

Rules That Reclassify Passive Basket Income as General Basket Income

A domestic corporation is entitled to claim a foreign tax credit for the amount of income taxes it pays or accrues to a foreign country.¹ A domestic corporation also can claim an indirect foreign tax credit for income taxes paid or accrued by a foreign subsidiary when the earnings bearing the tax become subject to U.S. taxation, either when distributed as a dividend or included in income under Subpart F.²

The amount of foreign tax credits that can be claimed for a year is limited to the amount of U.S. taxes paid on net foreign source income.³ The foreign tax credit limitation is calculated separately for active foreign source income (general basket) and passive foreign source income (passive basket).⁴

Thus, when calculating the foreign tax credit limitation, it must be determined whether an item of income falls within the general basket or the passive basket. For foreign tax credit purposes, passive income is generally defined as any income which is of a kind which would be Subpart F foreign personal holding company income (FPHCI). General basket income is all income that is not passive income.⁵ Foreign taxes paid or accrued on an item of income are in the same basket as the item of income.⁶

Code Sec. 954(c)(1) defines FPHCI as including dividends, interest, rents, royalties, gain from sales of certain property, commodities gains and foreign currency gains. If an item of income that is FPHCI under the general definition qualifies for an exception, it will be general basket income. Exceptions are provided for income arising in the conduct of an active trade or business.⁷

For example, a domestic corporation earns \$1,000 of foreign source interest income from a foreign bank subject to a 10-percent withholding tax. Such interest is FPHCI and, therefore, falls within the passive basket. The \$100 of foreign taxes paid on the interest can reduce the \$350 of U.S. taxes to \$250, but any excess foreign tax credits the domestic corporation may have in the general basket would not be available to offset the incremental U.S. tax on this passive income.

To illustrate further, assume a domestic corporation earns \$2,000 of royalty income from a foreign licensee that is subject to a 10-percent withholding tax. The intangible property was developed by the domestic corporation. While such royalty income would generally be FPHCI, it qualifies for the active business exception to the definition of FPHCI. Therefore, the royalty would be treated as general basket income, and any excess foreign tax credits of the domestic corporation in the general basket can reduce the incremental \$500 of U.S. tax on the royalty.

Rents and royalties are considered as general basket income if an affiliated group as a whole satisfies the active business test. For example, if royalties received by a member of the group are within the definition of FPHCI because the licensor itself does not satisfy the active test, it will nevertheless be classified within the general basket if the activities of the affiliated group as a whole satisfy the active test.⁸

The foreign tax credit provisions generally reclassify as general basket income dividends, interest, rents or royalties received by a U.S. shareholder from a controlled foreign corporation (CFC).⁹ Such amounts, however, will fall within the passive basket to the extent the corresponding payments are allocated or apportioned to passive



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income of the CFC (*i.e.*, looking through to the basket of the CFC's income from which the payment is made).¹⁰ This treatment also applies to inclusions under Subpart F.¹¹

If in the first example the domestic corporation instead earned \$1,000 of interest on a loan to one of its CFCs and paid \$100 of foreign withholding taxes, the income would be considered as falling within the general basket

In sum, an item of income that is passive income under the general definition of FPHCI can be reclassified as general basket income.

(assuming the CFC does not derive passive income). In such case, excess foreign tax credits in the general basket could be used to reduce the incremental \$250 of U.S. tax on the interest.

Look-through rules also apply for purposes of classifying income earned by a CFC.¹² For example, a royalty received by one CFC from a related CFC where the royalty expense reduces Subpart F sales income of the

licensee would be FPHCI, but the Subpart F income would nevertheless fall within the general basket of the domestic shareholder because the sales income reduced by the royalty expense is active.

If after applying the above rules a domestic corporation has foreign source income within the passive basket, an item of passive income may nevertheless fall within the active basket if it is subject to a "high" foreign tax rate. Passive income is considered as high taxed if, after allocating expenses, the effective foreign tax rate exceeds the highest U.S. corporate tax rate (*i.e.*, currently 35 percent), taking into account direct and indirect foreign taxes paid with respect to the income. This calculation is performed for separate items of passive income, such as income subject to different rates of withholding tax and income from each CFC. An item of passive income that is subject to an effective tax rate in excess of 35 percent is reclassified as general basket income along with the taxes associated with such item.¹³

In sum, an item of income that is passive income under the general definition of FPHCI can be reclassified as general basket income. This is the case for an item of income that qualifies for an exception to FPHCI, is received from a related CFC (subject to look-through rules) or is subject to an effective foreign tax rate exceeding 35 percent. Rents and royalties are general basket income if the affiliated group as a whole meets the active test.

ENDNOTES

¹ Code Sec. 901(a), (b)(1); Reg. §1.901-1(a).

² Code Secs. 902(a), 960(a). See Reg. §1.902-1(a) (11) ("dividends" include amounts under Code Secs. 302, 304, 305(b), 367(b) and 1248).

³ Code Sec. 904(a). See Reg. §§1.861-8 through 1.861-14T (expense allocation rules). The illustrations herein do not take into account the reduction of foreign source income for expenses allocated and apportioned to such income.

⁴ Code Sec. 904(d)(1). See also Code Secs. 904(d)(6), (h)(10) (separate basket for U.S. source income resourced as foreign source under a treaty). Foreign tax credits not used in a year may be carried back one year and carried forward 10 years. Code Sec. 904(c).

⁵ Code Sec. 904(d)(1), (2); Reg. §1.904-4(a), (b). See Code Sec. 904(d)(2)(C) (reclassifies certain otherwise passive financial services income as general basket income).

⁶ Reg. §1.904-6(a). The Code Sec. 78 gross

up amount for indirect taxes is treated as income in the same category as the taxes. Reg. §1.904-6(b)(3).

⁷ See, e.g., Code Sec. 954(c)(1)(C) (active commodities gains); Code Sec. 954(c)(1)(D) (business needs for foreign currency gains); Code Sec. 954(c)(2)(A) (active rents and royalties); Code Sec. 954(c)(2)(C) (dealers); and Code Sec. 954(h) (active finance income).

⁸ Reg. §1.904-4(b)(2)(iii)(B). An affiliated group is defined by reference to Code Sec. 1504(a) and includes CFCs of which the domestic members of the affiliated group own, directly or indirectly, at least 80 percent of the total vote and value. See Yoder, *The Incongruent Definitions of Active Royalties for Subpart F and Foreign Tax Credit Purposes*, 37 TAX MGMT. INT'L J. 128 (Feb. 10, 2006).

⁹ Code Sec. 904(d)(3)(A); Reg. §1.904-5(b).

¹⁰ Code Secs. 904(d)(3)(C) & (D); Reg. §1.904-5(c). See Code Sec. 904(d)(4); Reg.

§1.904-5(c)(4)(iii) (similar look-through rule for dividends from a 10-percent owned foreign corporation that is not a CFC, but not for rents, royalties or interest). See Yoder, *Foreign Corporate Joint Ventures: Foreign Tax Credit Planning*, 39 TAX MGMT. INT'L J. 482 (Aug. 9, 2013).

¹¹ Code Sec. 904(d)(3)(B); Reg. §§1.904-5(c), (d) & (e).

¹² Reg. §1.904-5(i). *Cf.*, Code Sec. 954(c)(6) (narrower look-through exception for FPHCI).

¹³ Code Sec. 904(d)(2)(B)(iii)(II), (F); Reg. §1.904-4(c). Foreign taxes imposed on passive U.S. source income are taken into account in determining the effective tax rate, but not the U.S. source income. If an item of passive income is zero or less after allocating expenses, any foreign taxes imposed on the passive income are treated as general basket taxes. See also Reg. §1.904-5(d)(2) (treatment of income subject to the Subpart F high-tax exception).

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