

LB&I Concept Unit

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General Overview

FTC (Business) General Principles

This Practice Unit discusses the following business Foreign Tax Credit (FTC) general principles. The Unit addresses the FTC as changed by the Tax Cuts and Jobs Act of 2017 (TCJA).

- Basic concept of FTC
 - Modified world-wide taxation
 - Double-taxation
 - Foreign tax credit limitation
- Taxpayers eligible to claim FTC
 - Domestic corporations
- What foreign taxes qualify for the FTC?
- Types of FTCs available
- Section 78 Gross-Up
- Foreign tax credit vs. foreign tax deduction
 - Annual election to claim FTC made on Form 1118
- Carryback and carryforward of unused credit
- Other changes made by TCJA

Detailed Explanation of the Concept

FTC (Business) General Principles

Basic Concept of FTC

Analysis	Resources
<p>The credit for foreign income taxes paid was first introduced into U.S. tax law by the Revenue Act of 1918. The existence of the credit is a testament to the recognition that some mechanism is needed to mitigate double taxation that results when income earned in a foreign country is taxed by both the United States and the foreign country. Since the United States taxes its domestic corporations on their directly-earned worldwide income, double taxation typically occurs whenever a U.S. corporation is taxed by a foreign country. Consider the following example:</p> <p>A U.S. corporation earns interest income from a Country X bank account. This U.S. corporation must pay income taxes to Country X on the interest, but also as a U.S. corporation must pay taxes on its worldwide income to the U.S., including income earned in Country X. As such, the Country X interest income is taxed by both the U.S. and Country X. This is double taxation.</p> <p>In order to alleviate the effects of double taxation, subject to certain limitations, the U.S. provides an FTC to the U.S. taxpayer above. The FTC reduces a U.S. taxpayer's U.S. tax liability by all or by part of the foreign taxes paid or accrued during the year. The FTC is generally limited to the lesser of the foreign tax paid or the U.S. tax on the foreign income. If in the above example, the U.S. taxpayer paid \$30,000 of income tax to Country X, but the U.S. tax on the same income earned in Country X is \$21,000, the FTC is limited to \$21,000.</p>	

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

Analysis

As discussed earlier, the FTC is designed to alleviate double taxation when the foreign source income is taxed by both the United States and a foreign country. It is not generally the purpose of the FTC, however, to reduce U.S. income tax on other income that is unrelated to the foreign taxes paid. Consider the following example:

Assume Country Y's tax rate is 30% and the U.S. tax rate is 21%. Taxpayer B pays \$30 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 of Country Y income would be a negative \$9 (\$21 of pre-credit U.S. tax less \$30 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 \$9. The latter effect is not necessary to alleviate double taxation.

Under IRC 904(a), the credit for foreign income taxes is limited to an amount equal to the precredit U.S. tax on the taxpayer's foreign source income. In the above example, IRC 904(a) will limit the FTC to \$21, the lesser of the foreign tax paid or the U.S. tax on the foreign source income. The taxpayer is allowed to carry back the excess foreign tax credit of \$9 to the preceding tax year and carry over any unused portion for 10 taxable years, as explained later.

Resources

- IRC 904(a)

- IRC 904(c)

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles	
Analysis	Resources
<p>For corporations, subsequent to the TCJA, there are six separate categories of income for which a separate FTC limitation must be calculated. This applies to taxable years beginning after 12/31/2017.</p> <ul style="list-style-type: none">▪ Global Intangible Low-Taxed Income (GILTI) under IRC 951A▪ Foreign Branch income▪ Passive income▪ Income from certain sanctioned countries under IRC 901(j)▪ Certain income resourced by tax treaty▪ General category income <p>It is not within the scope of this Practice Unit to discuss the complex limitation rules under IRC 904.</p>	<ul style="list-style-type: none">▪ IRC 904(d)

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

Taxpayers Eligible to Claim FTC

Analysis	Resources
<p>IRC 901(b) allows the following categories of taxpayers to claim the FTC:</p> <ul style="list-style-type: none">I. U.S. citizensII. U.S. residents (green card holders or those who meet the substantial presence test)III. Bona fide residents of Puerto RicoIV. Domestic corporationsV. Any person described in I through IV who is a member of a partnership or a beneficiary of an estate or trust may claim as a credit a proportionate share of the qualifying foreign taxes paid or accrued by the entity <p>Nonresident aliens (NRAs) and foreign corporations generally cannot claim the FTC because they are not taxed by the U.S. on their foreign source income. However, when an NRA or a foreign corporation is engaged in a trade or business in the U.S., they are taxed on their effectively connected income (ECI) and may claim a FTC for foreign income taxes paid with respect to the ECI, provided the tax is not imposed solely because of residency or citizenship, or with respect to a foreign corporation's place of incorporation or domicile.</p> <p>Discussion of taxpayers other than domestic corporations is beyond the scope of this Practice Unit. As such, the IRC 962 election for individuals to claim FTCs on IRC 951 Subpart F income and IRC 951A GILTI will be covered by another Practice Unit.</p>	<ul style="list-style-type: none">▪ IRC 901(b)▪ Treas. Reg. 1.901-1(a)▪ IRC 906

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

What Foreign Taxes Qualify for an FTC?

Analysis	Resources
<p>In order for a foreign tax to qualify for the FTC, the following four general criteria must be met:</p> <ul style="list-style-type: none">I. The tax must be the legal and actual foreign tax liabilityII. The tax must be an income tax (or a tax in lieu of an income tax)III. The tax must be imposed on the taxpayerIV. The taxpayer must have paid or accrued the tax	<ul style="list-style-type: none">▪ Treas. Reg. 1.901-2

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

Type of FTC Available - Direct FTC

Analysis	Resources
Direct credits are foreign taxes paid or accrued by the U.S. taxpayer on foreign branch income, as well as withholding taxes paid on Fixed, Determinable, Annual or Periodic (FDAP) income received, and the taxpayer's distributive share of taxes paid or accrued to a foreign country by a partnership, an S corporation, or a trust or other flow-through entity.	<ul style="list-style-type: none">▪ IRC 901

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

Type of FTC Available - Indirect (or deemed paid) FTC

Analysis	Resources
<p>Indirect or deemed paid credits are for taxes paid by foreign corporations with 10 percent domestic corporate shareholders for pre-2018 tax years, in connection with dividends and subpart F inclusions, including deemed repatriations under IRC 965.</p> <p>For post-2017 tax years, indirect or deemed paid FTCs are based on foreign income taxes paid by controlled foreign corporations and deemed paid by a U.S. domestic corporation that has a subpart F or GILTI inclusion and meets the U.S. shareholder ownership threshold.</p> <p>As such, taxpayers may be eligible for indirect or deemed paid FTCs related to:</p> <ul style="list-style-type: none"> ▪ Subpart F inclusions under IRC 951(a)(1)(A); No foreign income taxes are deemed paid with respect to an IRC 956 investment in U.S. property inclusion under Section 951(a)(1)(B) ▪ Distributions from previously taxed earnings and profits ▪ GILTI inclusions under IRC 951A ▪ Dividends and deemed repatriations under subpart F, including IRC 956 and 965, in pre-2018 tax years 	<ul style="list-style-type: none"> ▪ IRC 902 (Repealed by TCJA) ▪ IRC 965 ▪ IRC 960 ▪ IRC 951(a)(1)(A) ▪ IRC 951(a)(1)(B) ▪ IRC 951A ▪ IRC 956 ▪ IRC 965

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

Section 78 Gross-Up

Analysis	Resources
<p>The indirect or deemed paid credits claimed by a U.S. shareholder are required by IRC 78 to “gross-up” any such inclusion by the amount of the deemed paid FTC and that such indirect FTC is treated as a dividend. When a U.S. shareholder is deemed to have paid taxes on behalf of its foreign subsidiary, the Section 78 gross-up ensures the parent reports the same amount of income and foreign taxes that it would have reported if the U.S shareholder earned the income directly, rather than through its foreign subsidiary.</p> <p>The IRC 78 gross-up is included in the same IRC 904 category to which the taxes are allocated when they are deemed paid by the U.S shareholder.</p> <p>As a result of TCJA, the gross-up concept has been extended to GILTI inclusions. While the U.S. shareholder meeting the 10% ownership threshold of a GILTI inclusion is allowed an 80% deemed paid foreign tax credit on the amount of foreign taxes paid by the foreign corporation attributable to the GILTI inclusion, the IRC 78 gross-up is based on 100% of the inclusion.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.78-1▪ Treas. Reg. 1.904-4(o)▪ IRC 960(d)

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

Foreign Tax Credit vs Foreign Tax Deduction

Analysis	Resources
<p>Taxpayers can make an annual election to claim the FTC or choose to deduct the foreign taxes. Taxpayers may claim a credit in one year and a deduction in the following year, or vice versa. If a taxpayer chooses to claim an FTC, it has to complete Form 1118.</p> <p>Once an election is made to either claim a credit or a deduction, all foreign taxes must be treated the same way for that particular year. In other words, if the taxpayer chooses to take a credit for qualified foreign taxes, it must take the credit for all of the foreign taxes paid or accrued; the taxpayer cannot take a credit for some foreign taxes and a deduction for others. Exceptions to this rule permit deductions for certain taxes for which credit is disallowed even though a credit is claimed for all other foreign taxes. Conversely, if the taxpayer chooses to deduct the foreign taxes, all of the foreign taxes must be deducted. If a deduction is taken in lieu of the credit in a particular tax year, the taxpayer loses the opportunity to use any FTC carryback or carryover to or from that year. In addition, the taxpayer is treated as though it did use otherwise allowable FTC carrybacks or carryovers in the deduction year, and must reduce its carryback or carryover.</p>	<ul style="list-style-type: none">▪ IRC 901(a)▪ IRC 164(a)(3)▪ IRC 275(a)(4)▪ IRC 904(c)

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

Carryback and Carryover of Unused Credit

Analysis	Resources
<p>If, because of the limit on the credit, a taxpayer cannot use the full amount of qualified foreign taxes paid or accrued in the tax year, the taxpayer is allowed a 1-year carryback and then a 10-year carryover of the unused foreign taxes.</p> <p>The unused foreign tax in each separate category of foreign source income is the amount by which the qualified taxes paid or accrued are more than the limit for that category. On the other hand, the excess limitation in each separate category is the amount by which the limitation is more than the qualified taxes paid or accrued for that category. Taxpayers should calculate their carrybacks or carryovers separately for each separate category of income.</p> <p>Note that taxes in the GILTI basket may not be carried back or carried over.</p>	<ul style="list-style-type: none">▪ IRC 904(c)

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

Analysis

Example: Assume all foreign income is general category income for the 2018 and 2019 taxable years. The limitation on the credit and the qualified foreign taxes paid on the income are as follows:

			Unused Foreign Tax
Tax Year	Limit on FTC	Tax Paid	(+) or Excess Limit (-)
2018	200	100	(100)
2019	300	500	200

In 2019, the taxpayer has unused foreign tax of \$200 to carryback or carryover to other years. The taxpayer must carry back this unused foreign tax first to 2018 (the first preceding tax year) up to the excess limit in that year of \$100. The taxpayer can then carry over the remaining \$100 of unused tax to future years.

Resources

- IRC 904(c)

Detailed Explanation of the Concept (cont'd)

FTC (Business) General Principles

Other changes to Foreign Tax Credits made by TCJA

Analysis	Resources
<p>The TCJA made several other changes to FTCs. It is expected that these changes will be discussed in detail in future practice units.</p> <ul style="list-style-type: none">▪ Before TCJA, a 10% corporate U.S. shareholder of a foreign corporation was deemed to have paid a portion of the foreign corporation's foreign income tax under IRC 902 when it received a dividend from that foreign corporation. Because such dividends are now generally eligible for a 100% Dividends Received Deduction (DRD), TCJA repealed the IRC 902 deemed paid foreign tax credit. This is effective for tax years of foreign corporations beginning after 2017 and for tax years of U.S. shareholders with or within which such tax years of foreign corporations' end.▪ The repeal of IRC 902 also results in the end of E&P and tax pools. This means that IRC 905(c) foreign tax redeterminations related to deemed paid taxes for Subpart F and GILTI will relate back to the tax year associated with the redetermined foreign taxes, although taxpayers may elect to reflect adjustments to CFC taxes for all pre-2018 tax years in the CFCs' last pooling year. As a result, post-TCJA taxpayers are expected to have an increase in amended tax returns because of IRC 905(c). <p>TCJA retains a deemed-paid credit for subpart F inclusions and extends it to GILTI inclusions (IRC 960(a) and (d)). TCJA modifies this credit so that the allowable credit is based on current-year taxes attributable to subpart F income and GILTI rather than a multi-year pooling approach. TCJA also provides rules applicable to foreign taxes attributable to distributions of previously taxed income. This is effective for tax years of foreign corporations beginning after 2017 and to tax years of U.S. shareholders with or within which such tax years of the foreign corporations' end.</p>	<ul style="list-style-type: none">▪ IRC 902 (Repealed by TCJA)▪ Treas. Reg. 1.905-5(e)▪ IRC 960(a)▪ IRC 960(d)▪ IRC 960(b)

Detailed Explanation of the Concept (cont'd)

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Analysis	Resources
<ul style="list-style-type: none"> ▪ TCJA created separate foreign tax credit limitation baskets for foreign branch income (IRC 904(d)(1)(B)) and for GILTI income (IRC 904(d)(1)(A)). ▪ TCJA repealed the fair market value method of valuing assets for purposes of interest expense apportionment under IRC 864(e)(2); now, tax basis (or alternative tax basis) must be used in all cases. ▪ TCJA included dividends eligible for the IRC 245A DRD and added back expenses apportioned to dividends under IRC 904(b)(4) in computing the IRC 904 FTC limitation. ▪ TCJA modified the sourcing of income from sales of taxpayer-produced inventory to be based solely on place of production (IRC 863(b)). This is effective for taxable years beginning after Dec. 31, 2017. ▪ TCJA allowed taxpayers to elect to recapture overall domestic loss accounts more quickly and recharacterize U.S. source income as foreign source income (IRC 904(g)(5)). 	<ul style="list-style-type: none"> ▪ IRC 904(d)(1)(B) ▪ IRC 904(d)(1)(A) ▪ IRC 864(e)(2) ▪ IRC 904(b)(4) ▪ IRC 863(b) ▪ IRC 904(g)(5)

Index of Referenced Resources

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Form 1118
IRC 164(a)(3)
IRC 275(a)(4)
IRC 863(b)
IRC 864(e)(2)
IRC 901
IRC 901(a)
IRC 901(b)
IRC 901(j)
IRC 902 (Repealed by TCJA)
IRC 904(a)
IRC 904(b)
IRC 904(c)
IRC 904(d)
IRC 904(g)(5)
IRC 906

Index of Referenced Resources (cont'd)

FTC (Business) General Principles
IRC 951
IRC 951(a)(1)(A)
IRC 951(a)(1)(B)
IRC 951A
IRC 956
IRC 960
IRC 960(a)
IRC 960(b)
IRC 960(d)
IRC 965
Treas. Reg. 1.78-1
Treas. Reg. 1.901-1(a)
Treas. Reg. 1.901-2
Treas. Reg. 1.904-4(o)
Treas. Reg. 1.905-5(e)

Training and Additional Resources

FTC (Business) General Principles	
Type of Resource	Description(s)
Databases/Research Tools	<ul style="list-style-type: none">▪ <i>BNA Tax Management Int'l Portfolio</i> 6020-1st
Internal Network Events	<ul style="list-style-type: none">▪ <i>Tax Reform Changes to FTC</i>- 4/25/2018▪ <i>CAP - Tax Reform and FTC</i> - 3/21/2019▪ <i>Corporate FTC Exam Basics</i> - 4/10/2019

Glossary of Terms and Acronyms

Term/Acronym	Definition
DRD	Dividends Received Deduction
ECI	Effectively Connected Income
FDAP	Fixed, Determinable, Annual or Periodic income
FTC	Foreign Tax Credit
GILTI	Global Intangible Low-Taxed Income
IRC	Internal Revenue Code
NRA	Non-Resident Alien
TCJA	Tax Cuts and Jobs Act of 2017
Treas. Regs.	Treasury Regulations

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9413	<i>Exhaustion of Remedies</i>
9413	<i>Exhaustion of Remedies and Transfer Pricing</i>
9413	<i>Exhaustion of Remedies in Non-Transfer Pricing Situations</i>
9413	<i>How to Allocate and Apportion Research and Experimental (R&E) Expenses</i>
9413	<i>Overview: Expense Allocation/Apportionment in Calculation of the FTC Limitation</i>
9413	<i>Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit</i>