# How to Lose a Foreign Tax Credit—Part II: Transactions Involving CFC Stock of U.S. Shareholders

By Brian Jenn*

When foreign taxes are imposed on transactions involving controlled foreign corporations (CFCs), there are a variety of ways a U.S. taxpayer may "lose" a foreign tax credit it may have expected to be available. The risk of losing a foreign tax credit is particularly great when foreign taxes are imposed on transactions involving a CFC that result in income recognition for foreign law purposes where there is no analogous U.S. recognition event in the same year. Part I of this series of articles considered the potential to lose foreign tax credits in fact patterns involving foreign taxes imposed on transactions of a CFC that are disregarded for U.S. federal income tax purposes. This Part II will consider cases where foreign tax is imposed on regarded transactions involving distributions from CFCs, and or dispositions of CFC stock, owned directly by a U.S. taxpayer.



## 1. Regarded Distributions Generally

When a foreign tax is imposed on a regarded distribution, the foreign tax must be assigned to a Code Sec. 904 foreign tax credit limitation category and, if the recipient is a CFC, to an income group or PTEP group within that Code Sec. 904 category. Foreign taxes also must be assigned for other purposes, including for applying the foreign tax credit disallowance rules in Code Secs. 245A(d) and (e)(3). The operative rules for assigning foreign taxes in these situations are in Reg. §1.861-20(d)(3)(i)(B).

To apply the distribution rules of Reg. §1.861-20(d)(3)(i)(B), it is necessary to determine the extent to which the distribution is, for U.S. federal income tax purposes, a distribution of earnings and profits (*i.e.*, the "U.S. dividend amount"),[1] a return of capital described in Code Sec. 301(c)(2) (*i.e.*, the "U.S. return of capital amount"),[2] or a deemed disposition of property described in Code Sec. 301(c)(3) (*i.e.*, the "U.S. capital gain amount").[3] It is also necessary to determine how the distribution is treated for foreign law purposes. That is, a taxpayer must determine the extent the distribution is a dividend under foreign law

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(*i.e.*, the "foreign dividend amount")[4] or results in capital gain under foreign law (*i.e.*, the "foreign capital gain amount").[5] (No foreign tax should be imposed under foreign law on any portion of a distribution treated as a return of capital.)

To the extent a distribution is treated as a foreign dividend (*i.e.*, the foreign dividend amount), foreign taxes are generally categorized based on how the distribution is characterized for U.S. purposes. That is, to the extent a distribution is treated as a dividend or PTEP distribution for U.S. purposes, foreign taxes are generally assigned to the categories and groupings to which the U.S. dividend (or PTEP distribution) is assigned.[6] Foreign taxes imposed on the portion of a foreign dividend amount that is treated as a U.S. return of capital amount are assigned to the categories and groupings to which the tax book value of the stock of the distributing CFC would be assigned under the asset method of Reg. §1.861-9.[7] Finally, foreign taxes imposed on the portion of the foreign dividend corresponding to the U.S. capital gain amount are assigned to the categories and groupings to which U.S. capital gain on the CFC stock is assigned.[8]

To the extent a distribution results in capital gain for both foreign and U.S. federal income tax purposes, foreign taxes are assigned to the categories and groupings to which U.S. capital gain on the CFC stock is assigned.[9] Next, to the extent of the U.S. return of basis amount, foreign taxes of the foreign capital gain are assigned to the categories and groupings to which the tax book value of the stock of the distributing CFC would be assigned under the asset method of Reg. §1.861-9.[10] Finally, any remaining foreign taxes imposed on the distribution are assigned to the categories and groupings to which the U.S. dividend amount is assigned.[11]

## 2. Regarded Distributions from CFCs to U.S. Shareholders

Foreign taxes imposed on regarded CFC distributions to U.S. shareholders (within the meaning of Code Sec. 951(b) ("U.S. shareholder") are generally withholding taxes. A less common case is where a CFC that is held through a foreign disregarded entity makes a distribution that is subject to tax in the foreign disregarded entity's jurisdiction. The rules described below for assigning foreign taxes apply to foreign taxes incurred in both of these situations.

As a general matter, foreign taxes imposed on regarded CFC distributions are creditable under Code Sec. 901. Additionally, a domestic corporation that is a U.S. shareholder of a CFC from which it receives a PTEP distribution generally may claim deemed paid foreign tax credits under Code Sec. 960(b) for taxes paid by CFCs with respect to that PTEP as it was distributed up the chain. As discussed further below, Code Secs. 245A(d) and (e)(3), and the regulations thereunder, impose the main limitations on the ability of a U.S. shareholder to claim a foreign tax credit in connection with a distribution from a first-tier CFC.

### a. PTEP Distributions

To the extent a distribution from a CFC to a U.S. shareholder is a dividend for U.S. purposes and is sourced from PTEP, foreign taxes imposed on the distribution will be allocated to the Code Sec. 904 limitation category (*i.e.*, passive or general) corresponding to the Code Sec. 904 limitation category of the CFC to which the PTEP is attributable.[12] In general, a foreign tax credit for such foreign taxes would only be disallowed if the PTEP is Code Sec. 245A(d) PTEP, which means PTEP arising from a deemed dividend under Code Sec. 964(e)(4) or Code Sec. 1248 that qualified for a Code Sec. 245A(a) DRD or from a Subpart F income inclusion resulting from a tiered hybrid dividend under Code Sec. 245A(e)(2).[13]

As noted above, a corporate U.S. shareholder of a CFC receiving a PTEP distribution from the CFC also may claim a foreign tax credit under Code Sec. 960(b) for foreign taxes paid by that CFC and lower-tier CFCs as the PTEP was distributed up the chain. The foreign taxes imposed on the PTEP generally will be allocated to the Code Sec. 904 foreign tax credit limitation category of the U.S. shareholder corresponding to the CFC-level foreign tax credit limitation category of the PTEP group from which the distribution was made (typically, general, passive, or Code Sec. 951A category).[14] Code Sec. 245A and Proposed Reg. §1.245A(d)-1(a) would disallow a Code Sec. 960(b) foreign tax credit, however, to the extent the foreign taxes are attributable to a distribution of Code Sec. 245A(d) PTEP.[15]

The Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") have not yet issued proposed or final regulations for determining the extent to which a PTEP distribution is out of Code Sec. 245A(d) PTEP or other PTEP. Nonetheless, Notice 2019-1 provides some guidance as to what PTEP ordering rules will look like under future regulations. Assuming there is no Code Sec. 959(c)(1) PTEP (attributable to the application of Code Sec. 956), after all Code Sec. 965 PTEP has been distributed, PTEP generally will be sourced from annual PTEP layers on a LIFO basis. Within an annual PTEP layer, PTEP will be sourced *pro rata* from different PTEP groups, including a designated group for Code Sec. 245A(d) PTEP.[16]

Thus, for example, to the extent a $50 distribution is sourced from a 2019 PTEP layer, and the distributing CFC has $100 of Code Sec. 245A(d) PTEP and $300 of Code Sec. 951A PTEP in the 2019 PTEP layer, $12.50 of the PTEP distribution would be attributable to Code Sec. 245A(d) PTEP. If 10% foreign withholding tax applied to the distribution, Code Sec. 245A(d) would disallow a foreign tax credit for that $1.25 (10% × $12.50 of Code Sec. 245(d) PTEP) of withholding tax.

## b. Non-PTEP Dividend (Actual and Deemed) Distributions

In general, Code Sec. 245A(d) disallows a foreign tax for any foreign taxes imposed on non-PTEP distributions from a CFC to a U.S. shareholder that are treated as dividends eligible for the Code Sec. 245A DRD. This could include foreign taxes imposed on a sale of stock that Code Sec. 1248 treats as a deemed dividend eligible under Code Sec. 1248(j) for a Code Sec. 245A DRD, to the extent the foreign tax is allocated under Reg. §1.861-20(d)(3)(i)(B)(3) to such deemed dividend.

A foreign tax imposed on a dividend that does not qualify for a Code Sec. 245A DRD, for instance because the requisite holding period under Code Sec. 246(c)(5) is not met, generally should be assigned to the Code Sec. 904 category (general or passive) to which the dividend is assigned under the Code Sec. 904(d)(3) lookthrough rule.[17] A foreign tax credit would be disallowed on such a distribution, however, to the extent the distribution is considered paid out of a hybrid dividend account.[18]

An interesting issue arises where a distribution is eligible for a Code Sec. 245A(d) DRD but, under Code Sec. 1059(a)(2), results in capital gain because the distribution exceeds basis. Under Proposed Reg. §1.245A(d)-1(c)(5), such a distribution appears to be a "specified distribution," such that any foreign taxes attributable to the distribution are disallowed under Proposed Reg. §1.245A(d)-1(a). As a policy matter, however, it is unclear why such a foreign tax should not be assigned to the category to which the U.S. capital gain amount is assigned, consistent with Reg. §1.861-20(d)(3)(i)(B)(2).[19] Note that Code Sec. 1059 can apply where there is an extraordinary dividend with respect to stock the shareholder has held for less than two years before the dividend announcement date,[20] or where the holding period is met but the extraordinary dividend results from certain redemptions under Code Sec. 302.

## c. Code Sec. 301(c)(2) Return of Capital Distributions

Foreign taxes imposed on a Code Sec. 301(c)(2) return of capital distribution by a CFC to its U.S. shareholder (which is treated as a dividend or capital gain for foreign law purposes) generally will be categorized in the same way current-year earnings equal to the return of capital amount would be assigned. The regulations generally provide that these earnings are deemed to arise in categories and groupings in the same proportions as the proportions in which the tax book value of the stock of the distributing corporation are assigned under the asset method of Reg. §1.861-9 in the year of the distribution.[21]

In assigning taxes based on the tax book value of the stock of the distributing corporation, the regulations appear to contemplate that special rules of Reg. §1.861-12 and -13 for categorizing CFC stock should be taken into account.[22] This implies that foreign taxes could be assigned not only to the passive and general categories, but also under Reg. §1.861-13 to the Code Sec. 951A category. Unlike with respect to taxes allocated to the passive and general categories, taxes allocated to the Code Sec. 951A category cannot be carried forward to future years if there is insufficient Code Sec. 904 limitation in the relevant Code Sec. 904 category in the year of distribution.[23] Regardless of which Code Sec. 904 category foreign taxes imposed on a Code Sec. 301(c)(2) distribution are assigned to, however, a lack of foreign tax credit limitation may be an issue since a Code Sec. 301(c)(2) distribution will not create additional foreign-source income to credit the foreign taxes imposed on the distribution.

In applying Reg. §1.861-13 for purposes of applying the tax book value method to categorize the distributing CFC's stock, a portion of the stock may be assigned to the Code Sec. 245A subgroup. Accordingly, a portion of foreign taxes imposed on the distribution may be assigned to the Code Sec. 245A subgroup. Under proposed Code Sec. 245A regulations, a foreign tax credit is disallowed for any such foreign taxes.[24]

## d. Code Sec. 301(c)(3) Capital Gains Distributions

Foreign taxes imposed on distributions that result in U.S. capital gain under Code Sec. 301(c)(3) are assigned to the category that such capital gain is assigned under U.S.

federal income tax law.[25] In general, Code Sec. 301(c)(3) gain is assigned to the passive category, such that foreign taxes imposed on the Code Sec. 301(c)(3) distribution are also allocated to the passive category for Code Sec. 904 purposes. Availability of foreign tax credit limitation may be an issue for these distributions, as well, since the Code Sec. 301(c)(3) gain of a U.S. person generally would be U.S.-source income. Accordingly, there is generally no additional foreign tax credit limitation to credit foreign taxes imposed on the Code Sec. 301(c)(3) distribution.

## 3. Foreign Law Distributions

A foreign jurisdiction may impose foreign taxes on a transaction that is treated as a taxable distribution under foreign law but that is not considered a distribution of property within the meaning of Code Sec. 317(a) for U.S. federal income tax purposes. Such a transaction, referred to in the regulations as a foreign law distribution, may be a Code Sec. 305 distribution or a foreign law consent dividend.[26] A deemed dividend may also result under foreign law as a result of a foreign transfer pricing adjustment for which there is no U.S. corresponding adjustment.

In general, a foreign tax on a foreign law distribution is assigned to the same categories to which a foreign tax imposed on a distribution on the foreign law distribution date that is regarded for U.S. federal income tax purposes would be assigned under the rules described above.[27] Because the lack of a distribution for U.S. federal income tax purposes means that there is no reduction to earnings and profits or PTEP as a result of the foreign law distribution, there is a potential that the same PTEP or earnings and profits could be taken into account in assigning foreign taxes more than once—such as if there is a foreign law distribution in one year and an actual distribution in the following year.

The proposed Code Sec. 245A regulations include an anti-avoidance rule intended to prevent, among other things, the avoidance of Code Sec. 245A(d) through foreign law distributions.[28] An example in the proposed regulations illustrates that anti-avoidance rule applying where a CFC declared consent dividends (subject to withholding tax) in two successive years. In the next year, there is an actual distribution that was part PTEP distribution and part dividend eligible for a Code Sec. 245A DRD but was not subject to withholding because it was treated as a return of capital for foreign purposes. That is, the consent dividends had cleared out the earnings and profits of the CFC for foreign law purposes, such that the actual distribution was not a dividend subject to withholding. Absent the application of the anti-avoidance rule, the consent dividends, which would be treated as made out of the same PTEP, would have allowed the shareholder to claim a foreign tax credit for the full withholding tax on the consent dividends, even though a portion of the withholding tax would have been disallowed under Code Sec. 245A(d) if the consent dividends were actual dividends.

## 4. CFC Stock Sales

Proposed regulations would provide for assignment of foreign taxes on a disposition of CFC stock by a U.S. person in a manner generally consistent with the rules described above for assignment of taxes imposed on distributions. These taxes could be withholding taxes imposed under a FIRPTA-like regime or imposed by a jurisdiction that does not have a tax treaty with the United States that prevents the imposition of capital gains tax. Foreign taxes could also include taxes imposed by the jurisdiction of a foreign disregarded entity that is treated as a foreign branch for U.S. purposes and that owns the CFC stock that is disposed of.

Under these rules, foreign tax imposed on a sale or exchange of stock for U.S. federal income tax purposes is first assigned to the same categories any deemed dividend under Code Sec. 1248 would be assigned.[29] Because a Code Sec. 1248 deemed dividend qualifies for a Code Sec. 245A DRD by reason of Code Sec. 1248(j), Code Sec. 245A(d) disallows a foreign tax credit for the foreign tax to the extent of the amount of the Code Sec. 1248 deemed dividend.[30]

To the extent the foreign capital gain on which foreign tax is imposed exceeds the Code Sec. 1248 amount, the foreign tax is next assigned to the same category as the amount treated as U.S. capital gain to the extent thereof.[31] This generally will mean that the tax is assigned to the passive category. As in the case of a Code Sec. 301(c)(3) distribution, availability of foreign tax credit limitation to credit such taxes could be an issue, since the capital gain likely would be domestic source, unless Code Sec. 864(f) (which applies to certain stock sales that occur "in a foreign country") applies.

Finally, foreign tax imposed on any remaining foreign capital gain is assigned to the groupings and categories to which the CFC stock is assigned under the tax book value method of Reg. §1.861-9 in the year of the stock disposition. As in the case of a Code Sec. 301(c)(2) distribution, this approach means foreign taxes potentially could be assigned for Code Sec. 904 purposes to the general or passive category, and apparently also to the Code Sec. 951A category. To the extent there is not sufficient limitation in the Code Sec. 951A category from GILTI inclusions, the foreign capital gains tax would not be creditable in any year due to the lack of foreign tax credit carryforward in the Code Sec. 951A category. Additionally, as noted above, foreign tax assigned based on the categorization of CFC stock may be assigned to a Code Sec. 245A subgroup and disallowed under Code Sec. 245A(d).[32]

## 5. Conclusion

As in the case of disregarded transactions of CFCs, which were considered in Part I of this series of articles, transactions involving CFC stock held by a U.S. taxpayer can result in taxpayers "losing" a foreign tax credit in unexpected ways. Under Code Sec. 245A(d) proposed regulations, Code Sec. 245A(d) and (e) can disallow a foreign tax credit in connection with a PTEP distribution, a non-PTEP dividend distribution, a Code Sec. 301(c)(2) return of capital distribution, and a disposition of CFC stock.[33] Additionally, under final Reg. §1.861-20, foreign taxes on Code Sec. 301(c)(2) distributions and CFC stock dispositions may be assigned to Code Sec. 904 categories in which there is no current-year limitation and, in the case of the Code Sec. 951A category, in which there is no possibility of carrying forward the foreign taxes to claim a foreign tax credit in a later year. U.S. taxpayers receiving distributions from first-tier CFCs or disposing of CFC stock should be mindful of these potential traps.

### ENDNOTES

* The author appreciates many helpful conversations with Brad LaBonte that contributed to the thinking in this article, as well as his comments on a draft. Errors and omissions are, of course, the sole responsibility of the author.

1 Reg. §1.861-20(b)(20). The U.S. dividend amount includes the amount of the distribution that is a distribution of PTEP and also includes any amount treated as a dividend under Code Sec. 1248 or Code Sec. 964(e).
2 Reg. §1.861-20(b)(23).
3 Reg. §1.861-20(b)(19).
4 Reg. §1.861-20(b)(5).
5 Reg. §1.861-20(b)(4).
6 Reg. §1.861-20(d)(3)(i)(B)(2).
7 *Id.*
8 *Id.*
9 Reg. §1.861-20(d)(3)(i)(B)(3).
10 *Id.*
11 *Id.*
12 Reg. §1.861-20(d)(3)(i)(B)(2) and (3).
13 Proposed Reg. §1.245A(d)-1.
14 Reg. §§1.960-3(b)(1); 1.904-6(b)(2).
15 Proposed Reg. §1.245A(d)-1.
16 Notice 2019-1, §3.02.
17 Reg. §1.861-20(d)(3)(i)(B)(2) and (3).
18 Code Sec. 245A(e)(3); Proposed Reg. §1.245A(d)-1(a) and (c)(5).
19 Under Reg. §1.861-20(b)(19), the U.S. capital gain amount means any gain recognized by a taxpayer on the sale or exchange of stock, except to the extent treated as a dividend under Code Sec. 964(e) or Code Sec. 1248.
20 Code Sec. 1059(a) and (e)(1).
21 Reg. §1.861-20(d)(3)(i)(B)(2) and (3).
22 *See* Proposed Reg. §1.861-20(g), Ex. 9.
23 Code Sec. 904(c).
24 Proposed Reg. §1.245A(d)-1(a) and (c)(6).
25 Reg. §1.861-20(d)(3)(i)(B) and (C). Code Sec. 301(c)(3) gain can be recharacterized as a Code Sec. 1248 dividend. *See* Reg. §1.1248-1(b). Such Code Sec. 301(c)(3) gain should be treated as a "U.S. dividend amount" under Reg. §1.861-20(b)(20) rather than as "U.S. capital gain."
26 Reg. §1.861-20(b)(10).
27 Reg. §1.861-20(d)(2)(ii)(B).
28 Reg. §1.245A(d)-1(b)(2).
29 Proposed Reg. §1.861-20(d)(3)(i)(D).
30 Proposed Reg. §1.245A(d)-1(a) and (c)(5); Proposed Reg. §1.861-20(g), Ex. 9.
31 Proposed Reg. §1.861-20(d)(3)(i)(D).
32 Proposed Reg. §1.245A(d)-1(a) and (c)(6).
33 For calendar year taxpayers and CFCs, these proposed regulations generally would be effective for the 2020 tax year. Proposed Reg. §1.245A(d)-1(f).