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Dale Loepp CPA
San Jose State University

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New Foreign Tax Credit Regulations

By: Dale Loepp, CPA, MST Student

On December 28, 2021 the U.S. Department of the Treasury released final regulations on the foreign tax credit. Even though these regulations generally followed the proposed regulations issued in 2020, important changes related to the creditability of foreign taxes, accompanied by a new attribution requirement, have significantly shifted the economic landscape for multinational U.S. corporations and individuals who pay foreign taxes.

An explanation of these regulations was presented at a one-hour webinar on February 4, 2022 by Caroline Chen, Associate Professor in San Jose State’s Lucas College and Graduate School of Business. Professor Chen provided an informative overview on both the general nature of the foreign tax credit along with many of the old and new issues at play. This seminar, which followed a quick “lunch and learn” format, was attended by a wide variety of participants, ranging from practitioners and MST students who were generally unfamiliar with the foreign tax credit, to those with a great deal of experience on the subject.

Generally speaking, the foreign tax credit under Section 901 of the Internal Revenue Code is a dollar-for-dollar credit granted for certain taxes paid to a foreign country. Professor Chen laid out the basic requirements: the tax must be truly imposed, the tax must be paid or accrued, and the tax’s character must be that of a net income tax or a type of tax that is “in lieu of an income tax.” These requirements that seem relatively simple on the surface already raise complex issues, particularly when determining whether a foreign tax, which may be structured under a system of taxation that is quite different from our own, is sufficiently similar to the U.S. system to be deemed an income tax or a tax in lieu of an income tax. To complicate matters further, the specific tests for creditability of foreign taxes as set out in the old proposed regulations have now been supplemented by a controversial new attribution test which will more closely focus on the issue of nexus between the taxpayer’s business activities and the country levying the tax. Of course, not all foreign systems of taxation have nexus requirements that are sufficiently equivalent to the U.S. system that a foreign tax credit will be allowed. For example, although the foreign law need not conform to U.S. law in all respects, the applicable foreign sourcing rules must now at least be “reasonably similar” to U.S. sourcing rules. According to Professor Chen, these new requirements actually represent a significant shift in the foreign tax environment, noting that taxes which were creditable under the proposed regulations will now likely be disallowed under the new final regulations.

Ultimately, Professor Chen also believes that the new regulations will require tax preparers and tax advisors to gain a much deeper understanding of how any relevant foreign system of taxation actually functions—a task that will require greater collaboration with other professionals such as foreign lawyers, accountants, and translators. Tax treaties will be examined in more detail and may ultimately need to be revamped to accommodate prevailing views as to what constitutes a foreign tax in lieu of an income tax.
Although the brevity of the presentation limited the depth of what could be covered during the seminar, Professor Chen demonstrated that this format can provide a very valuable update both for those who would like to learn more about aspects of international taxation and those who must continue to deal with its impact on behalf of their employers or clients. Ultimately, Professor Chen clearly demonstrated that the foreign tax credit was already a complex area of practice, and one that has now been made even more complex and uncertain by new regulations.

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