7] Thus, for example, if foreign tax is imposed on a royalty paid by an unrelated person to a CFC and treated as passive foreign personal holding company income for U.S. federal income tax purposes, the foreign tax is allocated to a Subpart F income group for royalties (and dividends and interest) within the CFC's passive income group and potentially creditable under Code Sec. 960(a).

The hard work of Reg. §1.861-20 (the "2020 Final Regulations") and Proposed Reg. §1.861-20 (the "2020 Proposed Regulations") happens in cases where there is no CUSI, or corresponding U.S. item, by which to allocate the FGI and related foreign tax. This situation can arise because the transaction that gives rise to FGI on which foreign tax is imposed is, for U.S. federal income tax purposes, a disregarded transaction, a nonrecognition transaction, or a regarded transaction that occurs in a different taxable year. To allocate and apportion foreign taxes in these circumstances, Reg. §1.861-20 and Proposed Reg. §1.861-20 provide a general "timing difference rule" and other more specific sets of rules, including rules dealing with disregarded transactions, distributions that may be treated differently for U.S. and foreign purposes, and dispositions of stock and other interests in entities.

Disregarded Transactions of a CFC Generally

Under the 2020 Proposed Regulations, a disregarded payment generally means an amount of property that

is transferred to or from a taxable unit and includes remittances, contributions, and payments in exchange for property or services.[8] For purposes of these rules, a taxable unit means a tested unit as defined for purposes of the proposed Subpart F high-tax exception regulations.[9] Thus, a tested unit generally includes a CFC and any branch, partnership interest, or interest in a disregarded entity that is a tax resident of a foreign country.

The 2020 Proposed Regulations include specific rules for disregarded "reattribution payments," disregarded remittances (*i.e.*, distributions), disregarded contributions, and disregarded sales and exchanges of property. Each is discussed in turn below.

Reattribution Payments

Reattribution payments generally mean disregarded payments to the extent they result in the reattribution of income from one taxable unit to another. Whether income is reattributed as a result of a disregarded payment is determined under the Subpart F high-exception rules in Proposed Reg. §1.954-1(d), which apply the principles of the foreign branch disregarded payment rules in Reg. §1.904-4(f)(2)(vi). Under those rules, a disregarded payment causes gross income to be attributed from one taxable unit to another to the extent that a deduction for the payment, if regarded, would be allocated against the payor tested unit's U.S. gross income under the principles of Reg. §§1.861-8 through 1.861-14T and §1.861-17.[10] Importantly, income can only be reattributed from an income group of a taxable unit to the extent there is sufficient gross income recognized in the U.S. taxable year in which the disregarded payment is made.[11]

As described generally above, in order to allocate foreign taxes imposed on a disregarded payment to a CFC's Code Sec. 904 categories and income groups, it is necessary to assign the FGI on which the taxes are imposed to such categories and groups. In the case of a reattribution payment, FGI is assigned to the groupings to which the reattribution payment is assigned upon receipt by the taxable unit.[12] As noted above, the groupings of the payee taxable unit to which the payment is assigned generally will correspond to the groupings of the payor from which the payment is considered made. For instance, if one taxable unit makes a disregarded royalty payment to another taxable unit, and a deduction for that royalty would be allocated against the payor taxable unit's general category tested income group, then the FGI resulting from that disregarded royalty would be assigned to the payee taxable unit's general category tested income group. A foreign income tax imposed on that item of FGI would be allocated to the same category. In this regard, it is relevant that a disregarded interest payment generally would be allocated and apportioned ratably to all of a taxable unit's income, including income in the residual category.[13]

There are a few ways in which a foreign tax imposed on a reattribution payment between taxable units of a CFC could be ineligible for a foreign tax credit. One of those ways is if the reattribution payment on which foreign tax is imposed is allocated to a residual income group of a CFC because a deduction for the payment, if regarded, would be allocated to the payor taxable unit's residual income group. Tax allocated to a residual income group of a CFC—*i.e.*, not to a Subpart F income group, tested income group, or PTEP group—is ineligible for a foreign tax credit under Code Sec. 960.[14] Income in the residual income group is income that is neither tested income nor Subpart F income—*e.g.*, foreign oil and gas extraction income defined in Code Sec. 907(c)(1) or income effectively connected with the conduct of a trade or business in the United States or income qualifying for the Subpart F high-tax exception or dividends eligible for Code Sec. 954(c)(6).[15]

Another way in which a foreign tax imposed on a reattribution payment could be ineligible for a foreign tax credit is if the foreign tax causes the amount of net income in the income group to which it is assigned to fall to zero or below. In general, in computing the amount of income in a tested income group, Subpart F income group, or PTEP group, current-year foreign taxes must be allocated and apportioned to such groups, reducing income in such groups.[16] If tax imposed on a disregarded payment is allocated to an income group that already has been allocated other significant expenses, the deduction for that tax could cause the net income in that group to fall to zero or below zero. Where income in a tested income group or Subpart F income group falls below zero, no foreign tax allocated to that group may be credited under Code Sec. 960.[17]

Remittances

Under the 2020 Proposed Regulations, a remittance means a transfer of property by a taxable unit that would be treated as a distribution by a corporation to a shareholder if the taxable unit were regarded as a corporation for U.S. federal income tax purposes. A remittance also

includes any payment from one taxable unit to another taxable unit of the same CFC (other than a southbound payment that would be a contribution, as described below) to the extent it is not considered a reattribution payment—*e.g.*, because the payor taxable unit has no current-year taxable income recognized for U.S. federal income tax purposes that could be reattributed as a result of the payment.

FGI included by a CFC as a result of a remittance is assigned to the groupings of the payee taxable unit corresponding to the groupings of the payor taxable unit from which the payment is considered made.[18] The 2020 Proposed Regulations state that a remittance is considered made ratably out of the accumulated after-tax income of the taxable unit.[19] Fortunately, the regulations do not require maintenance of accumulated earnings and profits of a taxable unit but, rather, deem accumulated after-tax income of the taxable unit to have arisen in the relevant groupings in the same proportions as the proportions in which the tax book value of the taxable unit's assets would be assigned for purposes of apportioning interest expense under Reg. §1.861-9 in the taxable year in which the remittance is made.

For purposes of applying the asset method to assign FGI from a remittance, the assets of a taxable unit include stock held by the taxable unit, as well as "reattribution assets."[20] A reattribution asset is an asset that produces items of U.S. gross income to which a disregarded payment is allocated.[21] That is, if a taxable unit makes a disregarded payment to another taxable unit, a portion of the payor taxable unit's assets that produced the reattributed income are assigned to the payee taxable unit (and removed from the payor taxable unit) for purposes of applying the asset method. The reattribution asset rule, while no doubt nearly impossible to administer in practice, would have the effect of allowing FGI associated with a remittance by a taxable unit to be assigned based on the groupings of reattribution payments made to that taxable unit.

If a taxable unit that has no assets makes a payment that is treated as a remittance, FGI associated with that remittance is assigned to the residual grouping, meaning no foreign tax credit is available to the extent foreign tax is imposed as a result of that remittance.[22] The circumstances under which a taxable unit would be considered to have no assets for purposes of applying the asset method may be fairly limited. The issue may arise where a taxable unit that has as its only asset interests in another taxable unit receives a remittance from that other taxable unit and then re-distributes the same amount in the same year.[23]

A more common remittance situation in which a foreign tax credit might be lost is where a taxable unit making a remittance owns stock of a CFC that generates income that will qualify for the Code Sec. 245A DRD when ultimately distributed to a U.S. shareholder. In that situation, to the extent a portion of the stock of the CFC owned by the taxable unit may be assigned to a Code Sec. 245A subgroup under Reg. §1.861-13, the FGI associated with the remittance may also be assigned to such a subgroup, potentially resulting in disallowance of a foreign tax credit under Code Sec. 245A(d) and Proposed Reg. §1.245A(d)-1(a) (although this result is far from clear under the proposed regulations).

Remittances can also be problematic in the case of a taxable unit that generates much or most of its income from zero-basis or low-basis assets, such as self-developed IP. In that case, the asset method, which looks to asset basis, would not take into account such IP, meaning that FGI and foreign taxes would be allocated to groupings that may not generate significant regarded U.S. income. As discussed in the case of reattribution payments, if the foreign taxes allocated to such groupings exceed the U.S. gross income in such groupings, no foreign tax credit would be available.

Contributions

FGI included by a taxable unit as a result of a contribution is assigned to a CFC's residual grouping, such that related foreign taxes are not creditable by the CFC's U.S. shareholder under Code Sec. 960.[24] As would be expected, a contribution under the 2020 Proposed Regulations includes a disregarded transfer of property to a taxable unit that would be treated as a contribution to capital or a Code Sec. 351 contribution if the taxable unit were a regarded corporation for U.S. federal income tax purposes.[25] Less intuitively, however, a contribution also includes the excess of any "southbound" disregarded payment (*i.e.*, a payment from one taxable unit to another taxable unit that it owns) over the portion of the payment that is a disregarded reattribution payment.[26]

Although contributions that are capital contributions are rarely subject to foreign tax, the treatment of any southbound disregarded payment in excess of the reattribution amount as a contribution could create unwelcome surprises for taxpayers. For example, if one taxable unit makes a disregarded royalty payment to a taxable unit it owns, but the payor taxable unit does not have sufficient U.S. gross income in the grouping from which the royalty payment is reattributed in the year of the payment,

then a portion of the FGI from the royalty payment is assigned to the residual category. The result is that foreign taxes imposed on the disregarded payment would be ineligible for a foreign tax credit under Code Sec. 960.

Disregarded Transfers of Property Other Than Stock

FGI attributable to gain recognized under foreign law on a disregarded sale or exchange of property—including stock—is assigned under the so-called timing difference rules in Reg. §1.861-20(d)(2).[27] These rules generally require hypothesizing a transaction that is regarded for U.S. federal income tax purposes and determining the groupings to which hypothetical U.S. gross income associated with the transaction would be assigned. Under the special timing difference rule in Reg. §1.861-20(d)(2)(ii)(C) for a foreign law disposition of property, a FGI item of gain is assigned to the grouping to which a CUSI of gain or loss would be assigned on a taxable disposition of the property for U.S. federal income tax purposes.

Disregarded transfers of property other than stock present a hazard of non-creditable foreign taxes because there may be no U.S. gross income items for the year in the category to which the FGI item—and related foreign taxes—are assigned. Where the transfer of property would generate tested income for U.S. federal income tax purposes, this may be less of a concern, since a CFC with assets that would generate tested income on disposition may be likely to have U.S. gross income in tested income groups. Nonetheless, there could be an issue if the tax on the foreign law disposition is large enough—for instance, in the case of a disposition of self-developed IP with no basis—that the deduction for that tax exceeds the U.S. gross income in the group to which the FGI is assigned. In that case, as discussed above, no credit would be available under Code Sec. 960.

Where the disregarded transfer of property would generate Subpart F income for U.S. federal income tax purposes, there is a greater risk that foreign taxes imposed on the disposition of property would not be creditable. This is because there are separate Subpart F income groups for specific types of Subpart F income, including any item of foreign base company income that is treated as a single item of income under Reg. §1.954-1(c)(1)(iii).[28] Under those rules, for example, gain from property transactions is assigned to a different grouping than dividends, interest, rents, and royalties. Additionally, the grouping rules of Reg. §1.904-4(c)(3), (4), and (5) apply for this purpose; those rules separately group items based on whether the items are subject to foreign withholding tax or income tax and also separately group items attributable to different foreign qualified business units (QBUs). These granular grouping rules greatly increase the risk that FGI from any disregarded property transaction that would result in Subpart F income if regarded will be allocated to a grouping with insufficient U.S. gross income to claim a foreign tax credit for taxes imposed on that foreign gain.

Disregarded Transfers of Stock

FGI associated with a disregarded transfer of stock is also assigned based on the general timing difference rules. In this regard, the 2020 Proposed Regulations contain a special timing difference rule for FGI from a disposition of stock. Under that rule in Proposed Reg. §1.861-20(d)(3)(i)(D), an item arising from a disposition of stock is assigned first, to the extent of any amount that would be treated as a dividend under Code Sec. 964(e), to the same groupings to which the U.S. dividend amount is assigned under U.S. federal income tax law. To the extent the FGI exceeds the U.S. dividend amount, it is assigned, to the extent of any amount that would be U.S. capital gain, to the groupings to which U.S. capital gain would be assigned under U.S. federal income tax law. Any remaining FGI from the stock disposition is assigned based on the groupings to which the tax book value of the stock would be assigned under the asset method in Reg. §1.861-9.

Disregarded transfers of stock present many of the same challenges regarding claiming a foreign tax credit as other disregarded transfers of property. To the extent that a regarded disposition would be subject to Code Sec. 964(e), FGI from the disposition likely would be assigned to a general category Subpart F income group for dividends, interest, rents, and royalties (also subject to the granular Reg. §1.904-4(c) grouping rules described above), taking into account the look-through rules of Reg. §1.904-5. It would not be surprising if there were no U.S. gross income in such group after deduction for foreign taxes such that foreign tax allocated that the group is not creditable. Similarly, to the extent to which any FGI would be U.S. capital gain, the FGI would be assigned to a passive category Subpart F income group for certain property gains, a grouping in which there may not be any current-year U.S. gross income. Additionally, to the extent FGI from a disregarded disposition of stock is assigned based on the tax book value of the stock, a foreign tax credit could be disallowed under Code Sec. 245A(d)

and Reg. §1.245A(d)-1(a) to the extent such stock would be assigned to a Code Sec. 245A subgroup.

Conclusion

As illustrated in this article, there are many different fact patterns in which taxes imposed on a transaction that is disregarded for U.S. federal income tax purposes would not be creditable. Accordingly, taxpayers should carefully consider the creditability of any potential foreign taxes before undertaking such transactions, keeping in mind that the 2020 Proposed Regulations are generally proposed to apply, when finalized, to taxable years beginning after December 31, 2019.

ENDNOTES

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1 Regarding the foreign branch income category, *see* Brian Jenn, *Navigating the Foreign Branch Basket Under the New Final Regulations*, Int'l Tax J., March–April 2020.

2 Proposed Reg. §1.245A(d)-1.

3 The foreign tax credit under Code Sec. 960(d) is limited to the 80% of the foreign taxes paid or accrued with respect to tested income, multiplied by the "inclusion percentage" described in Code Sec. 960(d)(2).

4 Code Sec. 960(b)(2).

5 Reg. §1.960-1(d)(2)(ii).

6 Reg. §1.861-20(b)(6).

7 Reg. §1.861-20(b)(2).

8 Proposed Reg. §1.861-20(d)(3)(v)(E)(4).

9 Proposed Reg. §1.861-20(d)(3)(v)(E)(9).

10 Reg. §1.904-4(f)(2)(vi)(B).

11 Proposed Reg. §1.861-20(d)(3)(v)(B)(2).

12 Proposed Reg. §1.861-20(d)(3)(v)(B)(i).

13 Proposed Reg. §1.954-1(d)(1)(ii)(B)(4).

14 Reg. §1.960-1(e).

15 *See* Code Sec. 951A(c)(2)(A).

16 Reg. §1.960-1(c)(1)(ii).

17 Reg. §§1.960-2(b)(3)(i) and 1.960-2(c)(5).

18 Proposed Reg. §1.861-20(d)(3)(v)(C).

19 *Id*.

20 Proposed Reg. §1.861-20(d)(3)(v)(C)(1)(ii).

21 Proposed Reg. §1.861-20(d)(3)(v)(E)(6).

22 Proposed Reg. §1.861-20(d)(3)(v)(C)(1)(i).

23 It is unclear whether an interest in another taxable unit would be considered an asset for purposes of applying the asset method in this context.

24 Proposed Reg. §1.861-20(d)(2)(v)(C)(2).

25 Proposed Reg. §1.861-20(d)(3)(v)(E)(2).

26 *Id*.

27 Proposed Reg. §1.861-20(d)(3)(v)(D).

28 Reg. §1.960-1(d)(2)(ii)(B).