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Foreign Tax Credit Common Issues

Nationwide Tax Forums 2019



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Objectives

After the completion of this course, you will be able to:

- Explain the creditability of foreign taxes with respect to treaty rates vs. statutory withholding rates.
- Explain the impact that the recent Tax Cuts and Jobs Act of 2017 has on the foreign tax credit.
- Define foreign tax redeterminations.

Foreign Tax Credit Concepts

- Foreign tax credit (FTC) mitigates the effect of double taxation.
- FTC reduces a U.S. taxpayer's tax liability by all or part of foreign taxes paid or accrued during a tax year.
- Determining the source of income as U.S. source or foreign source is important to correctly compute the FTC.



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Foreign Tax Credit Concepts

Form **1116** **Foreign Tax Credit** (Individual, Estate, or Trust)
 Department of the Treasury Internal Revenue Service (99) **▶ Attach to Form 1040, 1040NR, 1041, or 990-T.**
 ▶ Go to www.irs.gov/Form1116 for instructions and the latest information.

OMB No. 1545-0121
2018
 Attachment Sequence No. 19

Name _____ Identifying number as shown on page 1 of your tax return _____

Use a separate Form 1116 for each category of income listed below. See *Categories of Income* in the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

a Section 951A income
 c Passive category income
 e Section 901(j) income
 g Lump-sum distributions
 b Foreign branch income
 d General category income
 f Certain income re-sourced by treaty

h Resident of (name of country) ▶ _____

Note: If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession.

Part I Taxable Income or Loss From Sources Outside the United States (for category checked above)

i	Enter the name of the foreign country or U.S. possession ▶	Foreign Country or U.S. Possession			Total
		A	B	C	(Add cols. A, B, and C.)
1a	Gross income from sources within country shown above and of the type checked above (see instructions): _____ _____ _____				1a
b	Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is \$250,000 or more, and you used an alternative basis to determine its source (see instructions) . . . ▶ <input type="checkbox"/>				



Foreign Tax Credit Concepts

Generally, the following four tests must be met for any foreign tax to qualify for the credit. The tax must:

1. Be an income tax, or a tax imposed in lieu of an income tax,
2. Be the legal and actual foreign tax liability,
3. Be a tax imposed on the taxpayer and
4. Must have been tax paid or accrued by the taxpayer.



Treaty Rates vs Statutory Withholding Rates

- The U.S. has income tax treaties with over 60 countries.
- Tax treaties establish specific withholding rates for certain types of income.
 - Generally passive income when FTC applies.
- Treaty rates may be used by taxpayers to reduce the amount of foreign taxes they pay to the foreign country.



Treaty Rates vs Statutory Withholding Rates

- The statutory withholding rate is the rate of tax withheld on certain types of income based on the internal tax laws of particular countries.
- If a treaty is in place with a foreign country, taxpayers must use the lower treaty rate instead of the higher statutory withholding rate for FTC computation purposes.



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Statutory Withholding Rates 1099

9191 <input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED		OMB No. 1545-0110	
PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1a Total ordinary dividends	2019
		\$	
		1b Qualified dividends	
		\$	Form 1099-DIV
		2a Total capital gain distr.	2b Unrecap. Sec. 1250 gain
		\$	\$
PAYER'S TIN	RECIPIENT'S TIN	2c Section 1202 gain	2d Collectibles (28%) gain
		\$	\$
RECIPIENT'S name		3 Nondividend distributions	4 Federal income tax withheld
		\$	\$
Street address (including apt. no.)		5 Section 199A dividends	6 Investment expenses
		\$	\$
City or town, state or province, country, and ZIP or foreign postal code		7 Foreign tax paid	8 Foreign country or U.S. possession
		\$	
		9 Cash liquidation distributions	10 Noncash liquidation distributions
		\$	\$
FATCA filing requirement <input type="checkbox"/>		11 Exempt-interest dividends	12 Specified private activity bond interest dividends
		\$	\$
Account number (see instructions)	2nd TIN not. <input type="checkbox"/>	13 State	14 State identification no.
			\$
			\$

Dividends and Distributions

Copy A
For
Internal Revenue
Service Center

File with Form 1096.

For Privacy Act
and Paperwork
Reduction Act
Notice, see the
**2019 General
Instructions for
Certain
Information
Returns.**



Form 1116 – Foreign Taxes Paid

Part II Foreign Taxes Paid or Accrued (see instructions)											
Country	Credit is claimed for taxes (you must check one) (j) <input type="checkbox"/> Paid (k) <input type="checkbox"/> Accrued	Foreign taxes paid or accrued									
		In foreign currency				In U.S. dollars					
		(l) Date paid or accrued	Taxes withheld at source on:			(p) Other foreign taxes paid or accrued	Taxes withheld at source on:			(t) Other foreign taxes paid or accrued	(u) Total foreign taxes paid or accrued (add cols. (q) through (t))
			(m) Dividends	(n) Rents and royalties	(o) Interest		(q) Dividends	(r) Rents and royalties	(s) Interest		
A	XX/XX/XXXX	\$XX,XXX				\$X,XXX				\$X,XXX	
B											
C											
8 Add lines A through C, column (u). Enter the total here and on line 9, page 2 ▶										8 \$X,XXX	

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11440U

Form **1116** (2018)



Example 1: Treaty Rates vs. Statutory Withholding Rates

Taxpayer A earned \$10,000 of interest income from Foreign Country B. Tax was withheld at a rate of 30% but the treaty rate is 15%.

- Statutory Withholding rate ($\$10,000 \times 30\%$) \$3,000
- Reduced Withholding rate ($\$10,000 \times 15\%$) \$1,500
- **Creditable Foreign Taxes (lesser of the above) **\$1,500****



Example 2: Treaty Rates vs. Statutory Withholding Rates

Taxpayer B received a 1099-DIV reporting total dividends of \$20,000 and foreign taxes withheld of \$6,000. The foreign country is listed as “various”.

In reality, the \$20,000 in dividends consisted of:

- \$10,000 in dividends from Country C (treaty rate of 15% for dividends) and
- \$10,000 in dividends from Country D (treaty rate of 0% for dividends)



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Example 2: Treaty Rates vs. Statutory Withholding Rates

Taxpayer B's Form 1116 listed \$6,000 in foreign taxes paid on foreign dividends and listed the country as "various".

Taxpayer B incorrectly reported the amount of creditable foreign taxes. The correct reporting was:

- Each foreign country should have been identified on the Form 1116.
- The creditable foreign taxes should have been claimed based on the treaty rate, not the statutory withholding rate



Example 2: Treaty Rates vs. Statutory Withholding Rates

Taxpayer B's correct foreign taxes paid:

Country	Dividends Received	Foreign Taxes Paid (Treaty Rate)
C	\$10,000	\$1,500
D	\$10,000	\$ 0
Foreign Taxes Paid		\$1,500



2017 TCJA

Two New Income Categories

- ❖ Global Intangible Low-Taxed Income (GILTI)
 - ✓ IRC §904(d)(1)(A); §951A
 - ✓ Includible by U.S. Shareholder of a Controlled Foreign Corporation (CFC)
 - ✓ Unused FTC not eligible for carryback or carryover. IRC 904(c)

- ❖ Foreign Branch Income
 - ✓ IRC §904(d)(1)(B); §904(d)(2)(J)(i)
 - ✓ Passive income exempted – IRC §904(d)(2)(J)(ii)



Form 1116 (2018)

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 Department of the Treasury Internal Revenue Service (99) **► Attach to Form 1040, 1040NR, 1041, or 990-T.**
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OMB No. 1545-0121
2018
 Attachment Sequence No. **19**

Name _____ Identifying number as shown on page 1 of your tax return _____

Use a separate Form 1116 for each category of income listed below. See *Categories of Income* in the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

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b Foreign branch income **d** General category income **f** Certain income re-sourced by treaty

h Resident of (name of country) ► _____

Note: If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession.

Part I Taxable Income or Loss From Sources Outside the United States (for category checked above)

	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
i Enter the name of the foreign country or U.S. possession ►				
1a Gross income from sources within country shown above and of the type checked above (see instructions): _____				1a
b Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is \$250,000 or more, and you used an alternative basis to determine its source (see instructions) ► <input type="checkbox"/>				
Deductions and losses (Caution: See instructions.):				
2 Expenses definitely related to the income on line 1a (attach statement)				



Election under IRC §962

- ❖ Available to U.S. Individual Shareholder of a Controlled Foreign Corporation (CFC) to be taxed at the domestic corporate rate on
 - ✓ Share of Subpart F Income under IRC §951(a)
- ❖ Foreign Tax Credit (FTC) shall be computed to such shareholder as if received by a domestic corporation
 - ✓ IRC §960
 - ✓ Deemed foreign taxes limited to 80% on GILTI tested income – IRC §960(d)
- ❖ Election also applies to the U.S. individual shareholder's share of income with respect to a Deferred Foreign Income Corporation (DFIC)
 - ✓ Reg. 1.962-1(b)(1)(i)
 - ✓ IRC §965(a)
- ❖ The election will provide for the deduction under IRC §250 related to GILTI
 - ✓ Prop. Reg. §1.962-1(b)(1)(i)(B)(3).



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Foreign Tax Redeterminations

- Foreign tax redeterminations generally occur if there is a change to the amount of creditable foreign taxes.
- A redetermination of U.S. tax liability is required under the following circumstances:
 - When a foreign tax claimed as a credit is refunded or
 - When the taxpayer elects to accrue taxes and
 - The amount of the creditable foreign taxes accrued differs from the amount actually paid or
 - The accrued taxes claimed remain unpaid after 2 years.



Example 3: Foreign Tax Redeterminations

- Taxpayer B properly accrued \$50,000 of Country X taxes in 2018 and claimed \$50,000 of FTC on his U.S. tax return.
- B computed his 2018 Country X tax liability. His actual foreign tax liability was \$25,000. He paid the tax. (B already filed his 2018 U.S. tax return.)
- B must file an amended return 2018 return to notify the IRS of the redetermination and compute the correct U.S. tax liability.



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Foreign Tax Redeterminations

- Taxpayers must file an amended return to notify the IRS of a foreign tax redetermination.
- An individual must file a Form 1040X with a revised Form 1116.
- If a redetermination results in an additional tax due, but the tax due is eliminated by a carryback or carryover, a Form 1040X does not generally need to be filed.



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Foreign Tax Redeterminations

- Refund claims (General rule): must be filed within the later of 3 years from the date the return was filed **or** 2 years from the date when the tax was paid.
- Refund claims due to foreign tax redeterminations:
 - Must be filed within 10 years from the original due date of the return, without regard to extensions.
- If a taxpayer redetermined his foreign tax for the 2017 tax year in 2019, he has until April 15, 2028 to file an amended return and claim the refund.



Example 4: Foreign Tax Redeterminations

Taxpayer C is subject to income tax in Country Z on net business income. C claimed a foreign tax credit for Country Z taxes when he filed his U.S. tax return. C later filed a claim for refund with Country Z due to extra deductions that were not originally claimed.

A foreign tax redetermination has occurred. Taxpayer C should file an amended return with IRS in the time provided by law.

- If Taxpayer C does not file an amended return to inform the IRS of the foreign tax redetermination, the IRS has an unlimited statute of limitations for FTC-related adjustments.



IRS Publications and Additional Resources

- Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*
- Publication 514, *Foreign Tax Credit for Individuals*
- Publication 901, *U.S. Tax Treaties*
- Form 1116 and the Form 1116 Instructions
- <https://www.youtube.com/watch?v=ph8A1eA11q4>



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Questions

