Published on *The National Law Review* https://natlawreview.com

Tax Reform Insight: New Foreign Tax Credit Rules May Warrant Restructuring Foreign Branches

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The 2017 Tax Act added a separate foreign tax credit limitation category, or basket, for income earned in a foreign branch. As a result, certain US groups may be limited in their ability to use foreign income taxes paid or accrued by a foreign branch as a credit against their US federal income tax liability.

This new limitation can present a problem for a taxpayer with losses in some foreign branches and income in other foreign branches. Consider, for example, a US consolidated group that has $1,000 of losses from Foreign Branch X and $1,000 of income in Foreign Branch Y on which it pays $200 of foreign income taxes. The group would have zero income in its foreign branch basket, and therefore the $200 of foreign taxes would not be currently usable as a foreign tax credit. The credits can be carried over to other tax years, but they may never be tax benefited if the above circumstances continue.

In addition, the reduction in the US corporate tax rate results in foreign taxes paid by a foreign branch in excess of 21 percent (vs. 35 percent) not being currently usable. This problem can be exacerbated by the allocation of expenses to the group's foreign branch income causing the foreign branch credit limitation to be even lower. Such taxes may never be benefited unless the US group has low-taxed foreign branch income.

Therefore, a taxpayer may consider taking steps to reduce foreign branch income subject to foreign taxation by moving all or a portion of the branch's business into the United States. The income generally would continue to be subject to US tax at a rate of 21 percent, or may qualify for a tax rate of 13.125 percent to the extent that income is foreign-derived intangible income. Any foreign tax implications of such restructuring will need to be considered.

Alternatively, a taxpayer may transfer the branch business to a foreign subsidiary (a CFC), or elect to classify a disregarded foreign entity as a corporation. The income earned by the CFC (less 10 percent of depreciable tangible assets) generally would be subject to a 10.5 percent US tax rate under the new Global Intangible Low-Taxed Income (GILTI) regime and US tax may be reduced by 80 percent of the foreign income taxes paid on the GILTI, but any foreign taxes not used in the current year would be lost. A portion of the CFC's income may be Subpart F income, which is generally taxed at a 21 percent rate, but if the foreign income tax rate exceeds that rate, an election can be made to exclude the income from current US taxation. Alternatively, the US tax on any Subpart F income may be reduced with foreign tax credits and any excess credits may be used to reduce US tax on other foreign source business income of the US group or carried forward. The transfer of a branch to a CFC would be taxable for US purposes, but the benefits may outweigh the costs (including that any annual deemed royalty income from the transfer of intangible property and goodwill may qualify for the 13.125 percent tax rate and fall within the general basket).

Evan Walters contributed to this article.

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National Law Review, Volume VIII, Number 178

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