FOREIGN TAX CREDITS: GENERAL PRINCIPLES AND AUDIT RISKS

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The foreign tax credit ("F.T.C.") is a keystone of U.S. outbound tax legislation. Its purpose is to alleviate the burden of double taxation in the presence of income subject to both U.S. tax and foreign tax. The main provisions of the Internal Revenue Code of 1986 as currently in effect (the "Code") addressing F.T.C. are found in Code §§901 to 909.

The I.R.S. Large Business and International Division ("LB&I") has published several International Practice Units that serve as training aids for examiners.[1] In doing so, LB&I has provided taxpayers with a good sense of the areas on which the I.R.S. will focus during an examination. Nevertheless, these materials cannot be used or cited as precedent by taxpayers.[2]

A recent practice unit, "F.T.C. General Principles," was published by LB&I on April 11, 2017. It deals with the general principles of F.T.C. applicable to individuals (the "Practice Unit"), and discusses the limitations under Code §904. More specifically, it addresses the following:[3]

- Basic concepts of the F.T.C.
- Identification of taxpayers eligible to claim the F.T.C.
- Foreign taxes that qualify for the F.T.C.
- F.T.C. versus foreign tax deduction
- Carryback and carryover of unused F.T.C.

OVERVIEW OF F.T.C.'S UNDER CODE §901

General

As a general rule, and upon election, eligible taxpayers can offset the U.S. taxes due on their non-U.S. sourced income by the creditable foreign tax paid or accrued on such income.[4]

Eligible Taxpayers

For purposes of claiming the F.T.C., eligible taxpayers, although to different extents,

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1 See our articles relating to other International Practice Units here.

2 "Practice Units," I.R.S., April 24, 2017.

3 "LB&I Concept Unit: Knowledge Base - International," I.R.S., February 28, 2017.

4 Code §901(a); absent an election, foreign taxes are generally allowed as a deduction under Code §§164(a)(1) and 275(a)(4).

are the following:

- U.S. citizens and U.S. corporations[5]
- Residents[6] of the U.S. or Puerto Rico[7]
- Alien residents[8] of the U.S. or Puerto Rico[9]
- Certain nonresident individuals of the U.S. and certain non-U.S. corporations[10]
- Certain U.S. beneficiaries of estates or trusts, certain U.S. partners, and certain U.S. settlors of grantor trusts[11]

This article is limited to the F.T.C. as applicable to U.S. individuals. For this purpose, a U.S. individual is any of the following:

- A U.S. citizen
- A U.S. green card holder[12]
- A U.S. resident individual as defined for purposes of the substantial presence test of Code Section 7701(b)(3)

"The amount of tax actually withheld by a foreign country isn't necessarily 100% creditable."

Creditable Taxes

The creditable taxes are defined as any "income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States."[13]

Treasury Regulations provide extensive rules as to what constitutes a creditable tax.[14] Those rules are summarized in the Practice Unit as payments that meet the following four requirements:

- The tax must be the legal and actual foreign tax liability.
- The tax must be an income tax (or a tax in lieu of an income tax).
- The tax must be imposed on the taxpayer.
- The taxpayer must have paid or accrued the tax.

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5 Code §901(b)(1).

6 *I.e.*, U.S. green card holders.

7 Code §901(b)(2).

8 *I.e.*, individuals meeting the substantial presence test of Code §7701(b)(3).

9 Code §901(b)(3).

10 Code §901(b)(4); but only with respect to foreign source income that is treated as effectively connected with a U.S. trade or business.

11 Code §901(b)(5).

12 Code §7701(b)(1)(A)(i).

13 Code §901(b)(1).

14 Treas. Reg. §1.901-2.

Thus, the amount of tax actually withheld by a foreign country isn't necessarily 100% creditable. For example, if Country X withholds $25 from a payment made to a U.S. individual, but under the income tax treaty between the U.S. and Country X, only $15 can be withheld under the circumstances, only $15 will be eligible for the F.T.C.

Credit or Deduction

For individual taxpayers, the F.T.C. is generally claimed on Form 1116, *Foreign Tax Credit*.[15] Limited exceptions apply to allow individuals to make the election on their U.S. tax return. If no election to claim the F.T.C. was made, individuals who choose to itemize their deductions may do so on Schedule A, *Itemized Deductions*, of their U.S. tax return.[16]

Whether an F.T.C. is claimed or a deduction is taken, the same treatment must apply to all foreign taxes paid or accrued in that given year.[17] Exceptions apply in certain circumstances, for example, when credit is disallowed with respect to foreign source dividends because the minimum holding period required was not met,[18] and when credit is disallowed because of the boycott rules.

Refunds or credits for overpayment of taxes attributable to foreign taxes paid or accrued can be claimed within 10 years from the filing date of the return for the year in which the taxes were actually paid or accrued.[19] This is an extended period compared to the general three-year rule applicable to other refund claims.

During this same 10-year period, the taxpayer can change its election to claim an F.T.C. and instead deduct the foreign tax, and vice versa.[20] However, note that a refund claim relating to a deduction of foreign tax doesn't benefit from the extended period that a refund claim relating to the F.T.C. benefits from.

While the I.R.S. generally has three years as of the filing date to assess additional taxes,[21] the I.R.S. has an unlimited statute of limitations to assess U.S. taxes that become due as a result of a redetermination of a foreign tax claimed as a credit. For that purpose, taxpayers who receive a refund of foreign taxes that were claimed as an F.T.C. must notify the I.R.S. of the refund.[22]

F.T.C. LIMITATIONS UNDER CODE §904

General Limitation

Since the purpose of an F.T.C. is to avoid double taxation, but not to reduce U.S. income tax on other income, the F.T.C. claimed is generally limited to the lesser of

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[15] Treas. Reg. §1.905-2(a).

[16] Code §§164(a)(1); 275(a)(4).

[17] Treas. Reg. §1.901-1(c).

[18] The required holding period is at least 16 days within the 31-day period that begins 15 days before the ex-dividend date.

[19] Code §6511(d)(3).

[20] Treas. Reg. §1.901-1(d).

[21] Code §6501(a).

[22] Code §§6501(c)(5); 905(c)(3).

(i) the foreign tax paid or (ii) the U.S. tax that is due on the foreign taxable income.[23]

The Practice Unit provides the following example to its agents:

> Assume country Y's tax rate is 46% and the U.S. tax rate is 35%. Taxpayer B pays $46 of foreign tax on $100 of income earned in country Y. Taxpayer B earned no other foreign source income, but earns $50 of U.S. source income. If the foreign tax were fully creditable, the after-credit U.S. tax on the $100 country Y income would be a negative $11 ($35 of pre-credit U.S. tax less $46 of credit). The credit would not only reduce U.S. tax on the country Y income, but also reduce U.S. tax on U.S. source income by $11. The latter effect is not necessary to alleviate double taxation.
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> […] In the above example, IRC 904(a) will limit the FTC to $35, the lesser of the foreign tax paid or the U.S. tax on the foreign source income.

The F.T.C. limitations must generally be computed separately for passive-type income and for general income ("income baskets").[24] Additional baskets include, *inter alia*, certain income resourced by treaty and foreign income paid from certain countries with which the U.S. has no diplomatic relations or that the U.S. has designated as repeatedly providing support for acts of international terrorism. These limitations are beyond the scope of this article.

Carryforward and Carryback

An F.T.C. in excess of the limitations ("excess credit") can be carried back one year and then carried forward 10 years.[25] This carryback and carryforward must be done separately for every basket.[26] It enables a taxpayer to use its excess credit in a year in which the taxpayer's limitation amount exceeded the taxpayer's creditable taxes ("excess limit").

The Practice Unit provides the following example:

> Assume all foreign income is general category income for 2014 and 2015. The limit on the credit and the qualified foreign taxes paid on the income are as follows:

Tax Year	Limit on F.T.C.	Tax Paid	Unused Foreign Tax (+) or Excess Limit (-)
2014	$200.00	$100.00	($100.00)
2015	$300.00	$500.00	$200.00

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[23] Code §904(a).

[24] This section applies for post-2006 income. Prior to 2007, there were eight separate categories that were eliminated by the American Jobs Creation Act of 2004.

[25] Code §904(c).

[26] Code §904(d)(1).

In 2015, the taxpayer has unused foreign tax of $200 to carry to other years. The taxpayer is considered to have paid this unused foreign tax first in 2014 (the first preceding tax year) up to the excess limit in that year of $100. The taxpayer can then carryover the remaining $100 of unused tax.

CONCLUSION

While taxpayers often believe that the concept of the F.T.C. is easy, and that no double taxation would apply as the U.S. will credit on a dollar-to-dollar basis any foreign tax paid, the actual computation of an F.T.C. is not that straight forward and tax leakage may nevertheless occur. The F.T.C. should be carefully examined as it constitutes an important element in an internationally mobile client's income structuring.

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