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Foreign Tax Credits' Demise

Although the elaborate regime around foreign tax credits remains mostly in place, the 2017 Tax Act repealed the indirect foreign tax credit for inbound dividends in Section 902. That means that the only taxes U.S. shareholders may be able to credit to inbound dividends are foreign withholding taxes. But it turns out those taxes mostly will not be creditable. And it further turns out that they will never be creditable; neither will the foreign taxes paid by the foreign corporations.

Example. USS incorporated FS in Country X in 2019 and capitalized it solely with cash, so that Section 367(a) did not require USS to recognize gain.[1] Because USS did not incorporate a branch with post-2017 net losses, new Section 91 did not apply.[2] FS's only income in 2019 was $100 derived from a business it actively conducted in Country X, all of which was subject to Country X income tax, for which FS paid $25, and all of which added to Section 312 earnings and profits as computed for purposes of a foreign corporation under Section 964(a) (and subject to currency translation rules). In 2019, FS distributes $100 to USS with respect to its stock and withheld $5 income tax; the stock is treated as stock in Country X and the dividend is not a hybrid dividend.[3] The $100 is a dividend as defined by Section 316. FS is a specified 10 percent owned foreign corporation. USS is a U.S. shareholder. Section 245 cannot apply, and the foreign source portion of the dividend is $100. Therefore, USS will include a $100 dividend in gross income, and Section 245A will allow a deduction of $100. The potential credit for $5 withholding tax is disallowed entirely for USS's 2019 return because it is entirely attributable to the deductible portion of the dividend,[4] and there will be no Section 78 gross-up because USS does not claim a credit. No rule allows USS to claim credit for the $5 tax in a later

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1 Because the Act eliminates Section 367(a)(3), USS would have included gain built into an incorporated branch.

2 Even though Congress removed Section 367(a)(3), it adopted a new section that can require recapture of previously deducted branch losses.

3 Section 245A(e) will not allow a DRD for a hybrid dividend.

4 Section 245A(d).

year. The $25 foreign tax that FS paid will not be available for later credit under Section 960 because it was attributable to dividend income USS has included.[5]

However, many preexisting foreign corporations that cause payment of the one-time tax of Section 965 will create substantial amounts of previously taxed income. Distributions of previously taxed income can incur withholding taxes that may be creditable, subject to several special rules.

Many will believe that trading the FTCs for the new Section 245A dividends-received deduction is a good thing. However, only domestic corporations that are U.S. shareholders can claim the deduction. The Act seems to have stacked the deck against individuals owning foreign corporations or wanting to incorporate foreign branch operations.

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5 Reg. Section 1.902-1(a)(8).

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