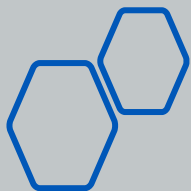


International Tax Updates

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Agenda

- Moore v. United States
- Christensen V. United States
- Farhy v. Commissioner
- Foreign Tax Credit and Notice 2023-55
- Schedule K-2/3
- PFIC Regulations



Case Law Update

Moore v. United States



Moore v. United States

- Moores owned an Indian CFC
- Paid a Section 965 Transition Tax
- Sued for a Refund citing that the income was not realized and it is therefore not a direct tax. Congress can't assert a indirect tax it without allocating among the states.
- Supreme Court Granted Certiorari on June 26, 2023, oral arguments were on December 5, 2023.

Moore v. United States

- A SC ruling can technically overturn GILTI, Subpart F and the Section 965 transition tax
- Oral arguments sounds like SC will hand down a narrow ruling
 - Realization
 - attribution
- Consider filing a Protective Claim under Section 6511(a) and Section 7422

Christensen v. United States

- Court of Federal Claims ruling in favor of taxpayer to allow taxpayer to use FTCs to offset NIIT
- The crux of the case was how on the interplay between Section 1411 and the treaty allowing for a credit of foreign taxes paid on dividends from French owned entities
- Oral arguments sounds like SC will hand down a narrow ruling
 - Realization
 - Attribution

Expect the IRS to appeal this decision however taxpayers should Consider filing a Protective Claim under

Fahry v. Commissioner

- Fahry owned 2 foreign corporations
- IRS assessed penalties for non-filing \$10,000 for each year and later assessed continuation penalties of \$50,000 per form
- Assessed per Section 6038(b)
- Taxpayer argued that 6038(b) did not provide IRS with the authority to assess penalties
- Tax Court found that 6201(a) authority does not include assessing penalties under 6038(b)

Fahry v. Commissioner – What time means?

- You Still need to file 5471s and every other foreign information return
- Taxpayers that have paid penalties should consider filing refund claim
- Taxpayers with assessments need not pay the assessment



Foreign Tax Credit

Purpose of the Foreign Tax Credit

- U.S. persons are subject to U.S. income tax on their worldwide income (i.e., U.S. source income as well as foreign-source income).
- Worldwide taxation without a foreign tax credit creates double taxation that distorts investment decisions by inhibiting foreign investment or business activities.
- The foreign tax credit provisions are intended to provide relief from double taxation and alleviate these distortions.

Who May Claim a Credit?

- U.S. citizens, individual residents, and domestic corporations may claim a credit – § 901(b)(1)
- U.S. person who is a partner in a partnership or a beneficiary of an estate or trust for the individual's proportionate share of foreign taxes – § 901(b)(5); see T.D. 9292
- Nonresident alien individuals and foreign corporations with respect to income effectively connected with the conduct of a U.S. trade or business – § 906

Creditable Taxes

- Section 901 allows a credit for income, war profits and excess profits taxes (collectively referred to as “income taxes”) paid by the taxpayer to a foreign country.
- Pursuant to Treas. Reg. § 1.901-2(a), a foreign levy is an income tax if and only if:
 1. It constitutes a “tax.”
 2. The predominant character is that of an “income” tax in the U.S. sense.

Notice 2023-55

- Allows taxpayers to rely on the Former FTC Regulations
- Retroactive relief for years beginning on or after December 28, 2021
- Two year delay in implementing the newer regs
- Still open is what next???

Section 904 FTC Limitation

- The FTC is used to avoid “double taxation of income”
- The FTC limitation is designed to ensure that foreign taxes may be credited only against U.S. taxes that are imposed on the same foreign income.
- The § 904(a) overall FTC limitation is calculated using the following formula:

$$\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{Tentative U.S. Tax Liability} = \text{FTC Limit}$$

Why Expense allocation and Apportionment is important

The expense allocation and apportionment rules play a central role in the determination of the § 904 foreign tax credit limitation.

- The greater the allocation of deductions to foreign source gross income, the lower the amount of foreign taxable income in the numerator in the foreign tax credit limitation fraction, and, therefore, the lower the amount of foreign income taxes that may be credited against U.S. tax liability in the taxable year.

$$\frac{\text{Foreign Source Net Taxable Income}}{\text{Worldwide Net Taxable Income}} \times \text{Tentative U.S. Tax Liability} = \text{FTC Limit}$$

The Overall FTC Limitation

Example 1:

- U.S. taxpayer has \$500 of taxable income for its 2010 taxable year (\$250 derived from U.S. activities and \$250 derived from service activities performed in France).
 - France levies taxes totaling \$57.
 - The U.S. tax liability prior to the foreign tax credit is \$105 (21% rate).

$$\begin{array}{r} \text{\$250 Foreign Source Income} \\ \text{\$500 Worldwide Income} \end{array} \times \begin{array}{r} \text{\$105} \\ \text{Tentative} \\ \text{U.S. Tax} \\ \text{Liability} \end{array} = \begin{array}{r} \text{\$53} \\ \text{FTC Limit} \end{array}$$

- The taxpayer's FTC is limited to \$53, leaving the taxpayer with \$4 of unused FTC. The taxpayer's U.S. tax liability is \$52 following the application of § 904 (\$105 - \$53).

The Overall FTC Limitation

Example 2:

- Assume instead that \$280 of the taxpayer's taxable income is derived from foreign sources pursuant to the source of income provisions.

$$\begin{array}{r} \text{\$280 Foreign Source Income} \\ \text{\$500 Worldwide Income} \end{array} \times \begin{array}{r} \$175 \\ \text{Tentative} \\ \text{U.S. Tax} \\ \text{Liability} \end{array} = \begin{array}{r} \$59 \\ \text{FTC Limit} \end{array}$$

- The taxpayer is now able to fully utilize its creditable foreign taxes paid of \$57.
- By increasing the amount of foreign source taxable income by \$30, the taxpayer was able to avoid double taxation with respect to its foreign source income. The taxpayer's U.S. tax liability is \$48 (\$105 - \$57).

Coordination with Section 904(d) – In Separate *Baskets*

- Section 904(d) requires that taxpayers apply § 902 separately to different categories of foreign source income (“baskets”).
- Determine taxable income (net of deductions) in each separate basket, then apply the § 902 formula.
- Income in specific baskets carries only the tax credits attributable to earnings in that basket.
- Prevents cross-crediting of high and low foreign taxes.

904(d) Separate Categories

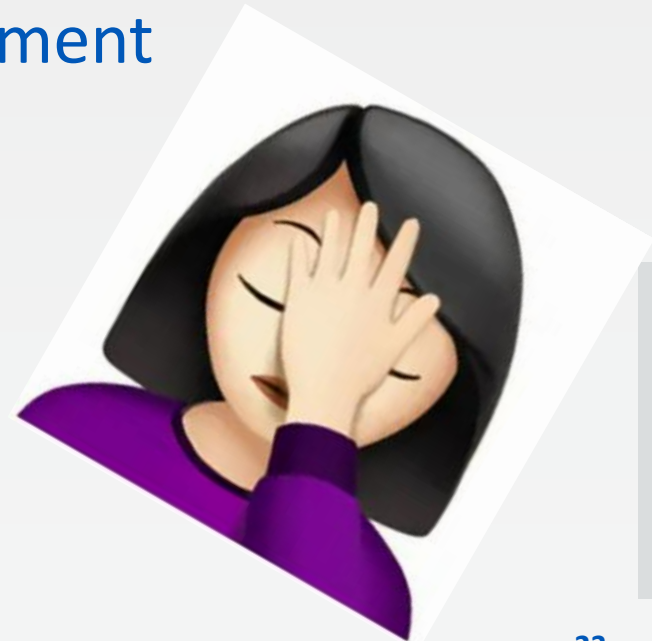
| Code | Category of Income |
|-------------|---|
| 951A | Section 951A Category Income |
| FB | Foreign Branch Category Income |
| PAS | Passive Category Income |
| 901j | Section 901(j) Income |
| RBT PAS | U.S. Source Passive Category Income Resourced by Treaty as Foreign Source Passive Category Income |
| RBT GEN | U.S. Source General Category Income Resourced by Treaty as Foreign Source General Category Income |
| RBT FB | U.S. Source Foreign Branch Income Resourced by Treaty as Foreign Source Foreign Branch Category Income |
| RBT 951A | U.S. Source Section 951A Category Income Resourced by Treaty as Foreign Source Section 951A Category Income |
| GEN | General Category Income |



Schedule K-2/3

Form K-2- Helpful Pointers

- Partnership only required to complete relevant sections of the form –
- There are items of international relevance **not** covered by this form – that is why you have Part I Box 13 – check this box and add a white paper statement



Form K-2- Helpful Pointers

- Partnership with no foreign income, assets, partners, and no foreign taxes paid may still need to prepare the K-2/K-3 for partners – to provide info they need to complete the Form 1118 and/or 1116
- May also need to file if there are deductible payments made to foreign related parties of any partners for BEAT calculations

Form K-2- Helpful Pointers

- Domestic Entity Filing Exception:
 - Domestic partnership does not have to file a K-2 or provide K-3 to partners if they meet the following criteria
 - No or Limited Foreign Activity
 - All partners for the full year were US citizens or tax residents – indiv, estate, trust only
 - ~~Partner Notification with 2 months of partnership due date~~
 - Partner notification as late as when Schedule K-1s distributed
 - The partnership does not receive a request for the form prior to 1 month before the due date of the tax return
- If a partner requests the form after the 1 month prior to the tax return due date window – partnership is not required to file with the IRS but partnership is required to provide to the partner either by the date it files its return or one month after request which ever date is later



What Happens if a Partner Requests

- Partnership would complete the form only to the extent requested by that particular partner and must remit to IRS
- Partnership not required to furnish to all partners only the partner that requested
- Partnership should track who asked for what!!!!

General Concepts

IRS is focused on Foreign Tax Credit related matters.

Large part of these new schedules relate to FTC.

In trying to understand which columns are the correct column you may need to consider the Income Sourcing and Expense Allocation Provisions.

Part II & III Filing Exception

Partnership is not required to file this section if all of their partners are eligible for the Form 1116 exception

Partnership needs to receive notification from all partners that they are not filing the Form 1116 by 1-month before the due date of the return

Sourcing Rules

| Income Type | Sourcing Rule |
|--|---|
| Interest | Residence of Payor |
| Dividend | Residence of Payor |
| Rent | Location of Property |
| Royalties: Natural Resources Patents Copyrights etc Software as a Service | Location of Property Where Property is Used *** |
| Sale of Personal Property (excl Inventory) | Residence of seller |
| Sale of Real Property | Location of property |
| Capital Gains/Losses | Residence of Seller (Sourced by Partner) |
| Services | Location where service provided |
| Sale of Purchased Inventory | Where title passes |
| Sale of Produced Inventory | Where Produced |
| CryptoCurrency Transactions | *** |

*** Additional Analysis Required

Part II

6 Does Part VI apply? If "Yes," complete and attach Part VI 6 12 Reserved for future use 12

Part I Partnership's Other Current Year International Information

- Check box(es) for additional specified attachments. See instructions.
- 1. Gain on personal property sale
 - 2. Foreign oil and gas taxes
 - 3. Splitter arrangements
 - 4. Foreign tax translation
 - 5. High-taxed income
 - 6. Section 267A disallowed deduction
 - 7. Reserved for future use
 - 8. Form 5471 information
 - 9. Other forms
 - 10. Partner loan transactions
 - 11. Dual consolidated loss
 - 12. Reserved for future use
 - 13. Other international items (attach description and statement)

Part II Foreign Tax Credit Limitation

Section 1 – Gross Income

| Description | Foreign Source | | | | | (f) Sourced by partner | (g) Total |
|---|-----------------|------------------------------------|-----------------------------|-----------------------------|---------------------------------|------------------------|-----------|
| | (a) U.S. source | (b) Foreign branch category income | (c) Passive category income | (d) General category income | (e) Other (category code _____) | | |
| 1 Sales | | | | | | | |
| A _____ | | | | | | | |
| B _____ | | | | | | | |
| C _____ | | | | | | | |
| 2 Gross income from performance of services | | | | | | | |
| A _____ | | | | | | | |
| B _____ | | | | | | | |
| C _____ | | | | | | | |
| 3 Gross rental real estate income | | | | | | | |
| A _____ | | | | | | | |
| B _____ | | | | | | | |
| C _____ | | | | | | | |
| 4 Other gross rental income | | | | | | | |
| A _____ | | | | | | | |
| B _____ | | | | | | | |
| C _____ | | | | | | | |

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. Cat. No. 73927C Schedule K-2 (Form 1065) 2023

Expense Allocation

-Expenses should be 1) allocated to a class of gross income and then 2) apportioned based on the gross income

Exception for: Interest Expense & R&E expense

Part II Section 2

| Part II Foreign Tax Credit Limitation (continued) | | Section 1 – Gross Income (continued) | | | | | | |
|--|------------------------|---|------------------------------------|------------------------------------|-----------------------------------|-------------------------------|------------------|--|
| Description | (a) U.S. source | Foreign Source | | | | (f) Sourced by partner | (g) Total | |
| | | (b) Foreign branch category income | (c) Passive category income | (d) General category income | (e) Other (category code) | | | |
| 5 Guaranteed payments | | | | | | | | |
| 6 Interest income | | | | | | | | |
| A | | | | | | | | |
| B | | | | | | | | |
| C | | | | | | | | |
| 7 Ordinary dividends (exclude amount on line 8) | | | | | | | | |
| A | | | | | | | | |
| B | | | | | | | | |
| C | | | | | | | | |
| 8 Qualified dividends | | | | | | | | |
| A | | | | | | | | |
| B | | | | | | | | |
| C | | | | | | | | |
| 9 Reserved for future use | | | | | | | | |
| 10 Royalties and license fees | | | | | | | | |
| A | | | | | | | | |
| B | | | | | | | | |
| C | | | | | | | | |
| 11 Net short-term capital gain | | | | | | | | |
| A | | | | | | | | |
| B | | | | | | | | |
| C | | | | | | | | |
| 12 Net long-term capital gain | | | | | | | | |
| A | | | | | | | | |
| B | | | | | | | | |
| C | | | | | | | | |
| 13 Collectibles (28%) gain | | | | | | | | |
| A | | | | | | | | |
| B | | | | | | | | |
| C | | | | | | | | |
| 14 Unrecaptured section 1250 gain | | | | | | | | |
| A | | | | | | | | |
| B | | | | | | | | |
| C | | | | | | | | |

Schedule K-2 (Form 1065) 2023

Part II Section 2 & Part III Section 1

Name of partnership

EIN

Part II Foreign Tax Credit Limitation (continued)

Section 2—Deductions (continued)

| Description | Foreign Source | | | | | (f) Sourced by partner | (g) Total |
|---|-----------------|------------------------------------|-----------------------------|-----------------------------|---------------------------------|------------------------|-----------|
| | (a) U.S. source | (b) Foreign branch category income | (c) Passive category income | (d) General category income | (e) Other (category code _____) | | |
| 46 Section 986(c) loss | | | | | | | |
| 47 Section 987 loss | | | | | | | |
| 48 Section 988 loss | | | | | | | |
| 49 Other allocable deductions (see instructions) | | | | | | | |
| 50 Other apportioned share of deductions (see instructions) | | | | | | | |
| 51 Reserved for future use | | | | | | | |
| 52 Reserved for future use | | | | | | | |
| 53 Reserved for future use | | | | | | | |
| 54 Total deductions (combine lines 25 through 53) | | | | | | | |
| 55 Net income (loss) (subtract line 54 from line 24) | | | | | | | |

Part III Other Information for Preparation of Form 1116 or 1118

Section 1—R&E Expenses Apportionment Factors

| Description | (a) U.S. source | Foreign Source | | | (e) Other (category code _____) (country code _____) | (f) Sourced by partner | (g) Total |
|--|-----------------|------------------------------------|-----------------------------|-----------------------------|--|------------------------|-----------|
| | | (b) Foreign branch category income | (c) Passive category income | (d) General category income | | | |
| 1 Gross receipts by SIC code | | | | | | | |
| A SIC code: _____ | | | | | | | |
| B SIC code: _____ | | | | | | | |
| C SIC code: _____ | | | | | | | |
| D SIC code: _____ | | | | | | | |
| E SIC code: _____ | | | | | | | |
| F SIC code: _____ | | | | | | | |
| 2 Exclusive apportionment with respect to total R&E expenses entered on Part II, line 32. Enter the following. | | | | | | | |
| A R&E expense with respect to activity performed in the United States | | | | | | | |
| (i) SIC code: _____ | | | | | | | 2A(i) |
| (ii) SIC code: _____ | | | | | | | 2A(ii) |
| (iii) SIC code: _____ | | | | | | | 2A(iii) |
| B R&E expense with respect to activity performed outside the United States | | | | | | | |
| (i) SIC code: _____ | | | | | | | 2B(i) |
| (ii) SIC code: _____ | | | | | | | 2B(ii) |
| (iii) SIC code: _____ | | | | | | | 2B(iii) |

Interest Expense Allocation

- Step 1: categorize assets by type of income they generate (i.e. GILTI, US source etc)
- Step 2: Allocate interest expense based pro rata on assets characterization

Interest Expense Allocation

- Partners in a partnership must look through partnership to the inside basis of the assets in the partnership to perform this calculation
- You **do not** have to complete Schedules k-2/k-3 Part II Section 3 (Interest Expense Apportionment Factor) if: all of your partners are less than 10% Limited Partners. If you have any partner that is holds a 10% or more interest in the PTE or is a General Partner you are still required to complete this section.

Part III Section 2

Name of partnership _____

EIN _____

Part III Other Information for Preparation of Form 1116 or 1118 (continued)

Section 2—Interest Expense Apportionment Factors

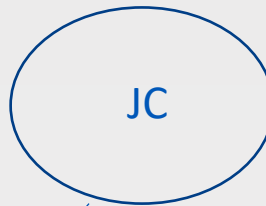
| Description | Foreign Source | | | | | (f) Sourced by partner | (g) Total |
|---|-----------------|------------------------------------|-----------------------------|-----------------------------|--|------------------------|-----------|
| | (a) U.S. source | (b) Foreign branch category income | (c) Passive category income | (d) General category income | (e) Other (category code _____) (country code _____) | | |
| 1 Total average value of assets | | | | | | | |
| 2 Sections 734(b) and 743(b) adjustment to assets— average value | | | | | | | |
| 3 Assets attracting directly allocable interest expense under Regulations section 1.861-10(e) | | | | | | | |
| 4 Other assets attracting directly allocable interest expense under Regulations section 1.861-10T | | | | | | | |
| 5 Assets excluded from apportionment formula | | | | | | | |
| 6a Total assets used for apportionment (subtract the sum of lines 3, 4, and 5 from the sum of lines 1 and 2) | | | | | | | |
| b Assets attracting business interest expense | | | | | | | |
| c Assets attracting investment interest expense | | | | | | | |
| d Assets attracting passive activity interest expense | | | | | | | |
| 7 Basis in stock of 10%-owned noncontrolled foreign corporations (see attachment) | | | | | | | |
| 8 Basis in stock of CFCs (see attachment) | | | | | | | |

Section 3—Foreign-Derived Intangible Income (FDII) Deduction Apportionment Factors

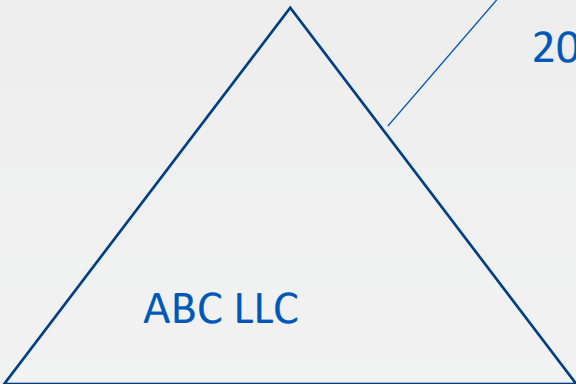
| Description | (a) U.S. source | Foreign Source | | | (e) Sourced by partner | (f) Total |
|---|-----------------|-----------------------------|-----------------------------|--|------------------------|-----------|
| | | (b) Passive category income | (c) General category income | (d) Other (category code _____) (country code _____) | | |
| 1 Foreign-derived gross receipts | | | | | | |
| 2 Cost of goods sold (COGS) | | | | | | |
| 3 Partnership deductions allocable to foreign-derived gross receipts | | | | | | |
| 4 Other partnership deductions apportioned to foreign-derived gross receipts | | | | | | |

Interest Expense Allocation

Interest in Partnership outside basis \$300,000
 Income from foreign sources \$50,000
 Foreign taxes paid 16,000
 Assets Generating Foreign income \$100,000
 Interest expense \$30,000



20%



Inside basis of assets
 \$2,000,000
 generating US source
 income

| Interest Expense Allocation | | | |
|----------------------------------|---------|-------------------------------|----------------------------|
| Without K3 Information | | | Interest Expense |
| Assets Generating Foreign income | 100,000 | 25% | 7,500 |
| Assets Generating US income | 300,000 | 75% | 22,500 |
| | | | 30,000 |
| With K3 Information | | | |
| Assets Generating Foreign income | 100,000 | 20% | 6,000 |
| Assets Generating US income | 400,000 | 80% | 24,000 |
| | | | 30,000 |
| | | | |
| | | Without K3 Information | With K3 Information |
| Gross Foreign Income | 50,000 | | 50,000 |
| Less Interest expense allocated | (7,500) | | (6,000) |
| Total Foreign Source Income | 42,500 | | 44,000 |
| Foreign Tax Credit Limitation | 15,725 | | 16,280 |
| Foreign Taxes paid | 16,000 | | 16,000 |
| Excess Credit | 275 | | - |



PFIC Updates

Proposed PFIC Regulations

- Regulatory trend towards treating Partnerships as aggregate of several taxpayers
 - Oct 2018 – Proposed Regs followed hybrid approach for GILTI
 - June 2019 – Final GILTI Regs took an aggregate approach
- This approach is seen in the final regs addressing GILTI and Subpart F
- January 2022 – Proposed PFIC regs – treat partnership as aggregate

Proposed PFIC Regulations

Under these regs :

- Partnership that owns a PFIC would no longer be making elections (QEF, MTM) on behalf of its partners the partners would have to make these elections directly
- Partnership would no longer file the Form 8621 on behalf of partners, partners would be required to file these forms on their own
- Existing QEF and MTM elections will be treated as made by the partners (i.e. there will be a continuation of these elections)

Thank You!

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Chaya and other Withum experts are available to assist with training at your firm or organization. Email us to learn more.

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