IRS finalizes certain foreign tax credit regulations

In June, the IRS finalized certain proposed regs pertaining to the foreign tax credit (FTC). The final regs include changes to the rules that address the interaction between the FTC and Internal Revenue Code (IRC) Section 965(n) rules on not applying the net operating loss deduction when calculating the Sec. 965 transition tax. Here are some highlighted areas of change.

Applicability date under Sec. 78

The proposed FTC regs provide that amounts treated as dividends under Sec. 78 (Sec. 78 dividends) that relate to tax years of foreign corporations that begin before January 1, 2018, as well as Sec. 78 dividends that relate to later tax years, aren't treated as dividends for purposes of Sec. 245A's dividends-received deduction.

Comments questioned whether the IRS has the authority to treat Sec. 78 dividends relating to tax years of foreign corporations beginning before January 1, 2018, as ineligible for the dividends-received deduction under Sec. 245A, which generally applies to certain dividends paid after December 31, 2017. Although some comments acknowledged that allowing a dividends-received deduction for Sec. 78 dividends would provide taxpayers with a double benefit that clearly wasn't intended by Congress, the comments claimed that the statutory language directly provides for the dividends-received deduction. Therefore, the rule applying an applicable proposed reg to tax years beginning before January 1, 2018, should be eliminated.

The IRS determined that Sec. 7805(a), Sec. 7805(b)(2) and Sec. 245A(g) provide it with ample authority for the rule in the proposed regs, so the agency finalized the proposed applicability date without change. Thus, a Sec. 78 gross-up isn't treated as a dividend for purposes of Sec. 245A, effective for Sec. 78 gross-ups received after Dec. 31, 2017.

Application of a basis adjustment

The Sec. 904 FTC limitation is determined, in part, by a taxpayer's taxable income from sources outside the United States. Regs under Sec. 861 through Sec. 865 provide rules for allocating and apportioning deductions to determine, among other things, a taxpayer's taxable income from sources outside the United States for Sec. 904 purposes.

Under the IRC and applicable regs, for purposes of apportioning expenses based on the tax book value of assets, certain adjustments should be made to the adjusted basis of stock in a 10% owned corporation based on the earnings and profits (E&P), or deficits in E&P, of the corporation attributable to the stock. A proposed reg confirmed that previously taxed E&P should be considered for purposes of the adjustment described in an applicable reg.

The proposed reg provided that a taxpayer should determine the basis in the stock of a specified foreign corporation as if it had made the election under the applicable reg — even if the taxpayer didn't make the election. However, the taxpayer shouldn't include the amount from the basis because the amount of that increase would be excluded if the increase was by operation of Sec. 961. For this purpose, the amount included in basis under the proposed regs was determined without regard to whether any portion of the amount is netted against other basis adjustments. The applicable proposed reg pertains to the tax year of the inclusion under Sec. 965 as well as to future tax years.

After issuance of the FTC proposed regs, final regs issued under Sec. 965 altered the election to allow taxpayers to limit the reduction in basis with respect to an E&P deficit foreign corporation under the election to the amount of the taxpayer's basis in the respective share of stock of the relevant foreign corporation.

To reflect the altered election, the final regs provide that an applicable regulation may cause the taxpayer's adjusted basis in the stock of the corporation to be negative if the adjustment for E&P increases the taxpayer's adjusted basis to zero or an amount above zero. If the taxpayer's adjusted basis in the 10% owned corporation is still below zero after application of the applicable regs, then, for the applicable purposes, the taxpayer's adjusted basis in the 10% owned corporation is zero for the tax year.

Effect of Sec. 965(n) election

Under Sec. 965(n), a taxpayer may elect to exclude associated Sec. 78 dividends and the amount of Sec. 965(a) inclusions, reduced by Sec. 965(c) deductions, in determining the amount of the net operating loss carryover or carryback that's deductible in the tax year of the inclusions. Regulations provide that, if the taxpayer makes a Sec. 965(n) election, the taxpayer shouldn't consider the associated Sec. 78 dividends and the amount of the Sec. 965(a) inclusions, reduced by Sec. 965(c) deductions, in determining the amount of the net operating loss for the tax year.

To some extent, the final regs modify the proposed regs regarding the interaction between Sec. 965(n) and the FTC limitation. Taxpayers that make a Sec. 965(n) election may not exclude the net Sec. 965 inclusion from the allocation and apportionment of expenses for Sec. 904 limitation purposes. They must, instead, treat the net operating loss that isn't considered as a result of the Sec. 965(n) election as being composed of a proportionate amount of deductions in each of the Sec. 904 limitation categories.

Applicability dates

The provisions of the applicable reg contained in the final regs apply beginning with the last tax year of a foreign corporation that begins before January 1, 2018. With respect to a U.S. citizen, the provisions apply beginning with the tax year in which or with which such tax year of the foreign corporation ends.

Generally, the applicable reg applies to tax years of foreign corporations that begin after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. As noted above, a special applicability date is provided to apply the second sentence of the applicable reg to Sec. 78 dividends received after December 31, 2017, with respect to a tax year of a foreign corporation beginning before January 1, 2018.

The applicable reg applies to tax years that both begin after December 31, 2017, and end on or after December 4, 2018. A special applicability date was provided in the proposed regs to apply the applicable reg to the last tax year of a foreign corporation beginning before January 1, 2018, because there may be an inclusion under Sec. 965 for that tax year. In the final regs, this special applicability date is extended to the applicable reg to accommodate the changes that were made to that rule to further implement the rule under the regulations.

New ramifications

Any taxpayer who may be seeking to claim the foreign tax credit should be aware of the ramifications of these new, finalized regs. Your tax advisor can assist you in understanding whether and how the changes may affect you. •

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