WHEN BASKETS GO BEYOND WEAVING – UNDERSTANDING FOREIGN TAX CREDIT BASKETS UNDER THE LOOK-THROUGH RULES

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Tags
Controlled Foreign Corporation
Dividend
Foreign Tax Credit
High Tax Kick Out
Look Through Rule
Previously Taxed Income
Subpart F

INTRODUCTION

While the word "basket" may trigger a mental image of a bicycle with a daisy basket that is a gift in early childhood, the term has a totally different connotation in the tax world. It denotes "foreign tax credit baskets" to an international tax geek in the U.S.

The foreign tax credit provisions are among the most complicated areas of the U.S. Internal Revenue Code ("Code"), and become further complicated when a "U.S. Shareholder" of a Controlled Foreign Corporation ("C.F.C.") includes income in one year but receives distributions in another.

This article explains the labyrinth of the foreign tax credit provisions that are encountered to ensure that (i) foreign source income and (ii) related foreign taxes are reported in the same foreign tax credit basket. If not computed properly, doubled taxation of income is sure to arise.

BACKGROUND

Here is a typical fact pattern involving a U.S. citizen who is a shareholder of a foreign owner-managed business.

- Mr. A is a U.S. citizen who is the sole shareholder of F Co, a corporation organized in country F.
- F Co serves as a holding company that has invested in several operating and investment companies outside the U.S.
- The ownership percentage of F Co in the foreign entities ranges between 1% and 50%.
- Dividends from the lower-tier foreign entities comprise F Co's main source of income.
- An income tax treaty is in effect between Country F and the U.S.
- The foreign entities timely distribute dividends to F Co.
- The divided income is treated as Subpart F income for Mr. A.
- Country F imposes a withholding tax rate of greater than 20% on distributions by F Co to Mr. A.
- F Co has not invested in any property in the U.S.

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GENERAL OVERVIEW

General Rules

F Co is a C.F.C. for U.S. tax purposes. A C.F.C. is a foreign corporation of which more than 50% of its authorized and outstanding shares, measured by total voting power or value, is owned by one or more "U.S. Shareholders." A U.S. Shareholder is a U.S. person that owns shares representing 10% or more of the value or the voting rights of all shares of the foreign corporation.

Broadly speaking, a U.S. Shareholder of a C.F.C. is required to include in U.S. taxable income its *pro-rata* share of the income of the C.F.C. The income inclusion is required even though no actual distribution is made by the C.F.C. The income inclusion typically takes either of two forms, Subpart F income or Global Intangible Low-Taxed Income ("G.I.L.T.I.").[1] Subpart F income typically includes passive income, for example, dividends, royalty, interest, royalty, etc. It also includes Foreign Base Company Income arising from related party transactions.[2] Whereas G.I.L.T.I. refers to the excess of the income of the C.F.C. over certain deductions, including

- a deduction for Subpart F income,[3]
- a deduction for certain income specifically excluded from Subpart F Income,[4]
- a deduction for dividends from certain related parties,[5]
- a deduction for expenses (including taxes) properly allocable to tested gross income under G.I.L.T.I.,[6] and
- a deduction for a hypothetical yield generated by the C.F.C. on its Qualified Business Asset Investment ("Q.B.A.I.").[7]

Application to Mr. A

Applying the Subpart F and G.I.L.T.I. rules to F Co, we see the following:

- F Co is a holding company and its income arising from dividends received from foreign entities would result in immediate U.S. taxation for Mr. A under the Subpart F provisions of U.S. tax law, except to the extent an exception applies.
- To the extent Mr. A is taxed immediately in the U.S. on income of F Co, subsequent distributions received from F Co will be viewed to be distributions of

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1 Other types of tax that may be imposed on a U.S. Shareholder of a C.F.C. include the Transition Tax for pre-2018 accumulated earnings and the tax on investments of earnings in U.S. property.

2 Foreign Base Company Sales Income (Code §954(d) and Foreign Base Company Services Income (e).

3 Code §951A(c)(2)(A)(i)(II).

4 Code §951A(c)(2)(A)(i)(III).

5 Code §951A(c)(2)(A)(i)(IV).

6 Code §951A(c)(2)(A)(ii).

7 Code §951A(b)(1)(B).

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previously taxed income ("P.T.I.") for U.S. tax purposes. A distribution of P.T.I. is not subject to U.S. tax a second time.[8]

- Nonetheless, the distribution will be taxed in Country F at the time a distribution is made by F Co to Mr. A.
- In the year of distribution, Mr. A would also have a Subpart F inclusion for that year.

ORDERING RULE TO DETERMINE THE SOURCE OF ACTUAL DISTRIBUTIONS

General Rules

When a distribution is made by a C.F.C. to a U.S. Shareholder, it is important to determine the source of the distribution to determine the extent to which the distribution represents P.T.I. and non-P.T.I. As mentioned above, a distribution made by a C.F.C. to a U.S. Shareholder is not subject to U.S. tax on receipt if, and to the extent, it represents P.T.I.[9] P.T.I. broadly describes the income of a C.F.C. that has already been subject to U.S. tax in the hands of a U.S. Shareholder under any of the anti-tax deferral regimes that exist under U.S. tax law, namely Subpart F, G.I.L.T.I., Transition Tax, and investments of earnings in U.S. property.

"When a distribution is made by a C.F.C. to a U.S. Shareholder, it is important to determine the source of the distribution to determine the extent to which the distribution represents P.T.I. and non-P.T.I."

When an actual distribution is made by a C.F.C., it is important to determine its source for the following reasons:

- To determine the extent to which the distribution represents P.T.I. and the particular category of P.T.I. from which the distribution is deemed made
- To determine the U.S. tax treatment of the distribution based on the P.T.I. category it represents
- To properly adjust the P.T.I. categories to ensure that each category reflects the appropriate residual amount of P.T.I.

P.T.I. is classified into several categories based on the anti-tax deferral regimes. The following set of ordering rules is followed to determine the category of P.T.I. that serves as the source of the distribution:[10]

- First, the distribution is deemed to come from E&P that has been taxed to the U.S. Shareholder as investments of earnings in U.S. property ("U.S. Property P.T.I. E&P").[11]
- Second, to the extent the distribution exceeds the U.S. Property P.T.I. E&P, the distribution is deemed to come from the E&P that has been taxed to

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[8] Code §959(b).

[9] Code §959(a).

[10] *Ibid.*

[11] Code §959(c)(1).

the U.S. Shareholder as Subpart F Income and G.I.L.T.I.[12] ("Subpart F P.T.I. E&P") on a *pro-rata* basis.[13]

> The amount subject to the Transition Tax is treated as an increase in Subpart F income ("Transition Tax P.T.I. E&P"). The amount is treated as included in the shareholder's gross income under Code §951(a) for purposes of Code §959.
>
> The Transition Tax P.T.I. E&P is given priority when determining the group of P.T.I. from which a distribution is made.[14] This implies that the distribution is first deemed to be made out of the Transition Tax P.T.I. E&P until it is fully exhausted under the Subpart F P.T.I. E&P. Thereafter, it is allocated to the residual distribution among Subpart F and G.I.L.T.I.

- To the extent the distribution exceeds the foregoing two categories, the distribution is deemed to come out the E&P that has not been previously subject to U.S. tax at the level of the U.S. Shareholder ("Non-P.T.I. E&P").[15]

Within each of the three types of E&P categories, a distribution is first allocated to the current year E&P and then to E&P from prior years going backward in sequential order, regardless of actual source of the distribution for accounting or corporate governance purposes.[16] In other words, a distribution is first allocated to the current year U.S. Property P.T.I. E&P, then to U.S. Property P.T.I. E&P of the immediately preceding year, followed by the second immediately preceding year, and so on so forth. The allocation continues in the backward order in the same P.T.I. category until either (i) the distribution amount is fully allocated or (ii) the P.T.I. in the P.T.I. E&P category is fully exhausted. Once the earning in the U.S. Property P.T.I. category is fully exhausted, the exercise of allocating the distribution amount continues under the Subpart F P.T.I. E&P category, starting with the current year, and going back to preceding years in a sequential order (giving the Transition Tax P.T.I. E&P priority). The exercise continues under the Non-P.T.I. E&P once the Subpart F P.T.I. E&P is depleted until the distribution amount is fully allocated.

Distributions to Mr. A out of the first two categories are excluded from the U.S. Shareholder's income. Distributions from Non-P.T.I. E&P are treated as taxable dividends. Taxable dividends are subject to U.S. tax in the hands of Mr. A rates of up to 20% if the dividends are treated as qualified dividends.[17] Dividends that are not qualified dividends are generally taxed at ordinary rates of tax that are capped at

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[12] Code §951A(f)(1)(A).

[13] Code §965(b)(4)(A).

[14] Section 3.2 of Notice 2019-1.

[15] Code §959(c)(3).

[16] Treas. Reg. §1.959-3(b).

[17] Dividends distributed by a foreign corporation are treated as qualified dividends if (i) the foreign corporation is eligible for benefits under a comprehensive income tax treaty between the U.S. and the foreign corporation's country of residence, (ii) the determines the treaty is satisfactory, and (iii) the treaty includes an exchange of information program. See Code §1(h)(11)(c)(II). In no event is a dividend treated as a qualified dividend if the foreign corporation distributing the dividend a P.F.I.C. a surrogate foreign corporation under the anti-inversion rules. See Code §1(h)(11)(C)(iii)(I) and (II).

37% under current law, except that excess distributions received from a P.F.I.C. are taxed under the P.F.I.C.[18] rules. Additionally, dividends are subject to the Net Investment Income Tax imposed at the rate of 3.8%.

Application to Mr. A

F Co has never invested in property in the U.S. and therefore, no portion of its E&P represents U.S. Property P.T.I. E&P. Therefore, any distribution made by F Co to Mr. A in 2025 would be deemed first to be made out of the 2025 Subpart F P.T.I. E&P. Any distribution in excess of the 2025 Subpart F P.T.I. E&P would be deemed to be made from the immediately preceding year's Subpart F P.T.I. E&P and so on and so forth. Mr. A would not be subject to U.S. tax on the distributions as long as the distributions represent the Subpart F P.T.I. E&P.

While the distribution would not be subject to U.S. income tax, Mr. A. would be subject to local withholding tax. At the same, Mr. A would be subject to U.S. income tax on Subpart F inclusion for the year of distribution.

FOREIGN TAX CREDIT COMPLEXITY

Background

The second issue that is faced by Mr. A is whether the foreign tax on the distribution by F Co to Mr. A can be claimed as a foreign tax credit in order to reduce or eliminate U.S. tax on the Subpart F inclusion for the year of the distribution.

F Co is a holding company and its income arising from dividends received from subsidiaries would result in immediate U.S. taxation for Mr. A under the Subpart F provisions of U.S. tax law, except to the extent an exception applies. To the extent Mr. A is taxed immediately in the U.S. on income of F Co, subsequent distributions from F Co will be viewed to be distributions of P.T.I. for U.S. tax purposes. As mentioned above, a distribution of P.T.I. is not subject to U.S. tax a second time. Nonetheless, the distribution will be subject to tax in Country F at the time Mr. A receives a dividend from F Co. For Mr. A to obtain a benefit under the foreign tax credit, his adviser must have an understanding of the way in which the foreign tax credit limitation works.

General Rules

Broadly speaking, the foreign tax credit rules impose the following limitations on a taxpayer's ability to claim a credit for foreign income taxes paid against the U.S. tax liability arising from a transaction:

- The foreign tax credit reduce U.S. Federal income tax on foreign source income, only.
- The U.S. Federal income tax on income in a particular F.T.C. basket can be reduced only by foreign income taxes imposed on the income in that basket. As a result, foreign taxes in one basket cannot be used to offset U.S. Federal income tax on income in another basket.

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[18] See Code §1291 *et seq*.

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- After 2017, five foreign tax credit baskets exist for most individuals:
  - The general F.T.C. basket
  - The passive F.T.C. basket
  - The foreign branch F.T.C. basket
  - The G.I.L.T.I. F.T.C. basket
  - The F.T.C. basket for income resourced under a provision of a particular income tax treaty

The issue at hand is to determine which of the above F.T.C. baskets applies when U.S. tax on foreign source income of a U.S. individual is determined in one year under Subpart F but foreign income tax on dividend income is imposed in a following year when a dividend distribution is paid to the U.S. individual. The problem arises because foreign taxes imposed on income in one basket cannot be used to reduce U.S. tax on income in a second basket. Cross-crediting of foreign taxes among F.T.C. baskets is not permitted. Ignoring timing differences, in order for the foreign tax that is imposed on the dividend income to offset the U.S. individual's U.S. tax on the Subpart F inclusion from the C.F.C. for the same year, the dividend and the Subpart F inclusion must fall in the same basket for F.T.C. purposes.

Look-through Rules Determine F.T.C. Baskets for Dividends and Subpart F Income

Generally, dividends received by a U.S. Shareholder from a C.F.C. are not automatically treated as passive category income.[19] Rather, the general rule is replaced by the application of the look-through rules that classify the character of the dividend by looking through to the types of income earned by the C.F.C.

Look to the Earnings and Profits of the Distributing Entity to Determine the Reportable Category of Income for the Recipient of Dividends

When a U.S. Shareholder receives a dividend from a C.F.C., the earnings and profits from which the dividend is paid are examined. The U.S. Shareholder must allocate the dividend to a separate category based on the ratio of the earnings and profits attributable to income in that category to the total earnings and profits. In particular, dividends paid out of the earnings and profits of a C.F.C. to its U.S. Shareholder is treated as passive category income in proportion to the ratio of the portion of earnings and profits attributable to passive category income to the total amount of earnings and profits of the C.F.C.[20] If C.F.C. does not have any passive income, all of the dividends are general category unless a separate category applies.

The Code and the regulations do not clearly define the meaning of "total" when applied to earnings and profits. It appears that the word refers to the earnings and profits from the year or years from which the dividend is paid.[21]

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[19] Code §904(d)(3)(A); Treas. Reg. §1.904-5(b)(1).

[20] Code § 904(d)(3)(D).

[21] Treas. Reg. §1.904-5(c)(4)(iii), Ex. 1

The dividends for the look through rule include actual dividends distributed, undistributed C.F.C. earnings that are taxed to a U.S. Shareholder under Subpart F because the C.F.C. has invested them in U.S. property, and gains on sales of C.F.C. stock that are treated as dividends under Code §1248.[22]

__Dividends Subject to High Tax Exception (90%) are not Passive Notwithstanding the Look-Through Rules__

If a C.F.C. has income that would otherwise be in the passive category, but the C.F.C. is taxed on the income by foreign countries at an effective rate higher than 90% of the maximum U.S. corporate rate, earnings and profits "attributable to" the income are removed from the passive basket and are either general limitation income or income in a specified separate category.[23] The rule applies only if the U.S. Shareholder proves the effective rate to the I.R.S.'s satisfaction.[24] At the present time, the U.S. corporate tax rate is 21%, thus, the dividend reclassification rule would apply if the C.F.C. is subject to a foreign income tax at an effective rate exceeding 18.9%.

__Look-Through Rules for Certain Distributions Received in a Multi-Tiers Structure__

Look-through rules apply in a multi-tier structure when the entities are related to each other. In effect, this means that the dividend income to the receiving entity is determined with reference to the E&P of the distributing entity[25] when dividends are received from a related entity ("Related Look-Through Entities"). For this purpose, two foreign corporations are considered Related Look-Through Entities if the same person is a U.S. Shareholder of both foreign corporations.[26]

> *Example:*
>
> U.S.P., a domestic corporation, owns two foreign subsidiaries, F1 and F2. F3, is a foreign corporation in which F2 owns 40% of the stock and the remainder is owned by a U.S. person unrelated to U.S.P. If F2 receives dividends from F3, the look-through rules apply to the dividends because U.S.P. is a U.S. Shareholder of both F2 (directly) and F3 (indirectly).[27] Therefore, the category of F2's dividend income is determined with reference to F3's E&P.

The dividend look-through rule between Related Look-Through Entities applies even if one or more entities are not C.F.C.s. Thus, if the balance 60% of the ownership interest in F3 is held by a non-U.S. person, the dividend look-through rule would nonetheless apply even though F3 is not C.F.C to characterize the dividend received by F2 from F3. This characterization may then pass through to U.S.P. by a second application of the look-through rules. For example, if *F2's* dividend is Subpart F income to U.S.P., the Subpart F income will be allocated among different categories of income for F.T.C. purposes in proportion to the categorization of the dividends under the dividend look-through rule. *(The application of the look-through rule applicable to Subpart F income is explained below).*

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[22] Code §904(d)(3)(G); Treas. Reg. §§1.904-5(c)(4)(i); 1.904-5(c)(7) Ex. 2.

[23] Code §904(d)(3)(E); Treas. Reg. §1.904-5(d)(2).

[24] Treas. Reg. §1.904-5(d)(2).

[25] Treas. Reg. §1.904-5(k)(1).

[26] Treas. Reg. §1.904-5(i)(3).

[27] Treas. Reg. §1.904-5(i)(5) Ex. 2.

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Subpart F Inclusion

The Character of a C.F.C.'s Subpart F Income Flows Through to the U.S. Shareholder; Thereby Implying that the Subpart F Inclusion is Treated as Passive-Basket Income to the Extent it is Attributable to Passive Income of the C.F.C.

The character of a C.F.C.'s Subpart F income flows through to the U.S. Shareholder.[28] In other words, if a U.S. Shareholder has a Subpart F inclusion, the foreign tax credit limitation category of the inclusion depends on the nature of the income that produced it. Subpart F inclusion is treated as passive-basket income if attributable to passive income of the C.F.C., otherwise, it is deemed to be general category income or income in a specified separate category under the F.T.C. rules.[29] This tracing rule looks specifically to the income that caused the inclusion under Section 951(a)(1)(A). In comparison, the dividend look-through rule takes into account all of the income of the C.F.C.

> *Example:*[30]
>
> U.S. Co wholly owns C.F.C. In Year 1, C.F.C. earns $100x of net income, $85x of which is general category foreign base company sales income and $15x of which is passive category foreign personal holding company income. No foreign tax is imposed on income. C.F.C.'s income of $100x is Subpart F income taxed currently to U.S.P. under section 951(a)(1)(A). Because $15x of the Subpart F inclusion is attributable to passive category income of C.F.C., the inclusion is passive category income to U.S. Co. The remaining $85x Subpart F inclusion is general category income to U.S. Co.

Interplay of the Dividend and Subpart F Look Through Rules

Example[31]

Facts

U.S. Co, a domestic corporation, owns all of the stock of C.F.C. 1. In turn, C.F.C. 1 owns 40% of the stock of C.F.C. 2, a Country X corporation. The remaining 60% of the stock of C.F.C. 2 is owned by V, a domestic corporation, unrelated to U.S. Co. C.F.C. 2 owns 40% (by vote and value) of the stock of C.F.C. 3, a Country Z corporation. The remaining 60% of C.F.C. 3 is owned by unrelated U.S. persons. C.F.C. 3 earns exclusively general category income that is neither Subpart F income nor tested income. In Year 1, C.F.C. 3 made a dividend distribution of $50x to C.F.C. 2.

Analysis

1. Application of the dividend look-through rule

   a. The nature of income for F.T.C. purposes will be ascertained first at the level of C.F.C. 2 before analyzing the treatment in the hands of U.S. Co.

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[28] Code §904(d)(3)(B).

[29] Treas. Reg. §1.904-5(c)(5).

[30] Treas. Reg. §1.904-5(c)(7)(i).

[31] Treas. Reg. §1.904-5(i).

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b. The dividend look-through rule would apply only if C.F.C. 2 and C.F.C. 3 are Related Look-Through Entities. If so, the nature of the dividend income in the hands of C.F.C. 2 for F.T.C. purposes would be ascertained with reference to C.F.C. 3's E&P.

i. U.S. Co indirectly owns more than 10% of the voting power of all classes of stock of both C.F.C. 2 (40%) and C.F.C. 3 (16%). Accordingly, C.F.C. 2 and C.F.C. 3 have the same U.S. Shareholder in common.

ii. Because C.F.C. 2 and C.F.C. 3 have a common U.S. Shareholder, C.F.C. 2 and C.F.C. 3 are Related Look-Through Entities. Accordingly, the dividend look-through rules would apply.

iii. Because C.F.C. 3 has no passive category income or earnings and profits, the dividend income is characterized as general category income to C.F.C. 2.

c. Treatment of the dividend received by C.F.C. 2 in the hands of U.S. Co under the Subpart F look-through rule.

i. The dividend is Subpart F income of C.F.C. 2 that is taxable to U.S. Co.

ii. The Subpart F look-through rules pass on the character of a C.F.C.'s Subpart F income to its U.S. Shareholder.[32] Accordingly, the Subpart F inclusion of U.S. Co is general category income.

Example[33]

Facts

U.S. Co, a domestic corporation, owns 50% of the voting stock of C.F.C. 1. In turn, C.F.C. 1 owns 10% of the voting stock of C.F.C. 2. The remaining 50% of the stock of C.F.C. 1 is owned by X. The remaining 90% of the stock of C.F.C. 2 is owned by Y. X and Y are each U.S. Shareholders of C.F.C. 2, but are not related to U.S. Co, C.F.C. 1, or each other. In Year 1, C.F.C. 2 pays a $100x dividend to C.F.C. 1.

Analysis

1. Application of the dividend look-through rule

a. The nature of income for F.T.C. purposes will be ascertained first at the level of C.F.C. 1 before analyzing the treatment in the hands of U.S. Co.

b. The dividend look-through rule would apply only if C.F.C. 1 and C.F.C. 2 are Related Look-Through Entities. If so, the nature of the dividend income in the hands of C.F.C. 1 for F.T.C. purposes would be ascertained with reference to C.F.C. 2's E&P.

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[32] Code §904(d)(3)(B).

[33] Treas. Reg. §1.904-5(i)(5)(iv).

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i. U.S. Co directly owns more than 10% of the voting power and value of C.F.C. 1. However, it only owns 5% of the voting power of all classes of stock of C.F.C. 2 through C.F.C. 1.

ii. X directly owns more than 10% of the voting power and value of C.F.C. 1. However, it does not own any interest in C.F.C. 2.

iii. Therefore, C.F.C. 1 and C.F.C. 2 are not Related Look-Through Entities because no person is a U.S. Shareholder of both C.F.C. 1 and C.F.C. 2.

iv. Because C.F.C. 1 and C.F.C. 2 are not Related Look-Through Entities, the dividend look-through rule should not apply.

v. Under the general rule for categorizing income into baskets for F.T.C. purposes, dividends are treated as passive income.[34]

c. No exception to the Subpart F inclusion applies with respect to the dividends distributed by C.F.C. 2 to C.F.C. 1.[35] Therefore, the dividends represent Subpart F income of C.F.C. 1 that is taxable to U.S. Co.

d. Under the Subpart F look-through rule, a Subpart F inclusion is treated as passive-basket income if attributable to passive income of the C.F.C. Because the dividend income is characterized as Foreign Personal Holding Company Income, it is passive category income for U.S. Co.[36]

"In the facts presented at the beginning of the article, two F.T.C. baskets are in play."

APPLICATION OF THE LOOK-THROUGH RULES TO MR. A

In the facts presented at the beginning of the article, two F.T.C. baskets are in play. The first is the basket in which the Subpart F Income that arises from F Co's investments is placed. The second is the basket to which the distributions from F Co and corresponding foreign withholding tax are placed.

<u>Foreign Tax Credit Basket of Subpart F Income</u>

- As explained above, the F.T.C. basket of the dividend distributed to F Co by the underlying entities must be ascertained before analyzing the treatment of Subpart F income in the hands of Mr. A.

- The dividend look-through rule would apply to the extent F Co and the underlying entities are Related Look-Through Entities. If the two entities are related, then the F.T.C. basket of the dividend income in the hands of F Co would be ascertained with reference to the E&P of the underlying distributing entity.

- Mr. A owns 100% of F Co. Therefore, F Co would be treated as related to each underlying entity in which it owns at least 10% of the voting rights or

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[34] Code §904(d)(2)(B)(i).

[35] Because CFC2 is not a related person to CFC1 within the meaning of section 954(d)(3), section 954(c)(3) and (c)(6) are inapplicable and therefore no exception to Subpart F inclusion applies.

[36] Code §904(d)(2)(B)(i) and Treas. Reg. §1.904-4(b)(2)(i)(A).

value. Consequently, the underlying entity and F Co would have Mr. A as a common U.S. Shareholder. Therefore, the dividend look-through rule would apply.

- The dividend look-through rule looks to the E&P of the distributing entity and the dividend is allocated between passive and general category in proportion to each type of income generated by the distributing entity. Thus, assume the underlying entity is a holding company that earns only passive income. The dividends in the hands of F Co would be placed in the passive income basket for F.T.C. purposes.
- No exception to Subpart F inclusion applies with respect to the dividends distributed by the underlying entity to F Co. Accordingly, the dividend is Subpart F income of F Co that is taxable to Mr. A.
- Under the Subpart F look-through rule, a Subpart F inclusion is treated as passive-basket income to the extent attributable to passive income of the C.F.C. Because the dividend income is foreign personal holding company income, Subpart F income is passive category income to Mr. A.

Applicable Foreign Tax Credit Basket to Distributions from F Co to Mr. A When the High Tax Kickout Rule does not Apply

- The dividend look-through rule would be applied once again to determine the F.T.C. basket of the dividends distributed by F Co to Mr. A.
- Since F Co is a holding company with only passive income, the entire dividend distribution from F Co to Mr. A would be reported under the passive income basket. As a result, any withholding tax in Country F would be viewed as a tax under the passive income basket.

Since U.S. tax law places both the Subpart F income and the foreign withholding tax on the distribution to Mr. A in the passive basket, Mr. A would be allowed to offset his U.S. tax liability on Subpart F income by the withholding tax paid in Country F.

Applicable Foreign Tax Credit Basket to Distributions from F Co to Mr. A is Determined at the Level of Mr. A Under the High Tax Kick Out Rule

High Tax Kick out ("H.T.K.O.") Rule

Income received or accrued by a U.S. person that would otherwise be passive income is not treated as passive income if the income is determined to be high-taxed income at the level of the U.S. person.[37] Income is considered to be high-taxed income if, after allocating expenses, losses, and other deductions, the sum of the foreign income taxes paid or accrued, and deemed paid, by the U.S. person with respect to such income exceeds the highest rate of tax specified in Code §1 for an individual multiplied by the amount of such income (including any gross up under Code §78).[38] Ambiguity exists in the statue as to whether the highest rate of tax

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[37] Treas. Reg. §1.904-4(c)(1).

[38] The H.T.K.O. rule is distinct from the high-tax exception in that the former relates to the income tax in the hands of the shareholder when a distribution is made by the foreign corporation. On the other hand, the high-tax exception relates to the foreign tax paid by the foreign corporation on its income.

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under Code §1 is to be taken literally. If so, the H.T.K.O. is triggered if the rate is 37% (the maximum tax rate for ordinary income individuals under current law), or the rate specified for qualified dividends, which is 20%.

At the risk of being repetitious, the H.T.K.O. rule is applied at the U.S. Shareholder level, not at the C.F.C. level.[39] Income that is passive under the applicable rules (before applying the H.T.K.O. rule) received by the C.F.C. is not reclassified as general category income at the C.F.C. level but will retain its passive character under the look-through rules when it passes to the U.S. Shareholder. The H.T.K.O. rule then applies at the level of the U.S. Shareholder to determine whether the income retains its passive status or is moved to the general category. For example, if a foreign tax is imposed on a dividend distribution from a C.F.C. to its U.S. Shareholder that is viewed as passive income under the dividend look-through rule, the dividend should retain its look-through character as passive income unless the foreign tax is high enough to trigger the high tax kick out at the U.S. Shareholder level, taking into account the allocation of expenses. If so, the income would be treated as a general category income for the U.S. Shareholder.[40]

If the withholding tax rate in Country F on dividends is greater than 20%, and assuming that is the triggering rate of tax for applying the H.T.K.O. rule, the F.T.C. basket for the dividends would be altered. So, let's assume the withholding tax rate in Country F is 25%. Since the tax rate on dividends in Country F is higher than the highest tax rate in the U.S. on qualified dividends (20%), the income is treated as high-taxed income. On the other hand, it could be argued that the triggering rate for application of the H.T.K.O. rule is 37%. Under this view the H.T.K.O. rule would not be triggered.

U.S. tax regulations[41] address the issue in the following way:

1. Any increase in taxes paid when a taxpayer receives an amount excluded from income under the P.T.I. provisions generally are not considered in judging whether the original inclusion as Subpart F income was high-taxed income.[42] Thus, additional taxes triggered by an actual distribution do not require a redetermination of the treatment of the originally included Subpart F income.

2. The next issue is to determine which basket receives the foreign taxes paid in the later year in which the taxpayer receives a P.T.I. distribution.[43]

3. If the original inclusion was H.T.K.O. income, the later taxes fall in the general basket.[44] In other words, the later taxes are treated as additional "high taxes," which are subject to the H.T.K.O. rule.

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39 Code §904(d)(3)(F)(i).

40 See H.R. Rep. No. 100-795, at 214 (1988).

41 Treas. Reg. §1.904-4(c)(6)(iii).

42 Treas. Reg. § 1.904-4(c)(6)(i).

43 Treas. Reg. § 1.904-4(c)(6)(iii)

44 *Ibid.*

4. If the item of income is not considered to be high-taxed income in the year in which Subpart F income is recognized, the taxpayer treats the increase in foreign taxes imposed on subsequent distributions in the following way.

   a. First, the gross income in the year of inclusion under Subpart F is multiplied by the highest rate of tax in Code §11, currently 21%. The foreign tax paid in the year of distribution to the extent of the amount so determined is treated as foreign taxes paid or accrued on passive category income.

   b. Second, taxes paid or accrued on the distribution in excess of the foregoing amount are treated as taxes related to the same category of income to which such inclusion would have been assigned had the income been treated as high-taxed income in the year of inclusion. The choices are general category income or Code §951(A) income.

   c. If these additional taxes are not creditable in the year of distribution, the carryover rules of Code § 904(c) apply. Note that no carryover is permitted regarding excess foreign taxes imposed on income taxed under Code §951A.

Therefore, Mr. A is subject to the H.T.K.O. rule as follows:

1. No foreign income taxes are paid by Mr. A in the year income is included on a U.S. tax return by reason of Subpart F.

2. In the subsequent year, when Mr. A receives an actual dividend from F Co, a portion of the income will be passive basket income, and a portion of the income will be treated as general basket income. Assuming a tax rate of 25% and a distribution from F Co of $100, the basket computation is as follows:

   a. Mr. A reports Subpart F income in year 1, when F Co recognizes net dividend income in the amount of $100. The income is passive is basket income for foreign tax credit purposes. There are no foreign taxes to take into account.

   b. Mr. A reports foreign taxes in year 2, when the dividends are distributed by F Co. In that year, he incurs foreign tax of $25. Of that amount, $21 is allocated to the passive F.T.C. basket and $4 is allocated to the general F.T.C. basket.

   c. If the facts of years 1 and 2 are repeated in years 2 and 3, so that F Co receives the same amount of dividend income in year 2 and distributes the same amount of dividends to Mr. A in year 3, the foreign taxes paid in year 2 by Mr. A in connection with the dividend he receives in year 2 should be available to offset the U.S. taxes in year 2 that are imposed on the passive basket Subpar F income in year 2.

   d. If in year 2, F Co receives no dividends, the unused foreign income taxes of Mr. A that are in the passive F.T.C. basket for year 2 are available to be carried back and claimed as a credit against U.S. tax on passive income in year 1.

CONCLUSION

As mentioned at the beginning of this article, the foreign tax credit provisions are among the most complicated areas of the Code, especially for U.S. individuals who are U.S. Shareholders for Subpart F purposes. One might say that the applicable I.R.S. regulations provide guidance only to those having a full understanding of the rules prior to reading the regulations.

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