KPMG

# I'm Losing Credits? Why FTC Planning Can Be Controversial

Transforming tax.
Redefining connections.

2025 US Cross-Border Tax Summit

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# Presenters

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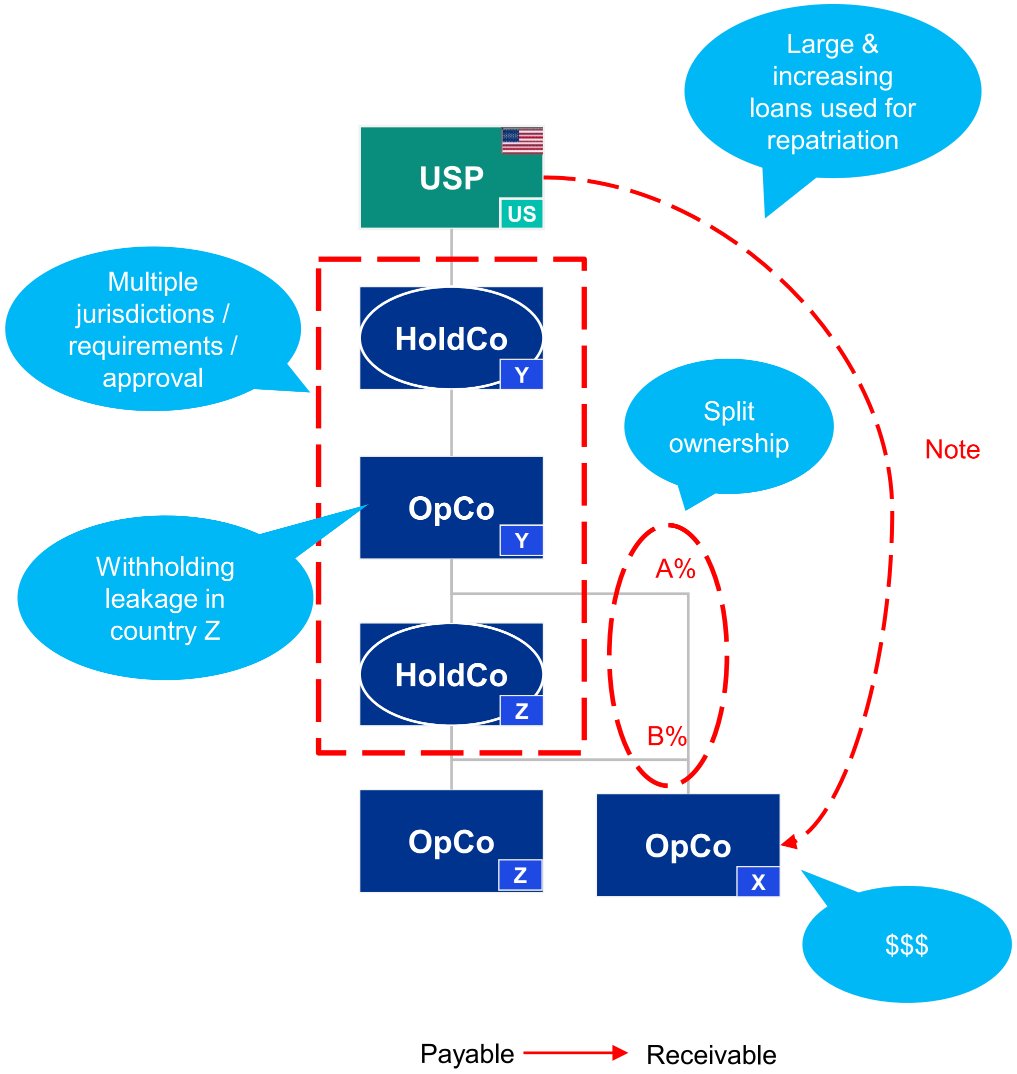
# Introduction

# Meet USP!

- Inefficient treasury situation – USP needs cash but cash sits far below at Opco X
- Unnecessary legal entities
- TP structure hasn't been reviewed in many years, while business evolved
- IP strategy uncertain
- Chronic excess GILTI credits; excess general basket FSI
- Thinly resourced for corporate tax matters



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# Lifecycle of an FTC Planning Project

## CTO Perspective

**Build a foundation to minimize controversy**

### 01 Identify Operational Goals

- LER / LEO
- Efficient cash management
- Foreign tax reductions
- Acquisitions / dispositions
- Tax risk mitigation

### 02 Ideation

- Develop / validate / communicate relevant facts
- Step plans
- Modeling
- Rinse and repeat

### 03 Generate Buy-in

- Treasury
- Legal
- Accounting
- Operations
- Works Councils / Unions
- C-suite
- Board

### 04 Execution

- Coordinate internal and external stakeholders
- Manage execution timeline
- Modeling
- Ongoing communication
- Disclosures
- Stakeholder education (e.g., QBU status)
- Documentation

### 05 Controversy

- Financial statement audit
- IRS audit
- Obtaining refunds

02

# Rebalancing Foreign Income Taxes

# Rebalancing Foreign Income Taxes

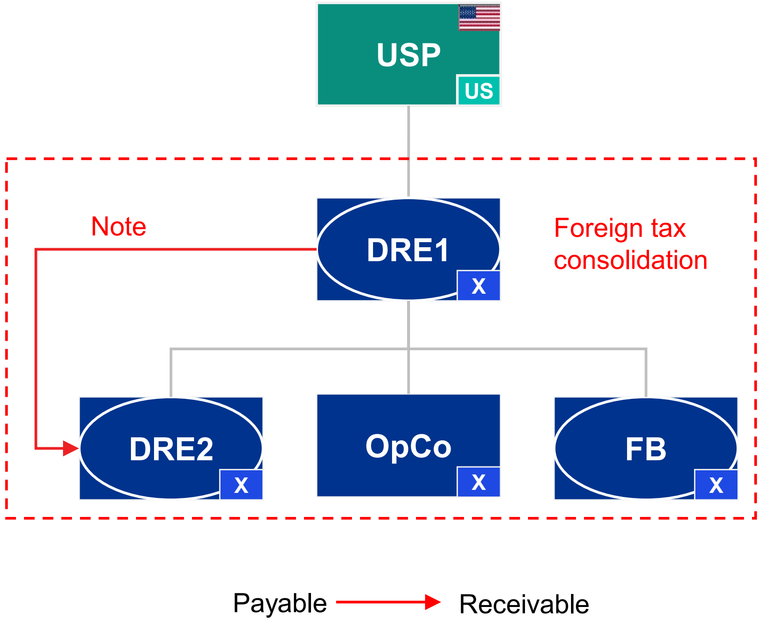


**Many taxpayers are perennially in an excess credit position in the section 951A ("GILTI") or the Foreign Branch separate limitation categories (i.e., "baskets") since the TCJA split the General basket into the General, GILTI, and Foreign Branch baskets.**

- Rebalancing attempts to "reconstitute" taxes in the General, GILTI, and Foreign Branch baskets into a single basket (usually the General basket) to maximize the cross-crediting of foreign income taxes.
  - Taxpayers generally attempt to reconstitute into the General basket because taxpayers are most often excess limitation in the General basket due to the receipt of "low" tax foreign source royalty income.

# Rebalancing Foreign Income Taxes

## Combined Income Regime




### Country X income tax assessed on DRE1 and computed by combining all items of DRE1, DRE2, OpCo, and FB

- Country X income tax system is a "combined income regime" within the meaning of Reg. § 1.901-2(f)(3).
- Results in the allocation of the Country X tax assessed on DRE1 among DRE1, DRE2, OpCo, and FB for U.S. federal income tax ("USFIT") purposes.

### Assignment of Country X income tax allocated to OpCo

- Income of OpCo recognized for USFIT purposes continues to be recognized as tested income (assuming all income of OpCo is tested income) and Country X income taxes allocated to OpCo are assigned to tested income/section 951A to extent deemed paid.
- Foreign income taxes paid by OpCo for USFIT purposes reduced as a result of disregarded interest payments on the Note thereby reducing taxes assigned to the GILTI basket.

### Assignment of Country X income tax allocated to FB

- Income of FB recognized for USFIT purposes continues to be recognized as Foreign Branch income (assuming all income of FB is foreign branch income) and Country X income taxes allocated to FB are assigned to the Foreign Branch basket.
- Foreign income taxes paid by FB for USFIT purposes reduced as a result of disregarded interest payments on the Note thereby reducing taxes assigned to the Foreign Branch basket.

### Assignment of Country X income tax allocated to DRE2

- Disregarded interest payment is a "contribution" within the meaning of Reg. § 1.861-20(d)(3)(v)(E)(2).
- Country X income tax is assigned to the "residual" basket pursuant Reg. § 1.861-20 20(d)(3)(v)(C)(2).

# LB&I Directive

**In 2010, the IRS issued an LB&I Directive requiring DFO approval in order to assert § 7701(o). Some commentators described this as a policy of restraint.**

*See* LMSB-20-0910-024 (2010); LB&I-04-0711-015 (2011)

**But now, the IRS expands its view of ESD, arguing:**

- ESD applies to every provision of the Code
- There is no threshold relevancy test
- ESD becomes a general anti-abuse

**IRS executive approval is no longer required.**

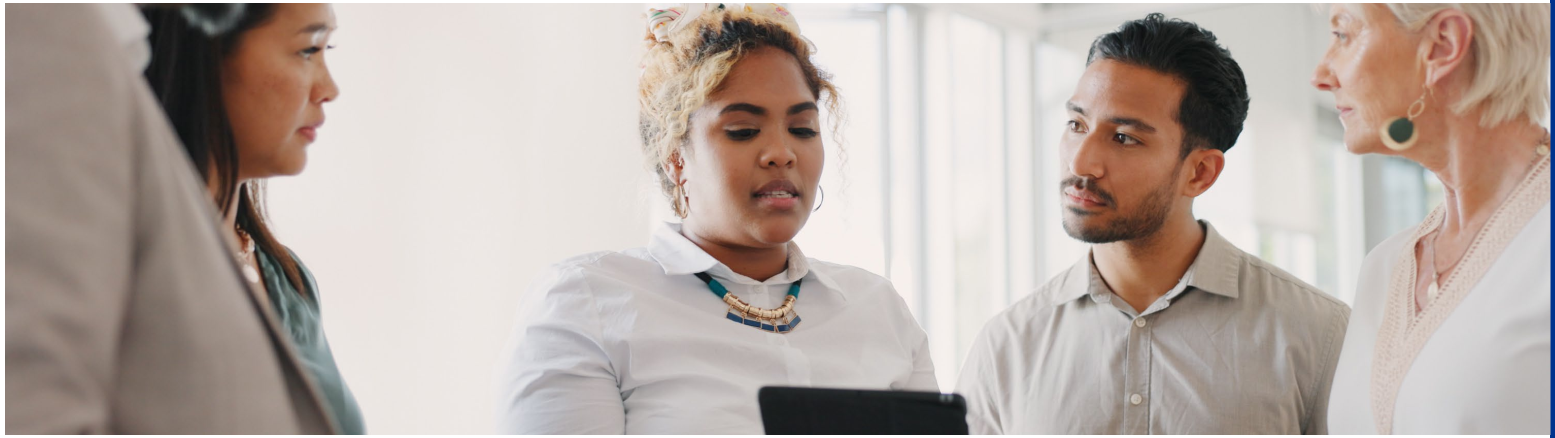
*See* IRS Interim Guidance Memorandum on Economic Substance (April 22, 2022)

# Rebalancing Foreign Income Taxes

## Losing Credits?

### Two arguments against ESD application

- Legal argument: ESD is not relevant
  - Under section 7701(o)(5)(c), the determination of whether ESD is relevant is made as if section 7701(o) was not enacted.
  - Therefore whether ESD is relevant to a transaction is determined under prior case law.
- Factual argument: ESD is satisfied because transaction has a business purpose and "substance."



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Section 7701(o): In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

- (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
- (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

# Recent ESD Cases

***Exxon Mobil Corp. v. United States*** **(District Court for Northern District of Texas)**

District court concluded that the economic substance doctrine is "inapplicable because judicial doctrines cannot override the congressionally mandated tax treatment of the production payment in Section 636(a), which specifies that the production payment "shall" be treated "as if it were" a mortgage loan."

***Liberty Global Inc. v. United States*** **(District Court for the District of Colorado/10th Cir.)**

Court held no threshold relevance determination for ESD under §7701(*o*); denied §245A dividends-received deduction following a check-the-box election and capitalization of CFC with debt and §351(g) non-qualified preferred stock (which resulted in E&P increase).

Currently on appeal before 10th Circuit. Amicus briefs submitted; oral arguments took place.

***Patel v. Comm'r*** **(Tax Court)**

Involves microcaptive insurance companies. Taxpayer lost on the merits; court is considering relevance of economic substance doctrine for purposes of penalty determination.

Tax Court requested amicus briefs on the issue.

***Otay Project LP v. Comm'r*** **(Tax Court)**

Taxpayer argues that economic substance doctrine is not relevant.

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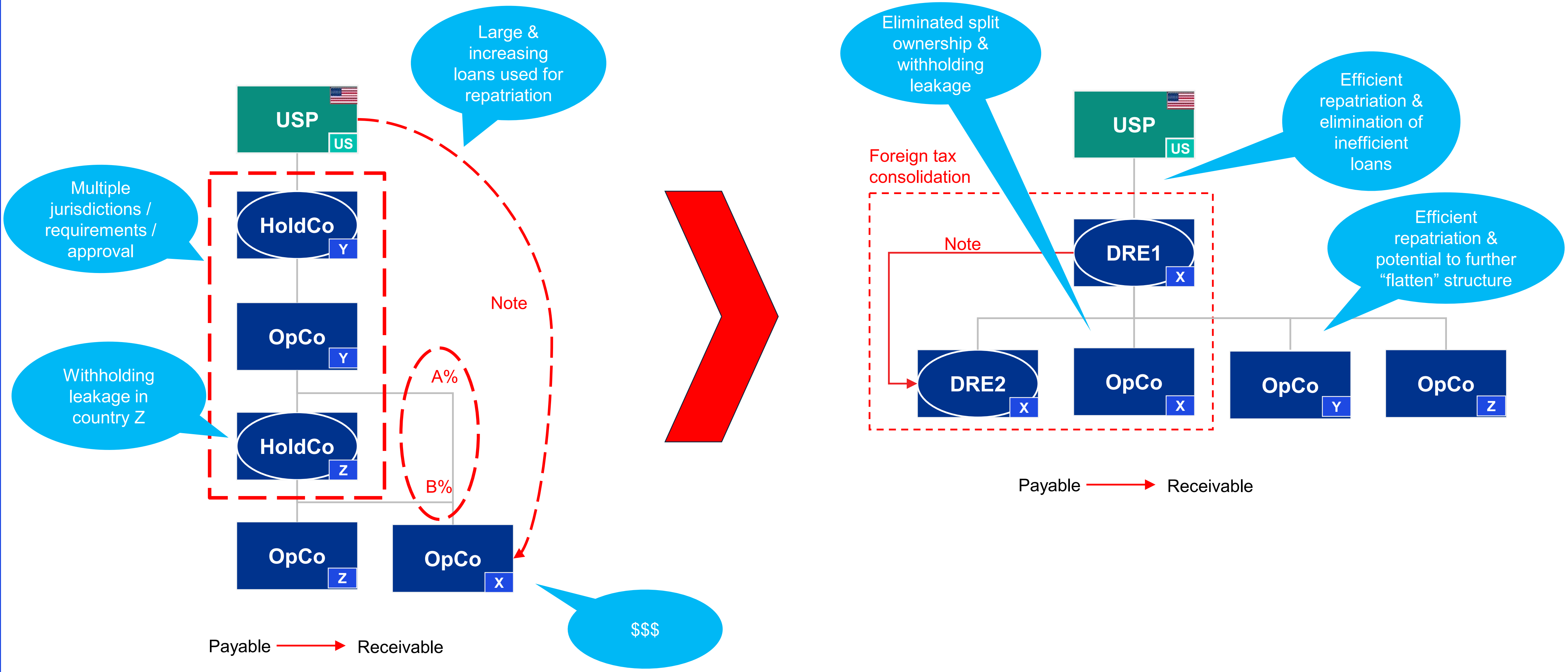
# Operational Goals & Minimizing ESD Risk



# Lessons learned

## CTO Perspective

- Mastery of facts and the role of the in-house team
- Stakeholder management
  - Getting the right people involved at the right time, and keeping them adequately in the loop (e.g., work councils, unions, etc.)
- Communication & documentation trail
  - Tension: ROI vs tax risk
- Budget considerations when time is off the essence
- Non-gaap policy
- Controversy

03

# Prepayments

# Prepayments to Increase “Low-Tax” Foreign Source General Basket Income

## Generating “low-tax” foreign source General basket income is critical for some taxpayers

- 10-year statute of limitations on General basket carryforwards generated in the mandatory repat year ending soon
- “Overly” successful rebalancing planning

## Additionally Starting in 2026 the FDII deduction is scheduled to be reduced from 37.5% to 21.875%, increasing the ETR on FDII from 13.125% to 16.406%, making it less favorable for taxpayers

- Companies may enjoy a permanent tax benefit from accelerating FDII-eligible income from foreign related parties.
- Separating gross FDDEI from its related expenses or QBAI can create a significant permanent benefit for companies that would otherwise have modest amounts of FDII due to significant expenses or high domestic QBAI.
- Even in a steady rate environment, taxpayers may benefit from no regrets planning, including the acceleration of FDII-eligible income (FDDEI)

**Income acceleration is a technical analysis that may involve accounting method, transfer pricing, and other considerations.**

# Prepaid Royalty

| No Pre-payment | 2025 | 2026 |
|---|---|---|
| **Gross FDDEI** | 200 | 200 |
| **FDDEI Expense** | 50 | 50 |
| **FDDEI** | 150 | 150 |
| **Total FS FDDEI** | **300** | |

| Pre-payment | 2025 | 2026 |
|---|---|---|
| **Gross FDDEI** | 395 | 0 |
| **FDDEI Expense** | 55 | 50 |
| **FDDEI** | 340 | 0 |
| **Total FS FDDEI** | **340** | |

### Allocation and Apportionment of Deductions

- Income acceleration will increase gross FDDEI, which will cause more interest expense to be apportioned to FDDEI.
- Taxpayers often allocate and apportion significant amounts of deductions (e.g., SG&A) using a gross income method.
  - In the context of a prepayment, these taxpayers often argue that the accelerated income should not be part of the gross income used for allocation and apportionment of expenses.
  - That position has been subject to significant IRS audit scrutiny such that taxpayers should consider refining their apportionment methodology.

# Apportionment Controversies

**2022 FDII GLAM** (AM 2022-001)

- Concludes that "deferred compensation expense" should be allocated to FDII for the year in which the compensation is deductible for federal income tax purposes *and* apportioned based on the grouping(s) that exist in the year taken into account
- Deductions should be tied to the gross income that they relate to
- Taxpayers generally expected the cost prior years' services should be allocated to those years' gross income
- Reverses a long-standing interpretation of § 1.861-8

**Other controversies**

- Factually intensive exercise
- Exam teams are often quick to spot improper methodologies; less eager to dig into details
- Prudence of holding a "better answer" in reserve?

# Lessons learned

## CTO Perspective

**Can be a great planning tool**

- FTC planning – expiration of excess credits, and also
- Anticipation of corporate tax rate increase (lower tax rate on future income streams)

**Not always a home-run**

- Lack of FSI in subsequent years – pressure on modeling
- Additional complexity for provision and compliance for years
  - Book-tax difference: Foreign jurisdictions may not respect immediate prepayment deduction (only as performance occurs). Result is timing differences between US and foreign deductions, which can impact local tax returns, E&P adjustments, etc.
  - Novel tax accounting issues raised by auditor
    - Asset transfer rules (ASU 2016-16: Intra-asset transfer other than inventory) – sale of an economic asset (right to receive future payments), versus mere prepayment.
    - In one example, auditor forced client to record multiple year's worth of financial statement benefit in transaction year (called-out from earnings) then no benefit in subsequent year tax rate

04

# 965 PTEP Repatriation

# 965 PTEP Repatriation

## Limitations on crediting foreign income taxes paid on distributions of 965(a) and 965(b) PTEP restrict repatriation

- “Haircut” of foreign income taxes impose on repatriations of section 965(a) and 965(b) PTEP under section 965(g)
- Limitation in general basket

## Opportunities

- Argue that the Regulation “haircutting” foreign income taxes on 965(b) PTEP is invalid
- Section 960(c)

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# 965 PTEP Repatriation

### Validity of regulations in light of *Loper Bright*

- Was there an express delegation by Congress?
- Statutes have a single meaning, not a broad range of meanings
  - Does the reg forbid what Congress permitted?
- How much flexibility does the Commissioner have within the ambiguity of his own regulations?

“The Administrative Procedure Act requires courts to exercise their independent judgment in deciding whether an agency has acted within its statutory authority, and courts may not defer to an agency interpretation of the law simply because a statute is ambiguous; Chevron is overruled.”

*Loper Bright v. Raimondo* (2024)

# What is 960(c) and when can it apply?

**Section 960(c) increases the section 904 limitation for the taxable year a PTEP distribution is received when the USSH:**

- Included an amount under section 951(a) or 951A in a taxable year and either (i) elected to claim a foreign tax credit in such year or (ii) did not pay or accrue any foreign income taxes in such year;
- Elects to credit foreign income taxes in a subsequent taxable year in which it receives a PTEP distribution attributable to amounts included in the prior year described above; and.
- For the taxable year in which it receives the PTEP distribution, the U.S. shareholder pays/deemed pays/accrues foreign income taxes with respect the PTEP distribution.

# What is the amount of the increase to the taxpayer's FTC limitation?

**Lesser of:**

- the foreign income taxes paid/deemed paid/accrued with respect to the PTEP distribution; or
- the amount of the excess limitation account ("ELA") as of the beginning of the relevant taxable year. I.R.C. § 960(c)(1)(flush language).
- The increase in limitation is computed for each separate section 904(d) basket (including the section 951A basket) or other limitation category (e.g., treaty basket). Treas. Reg. § 1.960-4(a)(1).

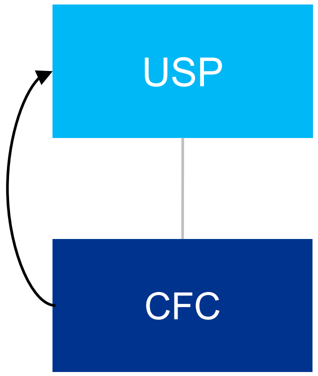
**While a foreign tax credit is a credit against tax – such that taxpayers must generally have a pre-credit USFIT liability to claim a foreign tax credit, section 960(c)(5) provides a special rule in cases where the increase in limitation allowed by section 960(c) exceeds the taxpayer's USFIT liability.**

- Section 960(c)(5): If an increase in the limitation under this subsection exceeds the tax imposed by this chapter for such year, the amount of such excess shall be deemed an overpayment of tax for such year.
- Such overpayment is refundable in accordance with chapter 65. *See* Reg. § 1.960-6(a).

# Taxpayer's with ELA and undistributed section 965 PTEP

## 2022

- Section 965 PTEP Distribution
- $20 withholding tax




### For its 2022 taxable year:

- USP does not pay any USFIT for 2022 because of a U.S. source loss that reduces its pre-foreign tax credit total taxable income to zero.
- CFC distributes general basket section 965 PTEP to USP and CFC's country of incorporation imposes a withholding tax of $20.
- USP's section 965 inclusion was fully related to cash and, as a result, USP's foreign tax credit with respect to the $20 of withholding taxes would be haircut by section 965(g)(1) to $8.86 ($20 * (1-.557)).
- USP has a general basket ELA of $30 as of the beginning of its 2022 taxable year.

### Absent section 960(c), USP would have a foreign tax credit limitation of zero for the year.

- Section 960(c) increases USP's general basket foreign tax credit limitation by $20 (the lesser of the $20 withholding taxes paid and USP's general basket ELA of $30).
- USP does not, however, have any USFIT to claim a foreign tax credit against.

### Pursuant to section 960(c)(5), USP would be deemed to have a refundable overpayment of $20 for its 2022 taxable year.

# Obtaining a refund



**Approval process:**

- Filing an amended return is only the first step in obtaining a refund
- Full examination or field survey
  - Interactions with ongoing examinations
- Possible Appeals
- Re-review of case by IRS's internal "Joint Committee Specialists"
- Joint Committee review and approval required for refund claims in excess of $5M (net)
- Payment occurs several months after the Joint Committee approves

**Timeline:**

- Joint Committee cases typically take 12-18 months from filing, *even without substantial controversy*
- IRS staffing disruptions make any timing estimates far less predictable

05

# Q&A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