2020

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INTERNATIONAL TAXATION

FORM 5471, FORM 965, FOREIGN TAX CREDIT

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SPEAKER

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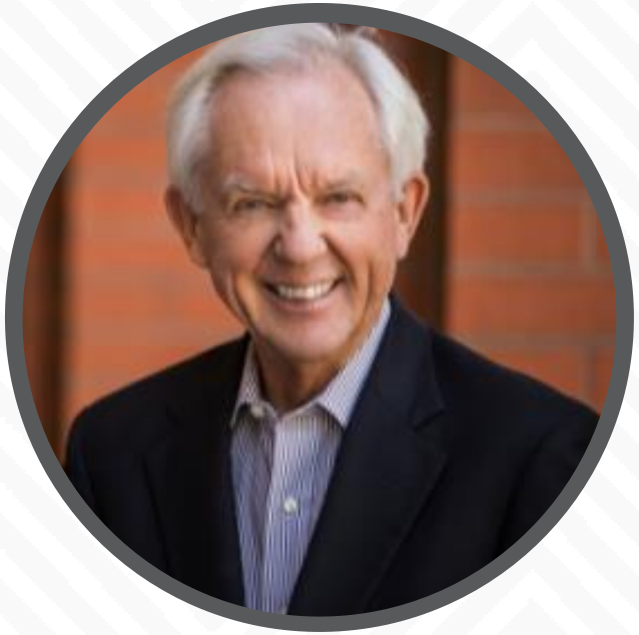

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6. Payment of Dividend to Parent Company

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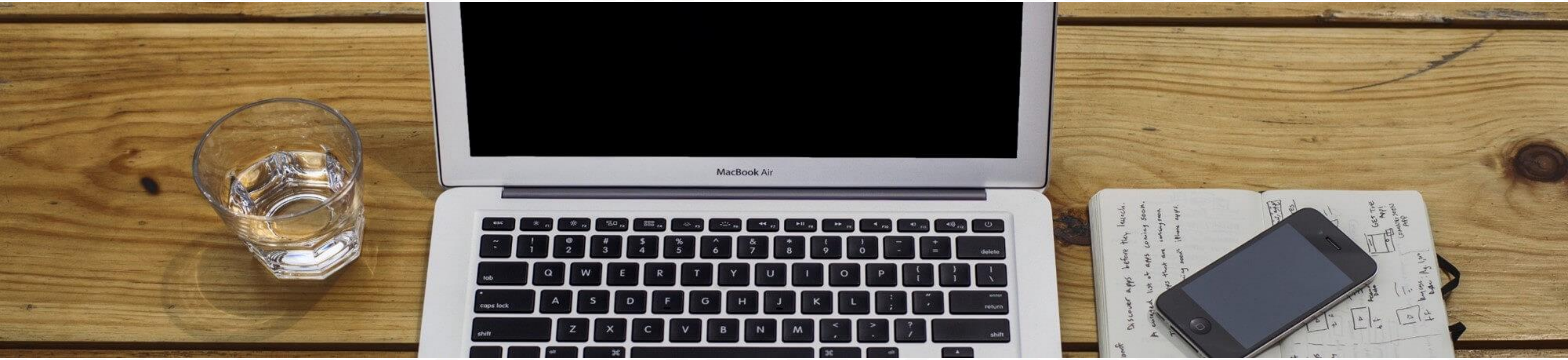
PART ONE

A Couple of Forms

Form 5471

A great deal has changed since the IRS first issued Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations). The taxpayer that falls within one of the five categories to which the Form applies is required to file the form, properly completed, with its tax return for the year to which the form relates.

Question 1



CATEGORY 1 FILER

A category 1 filer is a relatively new (2018) filer. That person is a **U.S. shareholder** of a foreign corporation that is an IRC section 965 **specified foreign corporation (SFC)** . For purposes of Category 1, an SFC (as defined in section 965) is:

1. A controlled foreign corporation (CFC) or
2. Any foreign corporation with respect to which one or more domestic corporations

CATEGORY 1 FILER

The tricky part: Your client owns 100 shares of a foreign corporation that has a domestic corporation as a “US Shareholder” (that is, the corporation owns 10 percent or more of the foreign corporation’s total voting power or value). **That foreign corporation is, as to your client, a specified foreign corporation.**

Question: how am I to know that a domestic corporation owns shares in XYZ Ltd?

CATEGORY 1 FILER

The tricky part: Your client owns 100 shares of a foreign corporation that has a domestic corporation as a "US Shareholder" (that is, the corporation owns 10 percent or more of the foreign corporation's total voting power or value). **That foreign corporation is, as to your client, a specified foreign corporation.**

Note, however, that a **passive foreign investment company** (as defined in section 1297) with respect to the shareholder is not a CFC, then such corporation is not an SFC.

CATEGORY 2 FILER

A category 2 filer is a **U.S. citizen or resident** who is **an officer or director of a foreign corporation** as to which a U.S. person (any U.S. person) has acquired during the taxable year **10 percent or more of the corporation's stock (vote or value)**. So, the officer or director needs to file the form when a U.S. person initially acquires the 10 percent or acquires an additional 10 percent.

CATEGORY 3 FILER

A category 3 filer is **any U.S. person** who acquires 10 percent or more of the foreign corporation's stock or who disposes of his stock in the foreign corporation in an amount that reduces his holdings to less than 10 percent of the outstanding stock.

Note: The Category 3 filer is **required to file even if the corporation is not a CFC.** Additionally, anyone who is treated as a U.S. shareholder or who becomes a U.S. person while owning the magic 10 percent is required to file the form.

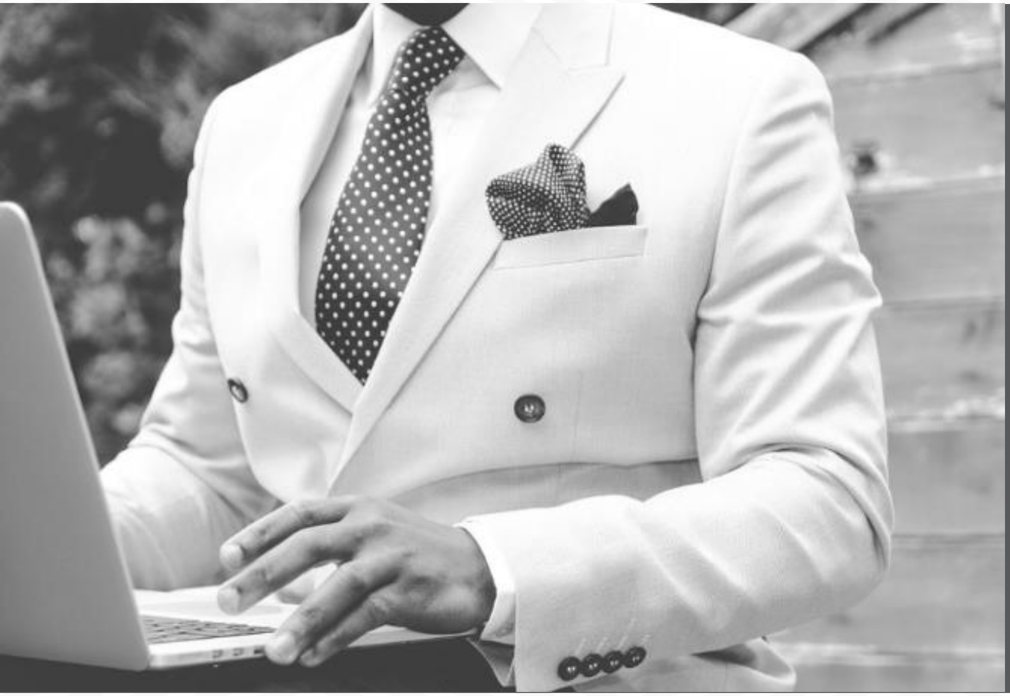
CATEGORY 4 FILER

A Category 4 filer is any **U.S. person** who **controls a foreign corporation** during the taxable year.

A U.S. person has control of a foreign corporation if, at any time during that person's tax year, it owns stock possessing:

1. More than 50% of the **total combined voting power** of all classes of stock of the foreign corporation entitled to vote, **or**
2. More than 50% of the **total value of shares** of all classes of stock of the foreign corporation.

CATEGORY 4 FILER



A person in control of a corporation that, in turn, owns more than 50% of the combined voting power, or the value, of all classes of stock of another corporation is also treated as being in control of such other corporation.

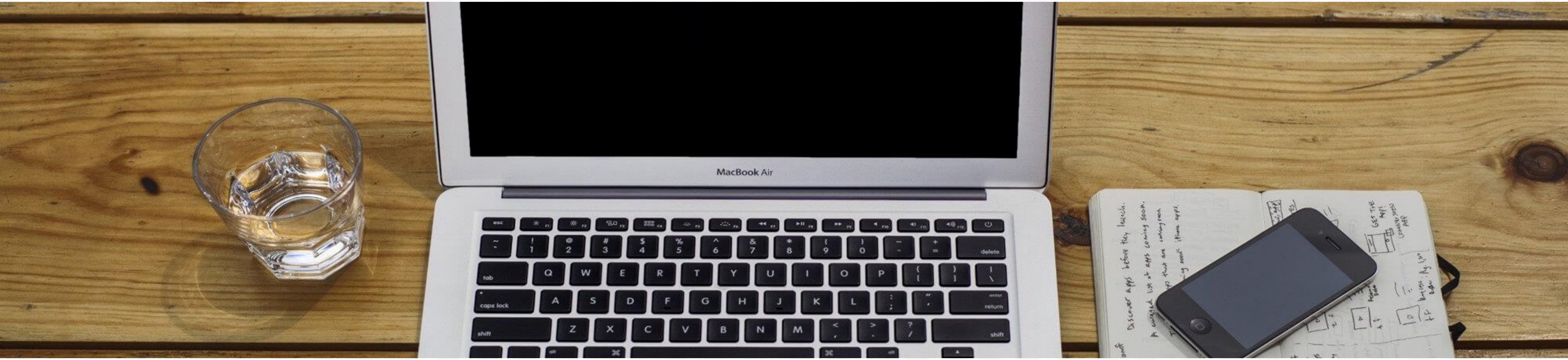
CATEGORY 5 FILER

A Category 5 filer is anyone who is a U.S. shareholder (that is, the shareholder owns 10 percent in vote or value of the corporation's stock) of a foreign corporation that is a CFC at **any time during any tax year and who owned the stock on the last day of that year**.

The Service issued, in 2019, a revenue procedure (Rev Proc 2019-40, 2019-43 IRB 982) designed to significantly limit the number of U.S. persons who are required to file Form 5471.

The basis for that procedure is that the Service recognized that a number of constructive shareholders of foreign corporations simply do not have the information that would allow those persons to file the form with any meaningful information.

Question 2



Form 965

Unlike Form 5471, Form 965 is really short. The major problem you, as an accountant, have with it is **whether or not your client needs to file it**. To start, you need to know what a DFIC is. Those initials stand for "**Deferred Foreign Income Corporation**".

A DFIC is simply a SFC, as defined above, that was covered by IRC § 965 (Treatment of deferred foreign income upon transition to participation exemption system of taxation).

Form 965

01. That was the section that brought all deferred foreign income into current taxation as of the end of 2017.

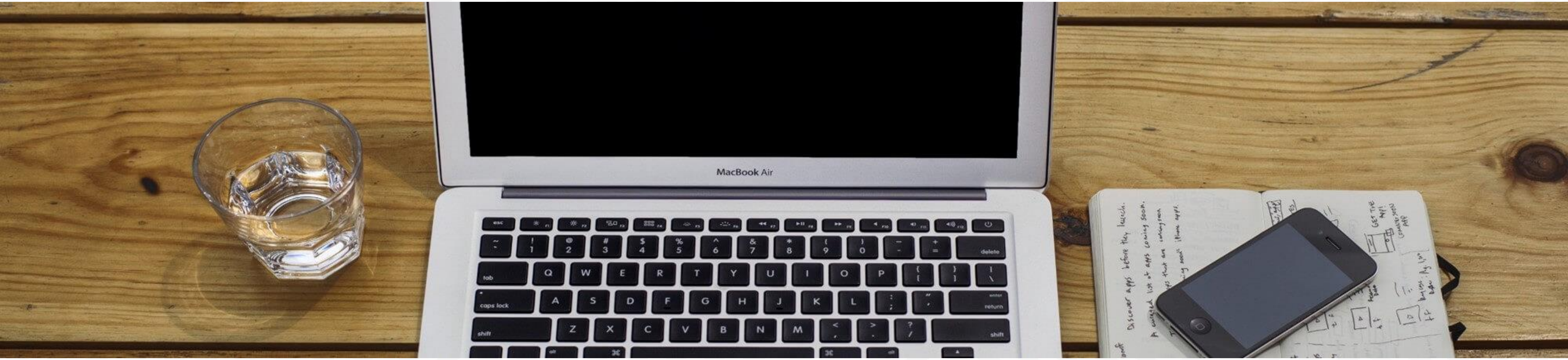
02. Form 965 is directed at the U.S. taxpayer who owns an interest in a pass-through entity, such as an S corporation or a domestic partnership when that entity is a U.S. shareholder of a DFIC and when the entity received a distribution from the DFIC.

03. A shareholder who received some amount from his pass-through entity that he is required to include in his income tax return for 2019 under IRC § 965 is required to file the Form.

04. A shareholder who did not receive any amount that he is required to include in his income tax return for 2019 need not file the Form.

05. Note the list of questions about various elections that are relevant to the section. The list is contained in Part III of the Form.

Question 3



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PART TWO

Thoughts on the Foreign Tax Credit

A. Individual claims of a foreign tax credit

1. Direct foreign tax credit to an individual
2. Individual Ownership of Foreign Corporate Shares
3. Majority Ownership of Foreign Corporate Shares

Scenario 1

Direct foreign tax credit to an individual

Congress long ago recognized that such a double taxation result was a damper on international trade, so it adopted the concept of the **foreign tax credit**. That credit says, in essence, that income tax paid to a foreign government on income that the U.S. also taxes is to be **a reduction in the U.S. tax obligation** related to that same income.

Example: Gretchen buys a $100,000 worth of stock issued by a Swiss corporation that pays quarterly dividends. The Swiss corporation issues a **$5,000 dividend** to Gretchen at the end of the first quarter of 2020 from which the corporation, according to Swiss law, withholds **$750 in Swiss income tax**.

Gretchen includes the $5,000 in her income for U.S. tax purposes, which generates a **U.S. tax of $1,750**. Gretchen is allowed to credit (reduce) her federal tax by the amount of Swiss tax that was withheld from the dividend (in this case $750). That credit is what everyone refers to as a **direct foreign tax credit**.

Scenario 2

Individual Ownership of Foreign Corporate Shares

Now, assume that Gretchen, a U.S. taxpayer, owns shares (about one percent) of a Belvedere, Ltd, a foreign corporation that is engaged in an active business in its home country. Belvedere pays foreign taxes on its income, as you would expect.

That fact, however, is irrelevant to Gretchen because **she is not authorized to take a foreign tax credit for the foreign tax that Belvedere pays** any more than she is authorized to take a tax credit for income taxes that General Motors pays.

Note, however that Gretchen should file a Form 5471 **if a domestic corporation owns 10 percent or more of Belvedere**.

Scenario 3

Majority Ownership of Foreign Corporate Shares

OK, so let's change the facts. Under this revised set of facts, Gretchen **owns 60 percent of Belvedere's stock** (making her a U.S. shareholder of Belvedere which is now a controlled foreign corporation). As before, Belvedere paid foreign tax on its income.

Although that income is Global Intangible Low-taxed Income (GILTI) as to Gretchen, she is still not entitled to take a foreign tax credit for the foreign taxes that Belvedere paid.

That comment also applies to domestic partnerships, trusts, and estates; that is, those entities are not allowed a foreign tax credit on taxes their foreign corporation pays.

B. Domestic Corporation Claims of a Foreign Tax Credit

4. Distributions From Controlled Foreign Corporations
5. High-Tax Kickout
6. Payment of Dividend to Parent Company

Scenario 4

Distributions From Controlled Foreign Corporations

Some of you may be familiar with the old, now repealed, indirect foreign tax credit. Under those old rules, a corporation that owned 10 percent or more of a foreign corporation could claim a foreign tax credit for foreign income taxes paid to a foreign government by that foreign corporation. **As mentioned, that provision is gone.**

Scenario 4

Distributions From Controlled Foreign Corporations

The closest set of rules we now have to the repealed indirect foreign tax is found in **IRC section 960**. Even those section 960 rules, however, are pretty limited. They **only apply to constructive or actual distributions** from controlled foreign corporations ("CFCs"), and, indeed, not all of those.

In other words, if a domestic corporation receives a dividend from a foreign corporation that is **not a CFC**, the domestic shareholder is **not entitled to a foreign tax credit** for the foreign taxes the foreign corporation paid.

Scenario 4

Distributions From Controlled Foreign Corporations

Rhoco, Inc. is a domestic corporation that owns all of the shares of Rhoco, Ltd., a U.K. corporation. During the year 2020, Rhoco, Ltd (Ltd) generated taxable income of $100,000 on which it paid U.K. tax of $15,000 (a 15 percent tax rate). For purposes of this discussion, assume that all of the taxable income of Ltd is reflected in Rhoco, Inc's income for the year under either the GILTI or the subpart F rules—say, $66,000 of GILTI and $34,000 of Subpart F.

Here is the somewhat tricky part. The foreign tax credit applies dollar for dollar on subpart F income but applies only at $.80 on the dollar for GILTI income. That means that Rhoco, Inc is only able to credit $8,000 of the foreign taxes paid by Ltd on its GILTI but is able to apply a full $5,000 on its subpart F income.

Scenario 5

High-Tax Kickout

Suppose, however, that Rhoco paid $25,000 to the U.K. rather than $15,000. That is a significant difference because that tax rate (25 percent) pushed Ltd into the "high tax kickout" range.

That is important to Rhoco, Inc. because the foreign income that generated that high tax is **excluded** from Rhoco Inc's calculation of **both GILTI and subpart F income.**

Scenario 5

High-Tax Kickout

By the way, foreign tax is treated as high enough to meet the kickout standard if the foreign tax rate is **at least 90 percent of the current U.S. domestic corporate tax rate** (21 percent). That means that any foreign tax rate that is 18.9 percent or more will be a high foreign tax rate.

Scenario 5

High-Tax Kickout

Here is an example of how that rule works: Rhoco, Ltd. earned $100,000 of net income in the U.K. in 2020, $65,000 from operating its business (GILTI) and $35,000 from passive investments (subpart F). Ltd paid the U.K. $25,000 on that income. Ltd doesn't do anything with the cash, so the net $75,000 was sitting in Ltd's U.K. bank account at the end of the year.

Since the income earned by Ltd is what we will call kick-out income (that is, the income that meets the requirement of a high tax as to both subpart F income and GILTI), neither the $65,000 nor the $35,000 is GILTI or subpart F income and, hence, Rhoco, Inc. simply ignores that income on its own return. Rhoco Inc., of course, must still file a Form 5471 as to Ltd, but none of Ltd's income flows through.

Scenario 6

Payment of Dividend to Parent Company

What happens, then, if, in 2021, Ltd issued a dividend to Rhoco of the $75,000?

Since the indirect foreign tax credit rules are limited to subpart F or GILTI income and, since the kick-out income is neither of those, what happened to the foreign tax that Ltd paid when Ltd issued a dividend to its parent company? The answer is, interestingly enough, nothing. That foreign tax is simply ignored. Rhoco picks up the $75,000 as gross income, but Rhoco does nothing with the foreign tax. Double taxation of Ltd's income? No, because Congress added another new section to the Code to deal with that issue.

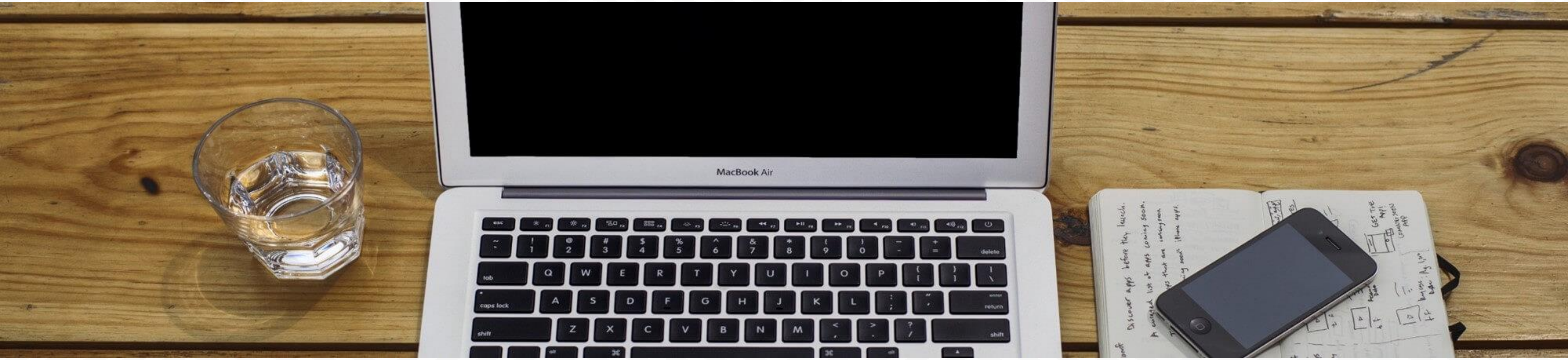
Scenario 6

Payment of Dividend to Parent Company

Under that new section (IRC § 245A), introduced in 2017, a domestic corporation that receives a dividend from a 10 percent or more owned foreign corporation that is otherwise not GILTI or subpart F income may claim a deduction in an amount equal to the foreign source portion (usually, that is all of the dividend) of that dividend.

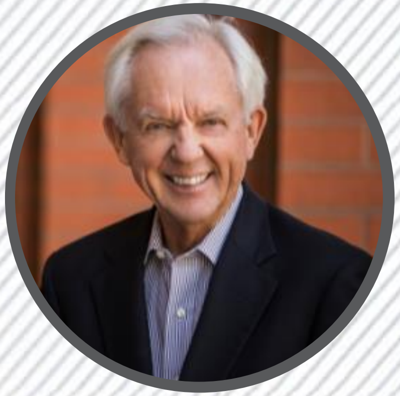
So, although Rhoco Inc. takes Ltd's dividend into gross income, Rhoco, Inc. receives an off-setting deduction in the same amount. That means that the Rhoco corporate group paid tax on Ltd's income, but only to the U.K.; Rhoco, Inc. does not pay any tax to the U.S. on the dividend from Ltd.

Question 4



One Final Point

A domestic corporation that simply has an investment in a foreign corporation—say, two percent—is not entitled to a foreign tax credit for taxes paid by that foreign corporation. For that purpose, the domestic corporate shareholder is the same as an individual.



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