Taxation of Dividends from Foreign Corporations

By Anthony Malik

Anthony ("Tony") Malik examines U.S. shareholder taxation upon their accessing foreign corporations’ earnings in the form of cash dividends.

U.S. persons frequently own legal entities abroad to pursue a variety of economic interests. Common U.S. ownership scenarios include expatriates forming foreign entities to locally operate businesses, U.S. residents forming foreign entities to capitalize on expansion opportunities, and entrepreneurial immigrants coming to the United States. More often than not, these foreign entities default to corporate status à la the tax law’s default classification regime.1 While the varying reasons for foreign corporate ownership2 are premised on myriad nontax considerations, there are a slew of specific tax considerations that, for the most part, concern all U.S. owners. One of these tax considerations pertains to accessing the foreign corporations’ earnings. This article will focus on U.S. shareholder taxation upon their access to these earnings in the form of cash dividends.3

Unarguably, consulting a U.S. owner of a foreign business lies firmly within the purview of the practice of international taxation. As in most all international tax determinations, it is imperative for practitioners to be aware of the special considerations, and modifications and exceptions to domestic tax rules, when analyzing an international transaction. The payment of dividends from a foreign, rather than a domestic, corporation is no exception. Treating a shareholder’s foreign dividends solely under the same rules and assumptions applicable to purely domestic dividends is improper and will inevitably translate into U.S. income tax noncompliance on behalf of the shareholder. As such, practitioners must necessarily traverse beyond the periphery to gain an understanding of the economic backdrop to the dividend distribution. As we will learn, the relevant factual and financial information will govern the U.S. tax treatment of foreign dividends.

In the ensuing sections, this article will explore two common tax implications concerning U.S. owners upon receipt of dividends from their foreign businesses, i.e.:
资格文件中的第i条不资本利得税率

为了使主题变得可管理，本文将假设股息将由外国公司的池中支付。目前的股利和利润。此外，为了保持同样的目的，本文将仅考虑股息在正常业务期间的事件，而且不会深入特殊的情况，这些情况触发股利收入，例如被视为股利分派、股票赎回、公司解散或外国股东的销售。

资格文件中的第ii条不资本利得税率

作为国内税法的延伸，股息在国际税法的实践中也被分为“非合格”和“合格”两种类型。这方面的分隔，以及与之相随的术语，是非常重要的，因为这两种股息类型被征税的方式是不同的。具体来说，非合格股息通常被按普通收入税率征税，而合格股息则是按资本利得税率征税。非合格股息税率通常低于普通收入税率。因此，几乎总是对美国个人（“USI”）有利，他们可以申报股息收入，而不是按普通收入税率征税。幸运的是，外国公司支付的股息可以按有利的资本利得税率征税，这表明某些要求已经得到满足。

留存收益

作为基础条件，合格股息需要满足的一些要求。首先，从受益人那里获得股息的事件必须发生在股票的除息日之前。其次，股票必须在除息日之前被持有至少60天。最后，股票必须在除息日之后的121天内被处置。这要求有效排除纳税人从满足有利的资本利得税率的条件。

“合格的外国公司”

如果需要满足额外或不寻常的情况，则通常情况下，所有属于紧密控股私人企业的所有者都按有利的资本利得税率征税。然而，在这种情况下，资本利得税的适用范围可能受到其所有者所在国的限制。大多数税法专家无疑会意识到该条件，因为它也适用于持有国内公司股票的必需条件。

授权的外国公司

根据授权的外国公司（“QFC”）的相关规定，外国公司支付的股息将被征税。在某种程度上，这将对美国个人有利。因此，对于美国个人而言，优先考虑的是可以申报股息收入，而不是按普通收入税率征税。幸运的是，外国公司支付的股息可以按有利的资本利得税率征税，这表明某些要求已经得到满足。

保持上述条款在脑海中，它值得注意的是，美国与某些国家之间的条约关系在确保其主权领土范围内不具有充分的资格地位。因此，根据最新的可用指南，财政部已经明确规定，授权的外国公司的地位（“Treaty”）。

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Kingdom) to the exotic (e.g., Egypt and Thailand) to the rather unexpected (e.g., Venezuela).

Axiomatically enough, dividends from corporations chartered in foreign jurisdictions besides those currently included in the Treasury’s list of 57 do not qualify to be taxed to their recipients at the favorable rates. Notwithstanding, the Treasury has publicized its intention to continually update this list as appropriate and thus it is imperative for practitioners to always seek the latest official guidance on this particular matter.

Foreign Tax Credit Considerations

The FTC mechanism, as applicable to dividends, particularly qualified dividends, from foreign corporations, bears special considerations for U.S. owners of foreign businesses and their tax advisors alike. Consider that a USI would likely be taxed abroad were the USI to carry on a trade abroad as a sole proprietor. USI could generally credit the foreign income taxes against the U.S. tax liability on their foreign source income. Suppose instead that USI operates a trade abroad through a foreign corporation. Normally, the earnings of the foreign corporation are unexposed to U.S. taxation because the income is foreign source and is earned by a foreign person. Consequently, USI is not entitled to a FTC in the United States. Nonetheless, once the foreign corporation makes a dividend distribution to USI, they could generally credit the foreign income taxes withheld from, or otherwise levied on, the dividend income in their hands.

Income Categorization

This brings us to the question of income categorization of the foreign dividends for FTC purposes. Determining the appropriate categorization of the income is a necessary first step because the law requires the computation of the FTC limitation for each separate category of foreign source income. Dividends are generally categorized as passive category income. However, it is critical for tax practitioners to know that the general rules for income categorization are inapplicable in cases where a USI owns at least 10 percent of the voting stock of a foreign corporation. This minimum ownership mark is virtually always met by USI owners of closely-held foreign businesses.

Instead such a USI is required to “look through” any distributions of items of income to the distributing foreign corporation’s underlying income, i.e., the income items continue to retain their categorization in the hands of the USI as if the USI directly, and not indirectly through a foreign corporation, earned and received the items of income. There is, therefore, a preservation of the symbolic order upon categorical inheritance by the items of income upon transfer. Looking through the distributions to the underlying income of the foreign corporation is a gesture of symbolic exchange wherein the USI first forms a foreign legal entity to transact business abroad, and then the USI—the true business operative—upon receipt of the income assumes the foreign entity’s income categorization upon oneself. In this regard, dividend distributions from the USI’s foreign business would most likely be categorized as general, not passive, category income in the hands of the USI.

Treating a shareholder’s foreign dividends solely under the same rules and assumptions applicable to purely domestic dividends is improper and will inevitably translate into U.S. income tax noncompliance on behalf of the shareholder.

Obviously, simply relying on perfunctory knowledge of the general categorization rules will cause noncompliance and invariably create exposure on behalf of the USI. Compliance oriented tax practitioners who rely heavily on tax preparation software are most likely particularly vulnerable to habitual malpractice in connection with this issue.

Technical Complexities

Irrespective of categorization, foreign qualified dividends introduce technical complexities to the FTC mechanism. Before delving straight into the adjustments required to the FTC calculation upon receipt of foreign qualified dividends, it will be helpful to briefly discuss the limitations built into the FTC mechanism.

Most thoughtful tax generalists will no doubt point out that the FTC mechanism functions to reduce or eliminate the possibility of double taxation. However, most practitioners will probably not readily conceive that the FTC mechanism inconspicuously achieves yet another goal all at once: to ensure that the United States preserves its right and ability to tax the income that it is entitled to tax. The FTC mechanism is thus not a simple embodiment of taxpayer welfare. It instead dualistically encapsulates both relief and imposition that belong to a long line of pro-taxpayer provisions stretching from the partial exemption...
of social security benefits to the eventual taxation of distributions from a traditional individual retirement account. To this effect, the FTC is subject to a slew of limitations designed to route funds from the taxpaying public to the government’s coffers. An elementary limitation of the FTC is that it cannot go beyond the excesses of the lesser of the following two amounts:

- The foreign taxes paid or accrued
- The U.S. taxes (pre-FTC) on foreign source taxable income

Computationally, the basic FTC limitation is derived as follows:

\[
\text{Foreign source taxable income} \times \text{U.S. tax on worldwide taxable income (pre-FTC)}
\]

Considering both the limitation formula above and the fact that qualified dividends are taxed at the favorable net capital gains tax rates, one should realize that computing the FTC limitation for each separate category of foreign source income using a given USI’s tax liability for a given year would result in an artificially-inflated FTC limitation. This unintended benefit would result because the ultimate U.S. tax liability of a USI in a given year would include taxes levied on items of income for which the tax rates would be higher than those applicable to foreign qualified dividends. In essence, statically following the formulaic approach would artificially inflate the amount of the pre-FTC U.S. taxes attributable to foreign qualified dividends. Resultantly, in the absence of any modifications to the FTC limitation formula, USIs would be able to claim a larger FTC than they would be properly entitled to by crediting foreign taxes against U.S. taxes levied on U.S. source income.

To remedy this discrepancy, the law imposes yet another limitation on the FTC computation. It effectuates this result by requiring USIs to reduce their numerator by the rate differential applicable to qualified dividends. Accordingly, USIs whose foreign qualified dividends are taxed at the 15- and 20-percent rates are required to multiply the amount of their foreign qualified dividends in each separate category by 0.3788 and 0.5051, respectively, and use the resulting amounts as their foreign qualified dividends for purposes of computing their categorical FTC limitation. Untaxed (i.e., taxed at the zero-percent rate) foreign qualified dividends are simply disregarded for FTC computation purposes. The rate differential also has a corresponding effect on the denominator of the FTC formula, i.e., USIs must reduce their denominator by the rate differential as well.

The consequence of these adjustments is that it produces the effect of a single tax rate by lowering the amount of preferably taxed income going into the FTC limitation formula to reflect more precisely the actual U.S. tax on that income. These adjustments accomplish this goal in an imprecise way as they are applied on the basis of a USI’s highest applicable tax rate rather than the USI’s effective tax rate on their ordinary taxable income. However, this slight transgression is purely formal: it lies in the operation of the law without producing an ultraprecise legislatively intended result. Nonetheless, in the grand scheme of things, the adjustments pragmatically represent legislative aims and intents without unduly burdening taxpayers with mathematical theatrics.

**Conclusion**

Dividend distributions from the foreign businesses of USIs trigger myriad international tax consequences. Some other tax consequences, not discussed herein, include procedures for claiming favorable foreign country withholding rates pursuant to applicable international tax treaties, deemed dividends triggered pursuant to an anti-deferral regime, the extent of the applicability of the net investment income tax, impact on the USI’s basis in his or her stock of the foreign corporation and so on. Needless to say, this article is obviously not a treatise on this subject and should certainly not be relied upon as a practice guide. Of course, any tax practitioner intending to serve a U.S. owner of a foreign business must necessarily develop a firm understanding of the U.S. international tax regime. This piece is simply an elucidation of the two most common issues that mystify general tax practitioners with the goal of helping them to develop an appreciation for, and inspiring them to further their understanding about, the practice of international taxation.

**ENDNOTES**

1. Under the current default rules, foreign business entities are automatically classified as corporations if their owners enjoy limited liability. Reg. §301.7701-3(b)(2)(i).
2. The foreign corporations referred to herein should be construed as “controlled foreign corporations” within the meaning of Code Sec. 957(a).
3. This article explores the taxation of U.S. individual shareholders—not U.S. parent business entity shareholders, the taxation of which could be altogether different.
4. Form 1099-DIV, in a domestic context, characterizes dividends as ordinary dividends and qualified dividends. The term “ordinary dividends” includes both qualified and nonqualified dividends. It is highly unlikely for foreign corporations to issue Forms 1099-DIV to their U.S. shareholders.
5. Net capital gains are the excess of net long-term capital gains over net short-term capital.
losses. Code Sec. 1(h)(1).

6 Code Sec. 1(h)(11).

7 The net capital gains tax rate for individuals is 20 percent for taxpayers in the 39.6-percent regular income tax bracket; 15 percent for the 25-, 28-, 33-, or 35-percent regular income tax brackets; and zero percent for the 10- or 15-percent regular income tax brackets. Code Sec. 1(h)(1).

8 Beyond the two requirements discussed herein, there are two additional requirements that will not be discussed as they pertain to foreign stock ownership vis-à-vis portfolio investment, and not as a consequence of business ownership. The first requirement mandates that dividends must be paid by a foreign corporation whose stock is publicly listed on an established U.S. securities exchange. The second requirement is that dividends must be paid to shareholders who do not hold long and short positions in the stock. Code Secs. 1(h)(11)(C)(i)(I) and 1(h)(11)(B)(ii)(ii). Code Sec. 246(c)(3)(A).


11 Code Sec. 904(b)(2)(B)(i); Reg. §1.904(b)-1(c)(2).

12 Code Sec. 901, subject to certain limitations, allows for a direct foreign tax credit in such situations. U.S. individual, partnership and S-corporation shareholders are not entitled to claim the indirect foreign tax credit allowable only to C-corporation shareholders upon the receipt of a dividend under Code Sec. 902. The indirect foreign tax credit essentially enables a domestic C-corporation shareholder to claim a credit for taxes paid by the foreign subsidiary with respect to the income used to make the dividend payment.

13 Code Sec. 904(d).


15 Code Sec. 904(d)(2).

16 Id.

17 Code Sec. 904.

18 Code Sec. 904(a).

19 A USI’s taxable income is computed without any deduction for personal exemptions. Code Sec. 904(b)(1).

20 Code Sec. 904(b)(2)(B)(i); Reg. §1.904(b)-1(c)(2).

21 Suringa, 6060 T.M., The Foreign Tax Credit Limitation Under Section 904.

22 The regulations provide a safe harbor for certain noncorporate taxpayers with a limited amount of foreign qualified dividend and net capital gains income. See Reg. §1.904(b)-1(b)(3).

23 Code Sec. 904(b)(2)(B)(ii); Reg. §1.904(b)-1(c)(2).

24 Instructions, Form 1116 (2015), at 7.

25 Id.

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27 Code Sec. 904(d).


29 Code Sec. 904(d)(2).

30 Id.

31 Code Sec. 904(b)(2)(B)(ii); Reg. §1.904(b)-1(c)(2).

32 The anti-deferral regime applicable to CFCs is subpart F. See Code Sec. 952.