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Direct Foreign Tax Credit and GILTI: The Curious Incidence of the Credit That Was Not Cut

By Libin Zhang[*]

The 2017 tax act (Pub. L. No. 115-97, formerly known as the Tax Cuts and Jobs Act of 2017, or the ''Act''), enacted new §951A,[1] which imposes U.S. federal income tax on so-called ''global intangible low-taxed income'' (GILTI) from a controlled foreign corporation (CFC). The U.S. income tax on GILTI may be reduced by certain indirect foreign tax credits for foreign income taxes paid by the CFC, through the Act generally cuts the indirect foreign tax credits by 20% and disallows any carryback or carryforward. It is not apparent, however, that any *direct* foreign tax credit may reduce the U.S. income tax imposed on GILTI. For a CFC shareholder who is an individual U.S. citizen, the effect may be a minimum 37% U.S. tax liability on GILTI. On the other hand, the direct foreign tax credits may be used for some of the shareholder's other foreign-source income, without the 20% reduction and with full carryback and carryforward of the credits. The legislative purpose is not evident for such disparate results, which may vary widely depending on the shareholder's other foreign activities.

GILTI

A CFC is generally any foreign corporation with stock owned more than 50% by ''United States shareholders,'' which is defined in §951(b) as U.S. persons who each owns 10% or more of the foreign corporation's stock, directly or constructively, by vote or value. New §951A generally provides that each of a CFC's United States shareholders has deemed income (GILTI inclusion) generally equal to its share of the CFC's foreign-source income. The GILTI amount is reduced by a deemed rate of return on the CFC's depreciable assets, income included in the shareholder's gross income under the subpart F rules, and certain other exceptions.

For a United States shareholder that is a domestic C corporation, new §250 allows a deduction equal to 50% of the shareholder's GILTI inclusion.[2] As the C corporation is normally subject to a 21% U.S. federal income tax rate, the deduction reduces the effective tax rate on GILTI to 10.5%. The C corporation is also allowed an indirect foreign tax credit under §960(d) for 80% of the foreign income taxes paid by the CFC. The net result is that if the CFC is subject to a foreign income tax rate of 13.125%, a United States shareholder that is a C corporation would be allowed a 10.5% indirect foreign tax credit and pay no additional U.S. federal income tax on GILTI.

After GILTI is included in the United States shareholder's gross income, the GILTI inclusion becomes ''previously taxed income'' in the CFC under §959 and §951A(f)(1). The CFC may generally make tax-free distributions of previously taxed income to the United States shareholder.

FOREIGN TAX CREDIT

Section 904 divides foreign-source income and foreign tax credits into various categories, so that the

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[1] All section references are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[2] The §250 deduction for GILTI is reduced to 37.5% in 2026 and later.

U.S. federal income tax on foreign-source income in one category can be reduced only by foreign tax credits in the same category. The Act added a new GILTI category to the two existing categories, ''passive'' and ''general.'' All GILTI is either passive category income or GILTI category income (not general category income), and the §960(d) indirect foreign tax credit is either a passive category foreign tax credit or a GILTI category foreign tax credit. A GILTI category foreign tax credit cannot be carried back or forward, whereas passive and general category foreign tax credits can be carried back one year or forward 10 years under §904(c). The Congressional intent was that non-passive GILTI should be exempt from U.S. taxes only if the CFC was paying at least 13.125% foreign taxes currently on that income,[3] though with no regard for any timing differences between the U.S. and foreign tax systems and their different ways on how to allocated interest and other expenses.

The GILTI taxation system does not clearly contemplate the effects of §901 direct foreign tax credits on GILTI, such as foreign withholding taxes imposed on the CFC's distributions of previously taxed income, which are tax-free in the United States under §959. Under §904(d)(2)(H), providing for the treatment of income tax base differences, if a foreign tax is imposed on an amount that does not constitute income under U.S. tax principles, it results in a general category foreign tax credit. Though there is no direct authority on point, a foreign tax imposed on an amount that is free from U.S. tax under §959, as a distribution of previously taxed income that was subpart F income or GILTI, appears to be subject to the base difference rule and results in a general category foreign tax credit.[4]

As GILTI is either GILTI category income or passive category income, the direct foreign tax credit on the CFC's distribution is a general category foreign tax credit that creates a category mismatch. This may reflect Congressional intent that GILTI must be subject to a minimum amount of U.S. tax if there are insufficient indirect foreign tax credits, allowed only on the basis of the foreign taxes currently paid by the CFC. Congress may have further thought that direct foreign tax credits are never associated with GILTI when the Act imposed the 80% limitation on only indirect foreign tax credits in §960(d), but no similar 20% cut on any direct foreign tax credits.

The GILTI inclusion and the direct foreign tax credit may have mismatched timing. If a taxpayer (whether an individual or a domestic corporation) has subpart F income in one year and a distribution of previously taxed income (attributable to that subpart F income) in a later year that is subject to foreign withholding taxes, §960(c) generally allows the direct foreign tax credits in the later year for a taxpayer with insufficient other foreign-source income. Although §951A(f) provides that GILTI is treated as subpart F income in many specific cases, GILTI is not treated as subpart F income for purposes of §960(c). A taxpayer who receives a later distribution of GILTI-related previously taxed income and has insufficient foreign-source income would not be able to use the direct foreign tax credits. The legislative disregard for the GILTI timing mismatch lends additional support to the idea that direct foreign tax credits cannot be attributable to GILTI.

Any foreign withholding taxes imposed on the CFC's distributions, even if paid in the same year as the GILTI inclusion, cannot reduce the U.S. tax on the GILTI inclusion. The good news for the United States shareholder is that the foreign withholding tax creates a general category foreign tax credit, which can be carried back one year and forward 10 years, in contrast to a GILTI category foreign tax credit with no carryover. The general category foreign tax credit can reduce the shareholder's U.S. tax on its other foreign-source income in the general category.

INDIVIDUAL SHAREHOLDER

The foreign tax credit provisions may be costly for an individual United States shareholder with GILTI. In the absence of a §962(b) election, the individual's GILTI inclusion is subject to individual U.S. federal income tax rates of up to 37%. No indirect foreign tax credits are allowed under §960(d) for the individual United States shareholder. The individual United States shareholder has the same category mismatch between GILTI and direct foreign tax credits. Therefore the individual United States shareholder must generally pay up to the full rate of 37% U.S. tax on GILTI without any foreign tax credit benefit. The individual's direct foreign tax credits may be used against the individual's other foreign-source income in the general category, if any. The Act places GILTI into a separate GILTI category income presumably to segregate the effects of the §960(d) indirect foreign tax credit on such income, but the separate categorization creates a punitive result for an individual United States shareholder who cannot benefit from §960(d) in the first place.

If the individual makes a §962(b) election, the individual's GILTI inclusion and subpart F income are both subject to the U.S. corporate income tax rate of 21% under §962(a)(1). Section 962(a)(2) permits the

[3] See H. Conf. Rep. 115-466, at 626–627.

[4] The foreign withholding tax may be imposed in the same year or many years later than the GILTI inclusion, without regard for the complex GILTI provisions in §951A, which makes the tax unlikely to be a mere timing difference subject to Reg. §1.904-6(a)(i)(iv). *See also* CCA 200223022 (June 7, 2002).

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deemed U.S. corporate income tax to be reduced by the §960(d) 80% indirect foreign tax credit for GILTI. Section 962 does not explicitly provide that the electing individual is also entitled to the 50% §250 deduction for GILTI that would reduce the effective deemed U.S. corporate income tax rate to 10.5%.

Section 962(d) provides that the CFC may distribute tax-free to the individual United States shareholder, as previously taxed income under §959, an amount up to the deemed U.S. corporate income tax paid. Additional distributions by the CFC out of its earnings and profits are included in the shareholder's gross income.

Any foreign withholding tax imposed on a tax-free distribution under §962(d) should be analyzed in the same manner as a tax-free distribution to a non-electing individual. The foreign tax is a base difference item that causes the foreign tax credit to be a general category foreign tax credit. The direct foreign tax credit may be used against the individual's foreign-source income in the general category within the carryover period, but not GILTI.

Any foreign withholding tax imposed on a taxable distribution under §962(d) should be in the same category as that of the taxable distribution, whether it be the passive category or the general category. Section 904(d)(3)(D) provides that a CFC dividend is passive category income to the extent that the CFC's distributed earnings and profits are attributable to passive category income. Section 904(d)(3)(A) provides that the remaining amount of the CFC dividend is not passive category income, which should be general category income. While §962(d) does not explicitly state that the taxable distribution is a dividend, it is a distribution of the CFC's earnings and profits that should be considered a dividend under §316(a), which may be a qualified dividend from a qualified foreign corporation under §1(h)(11)(B)(i)(II). Excess direct foreign tax credits may reduce the U.S. tax on the individual's other foreign-source income.

CONCLUSION

The separate foreign tax credit category for GILTI generally has the effect of preventing the shareholder from using direct foreign tax credits against the U.S. tax on GILTI, whether such credits are from foreign withholding taxes imposed on the CFC's distributions or from the shareholder's other foreign activities. For an individual shareholder, such lack of a direct foreign tax credit, when combined with the unavailability of an indirect foreign tax credit, may result in a minimum 37% U.S. tax liability on GILTI. A §962(b) election may improve the individual shareholder's foreign tax credit situation and may even result in the individual shareholder being better off than if he or she owned the CFC stock through an actual domestic C corporation, as the shareholder may use direct foreign tax credits against the shareholder's other foreign-source income at the individual level. Congress in drafting §951A may not have intended such disparate outcomes depending on the shareholders' particular circumstances.

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