VIEWPOINT
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The U.S. Foreign Tax Credit Limitation: How It Works, Why It Matters

by H. David Rosenbloom

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H. David Rosenbloom is a member with Caplin & Drysdale Chtd. in Washington and the director of the international tax program at New York University School of Law. He is also a member of Tax Analysts' board of directors. He thanks Tom Horst and Jaehong Lee for their assistance with this article.

In this article, Rosenbloom explains the foreign tax credit limitation in section 904.

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The goal of this essay is modest: to explain the limitation on the foreign tax credit in section 904. A taxpayer is entitled to a dollar-for-dollar credit against its liability for U.S. tax equal to the lower of its available creditable foreign taxes or the applicable FTC limitation. Nothing in this article will be surprising to anyone working in the international tax field. Nothing is intended to be controversial or disputable. Much of what is said will repeat, in simple language, points that have been made before in various publications. There is no argument here, no point of view expressed. This essay is intended merely to demystify the arithmetic of the limitation and to describe in accessible terms how it operates.

The basic limitation is in section 904(a):

> The total amount of the credit under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

In other words, the limitation is expressed as a fraction whose multiplicand is the U.S. tax on the taxpayer's entire taxable income before applying the credit — or the "tax against which such credit is taken," sometimes colloquially referred to as the "tentative U.S. tax." The numerator of the fraction is the taxpayer's taxable income from foreign sources, computed under U.S. rules. The denominator is normally the taxpayer's entire taxable income, also computed under U.S. rules (I say "normally" because, as we shall see, the Tax Cuts and Jobs Act has created an exception to that general rule). Foreign rules do not affect the FTC limitation; they determine only the amount of foreign tax liability, which is important in determining the foreign taxes available for credit. By algebraic transposition, the multiplicand and the numerator can be exchanged, so that the fraction is expressed as tentative U.S. tax divided by total taxable income, with the product multiplied by foreign-source taxable income.

The rest of section 904 contains variations on the basic theme of subsection (a). Those variations call for such things as reducing foreign-source income to reflect the lower rate applicable to an individual taxpayer's foreign capital gains taxed at a preferential rate, applying the section 904(a) fraction iteratively to different categories of income, allowing carrybacks and carryovers of credits that exceed the applicable limitation, applying special source rules for the limitation only, and addressing foreign and domestic losses. All those subsidiary rules reflect policy choices, and many are complex in their application. I

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ignore all of them but section 904(b)(4), enacted by the TCJA, which alters both the numerator and the denominator of the FTC limitation fraction in some circumstances. It is not that the other aspects of section 904 beyond subsection (a) lack importance but their explication would distract from my objective, which is to focus on the basic limitation. Thus, I proceed on the assumptions that our hypothetical taxpayer has taxable foreign income falling in a single section 904(d) category, is not an individual and therefore has no capital gain rate differential, has no foreign or domestic losses, and otherwise skirts most of the complexities of section 904 after subsection (a).

That still leaves hard questions regarding the "taxpayer's taxable income from sources without the United States." The two key concepts here are "income from sources without the United States" and "taxable." Gross income from sources without the United States — that is, foreign-source gross income — is generally addressed in sections 861-863 and 865, applicable regulations, and various court decisions and IRS rulings (as noted above, section 904 contains some special source rules). That is a subject of considerable amplitude in and of itself, and is complicated by the application of tax treaties, but the subject is largely beside my present point. It can be challenging to identify the source of income, particularly income that does not fall neatly in the standard taxonomy established by the statute and regulations, but I am going to assume away all those problems and proceed on the basis that our hypothetical taxpayer has gross income that indisputably has a foreign source.

The taxable concept is harder still. With a few limited exceptions, the United States does not generally assign a source to deductions. Rather, it associates deductions with the types of income to which they give rise. The vehicle for that association is a series of section 861 regulations (rather controversial at the time of their promulgation). Those regulations purport to allocate deductions to specific classes of gross income. If the income falls in more than one category relevant for the application of section 904 (or some other statute for which it is statutorily necessary to determine net or taxable income), the regulations then apportion the deductions so that they reduce the appropriate categories. The process is not always precise — the regulations have a flavor of "you might consider this, you might consider that" — but they have been with us in more or less their present form since 1976 and have become familiar over the years. From time to time Congress has intervened to second-guess the regulations in specific ways, and the issues have invariably been a topic of intense scrutiny, debate, and controversy.

I propose once again to sidestep all that, interesting though it may be. Our hypothetical taxpayer incurs only two deductions, one associated narrowly and directly with its foreign-source income and the other associated with all its income and subject to apportionment on that basis. The allocable deduction is for stewardship, the wages of a person employed by the U.S. taxpayer to oversee activities that produce the taxpayer's foreign-source gross income. The apportionable deduction is interest expense, and I will look to tax book value — the only apportionment factor for the interest deduction as a result of the TCJA — to assign the deduction to the proper categories. I make the simplifying assumption that tax book value and income production stand in the same proportions, so that the income figures I adopt are indicative of the relative tax book values of the taxpayer's assets.

The word "taxable" in section 904(a) refers to net income. The statute thus envisions that some deductions allowable to a U.S. taxpayer will reduce foreign-source income for the limitation fraction. That reduction should not be confused with expenditures by a U.S. taxpayer that provide benefits to a related person and for which that related person may be called on under U.S. transfer pricing concepts to make payment to the U.S. taxpayer. I am positing deductible expenses that do not give rise to a transfer pricing obligation but are properly associated with, and thus reduce, foreign-source gross income. The U.S. concept of taxable income from non-U.S. sources may, and generally will, be a lower number than the tax base a foreign country uses when it applies its own tax laws and computes tax liability. For the limitation, the income seen by the foreign country is reduced by the U.S. taxpayer's allocated and apportioned deductible expenses that the country does not recognize and is not expected to recognize.

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With all that as preamble, it is time to move to some numbers. Assume our taxpayer has U.S.-source gross income of 200X and foreign-source gross income of 300X, that its only U.S. expenses are 10X for stewardship and 50X for (fully deductible) interest. Net income for U.S. tax purposes is 200X + 300X - 10X - 50X, or 440X. Our hypothetical taxpayer is a corporation, and the post-TCJA corporate tax rate is a flat 21 percent, so the tentative U.S. tax is 440X * 0.21, or 92.4X.

Assume further that the foreign tax rate is 25 percent. If the taxpayer's foreign tax base is 300X, the foreign tax will be 75X. Foreign income tax is not a U.S. deduction when the FTC is elected, so foreign-source gross income for U.S. tax purposes is 300X and is not reduced for the 75X tax payment to the foreign country.

As explained above, the foreign tax base does not reflect any portion of the taxpayer's U.S. deductions for stewardship or interest. If those deductions were to be completely disregarded for section 904 purposes, the FTC limitation would be 300X of foreign-source income over total taxable income of 440X with the product multiplied by 92.4X, or 63X. That is equivalent to the U.S. corporate tax rate (21 percent) multiplied by foreign-source gross income (300X), the tax base used by the foreign country in computing its tax. The United States grants a credit for the lower of the limitation (63X) or the amount of creditable foreign tax available to the taxpayer (75X). If there were no U.S. deductions associated with foreign-source gross income, the result would be 92.4X of tentative U.S. tax minus an FTC of 63X, for a final U.S. tax liability of 29.4X. (See Table 1.)

Table 1. U.S. Foreign Tax Credit Limitation Without Allocation and Apportionment of U.S. Deductions

		<A>	<B>	<C>	<D>
		Total	U.S. Source	Foreign Source	Explanation
1	Gross income	500X	200X	300X	Assumed values
2	Stewardship expense	10X		10X	Proper allocation of Column <A> Total
3	Interest expense	50X	20X	30X	Proper allocation and apportionment of Column <A> Total
4	Total deductions	60X	20X	40X	Sum (#2:#3)
5	Taxable income	440X	180X	260X	#1 - #4
6	Tentative U.S. tax (21%)	92.4X			21% of #5
7	Foreign-source income with no deductions	300X			Col <C>, #5
8	Denominator of section 904 fraction	440X			#5
9	U.S. foreign tax credit limitation with no deductions	63X			#6 * (#7/#8)
10	Foreign tax available for credit (25%)	75X		75X	25% of Col <C>, #1
11	U.S. foreign tax credit with no deductions	63X			Lesser of #9 or #10
12	U.S. tax after foreign tax credit	29.4X			#6 - #11

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However, that is not consistent with what section 904(a) says. The numerator of the section 904(a) fraction is not 300X because the proper numerator is foreign-source taxable income, not foreign-source gross income. Foreign-source taxable income is determined under U.S. rules after the allocation and apportionment of deductions associated with foreign-source gross income. Here, those deductions are the 10X of allocated stewardship expense plus 30X of apportioned interest because the taxpayer's foreign-source gross income (300X) represents three-fifths of its total gross income (500X) (and by assumption, the taxpayer's tax book values are in the same relative proportions as its gross income). Three-fifths of the interest expense of 50X is 30X. Thus, the numerator of the section 904 fraction is 260X (300X - 10X - 30X) and the FTC limitation is 54.6X (260X/(440X * 92.4X)). The U.S. tax liability after reduction for the allowable credit is 37.8X (92.4X - 54.6X). (See Table 2.)

Notice what is happening here. The foreign-source taxable income for U.S. purposes (260X) is lower than the tax base used by the foreign country to determine its tax (300X), so the U.S. limitation is lower than the amount determined by multiplying the foreign tax base by the U.S. tax rate. The limitation is lower to the extent of the associated deductions (40X, or 10X + 30X) multiplied by the U.S. tax rate of 21 percent, or 8.4X. Instead of a limitation of 63X, our taxpayer has a limitation of 54.6X (63X - 8.4X).

Because the foreign tax rate in this example is higher than the U.S. rate, and because it is assumed that there is no dramatic difference between the foreign and U.S. tax bases, the taxpayer would be in an excess credit position even if there were no deductions to associate with its foreign-source gross income. Deductions that reduce the limitation in those circumstances have the effect of producing more excess FTCs, which may or may not be usable on a carryover basis in another year.

Table 2. U.S. Foreign Tax Credit Limitation With Allocation and Apportionment of U.S. Deductions

		<A>	<B>	<C>	<D>
		Total	U.S. Source	Foreign Source	Explanation
1	Gross income	500X	200X	300X	Assumed values
2	Stewardship expense	10X		10X	Proper allocation and apportionment of Column <A> Total
3	Interest expense	50X	20X	30X	Proper allocation of Column <A> Total
4	Total deductions	60X	20X	40X	Sum (#2:#3)
5	Taxable income	440X	180X	260X	#1 - #4
6	Tentative U.S. tax (21%)	92.4X			21% of #5
7	Numerator of section 904 fraction	260X			Column <C>, #5
8	Denominator of section 904 fraction	440X			#5
9	U.S. foreign tax credit limitation	54.6X			#6 * (#7/#8)
10	Foreign tax available for credit (25%)	75X		75X	25% of Column <C>, #1
11	U.S. foreign tax credit	54.6X			Lesser of #9 or #10
12	U.S. tax after foreign tax credit	37.8X			#6 - #11

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Insofar as the current year is concerned, the deductions have no economic value for the taxpayer because they are not applied to reduce ultimate U.S. tax liability. They have not been disallowed, and they (generally) reduce the total taxable income denominator of the section 904(a) fraction. Yet if they reduce the numerator, they are applied against income that is already fully shielded from U.S. tax liability by the FTC, even before that application. Applying deductions to reduce income that is not subject to U.S. tax even without those deductions (because there are sufficient FTCs to offset U.S. tax liability without them) drains the deductions of value, unless excess credits can be carried to another tax year and used then.

If we revert to the situation in which no deductions are applied to reduce the numerator of the FTC limitation fraction, the deductions have the effect of reducing domestic income. Thus, if no deductions reduce the numerator, the 8.4X of additional FTC limitation represents tax collected by the foreign country instead of the United States. The allowed FTC is higher by that 8.4X, and the deductions that are not applied to reduce the numerator have effectively been used to reduce U.S.-source income instead.

When U.S. deductions are associated with, and applied to reduce, the numerator of the FTC limitation fraction, the limitation is reduced by the product of the deductions so applied and the U.S. tax rate. When the limitation is reduced, deductions do not reduce U.S.-source income. In simple terms, that is why the FTC limitation matters and why the arcane rules governing allocation and apportionment of deductions exert a controlling influence on it. The allocation and apportionment rules are not, of course, the only influence — the rules for determining the source of gross income are equal in importance — but they are harder to understand and more difficult to analyze.

There is no question of a disallowance of deductions in any of the foregoing discussion. The IRC does contain a provision — section 265 — that in limited circumstances would deny deductions incurred to earn truly exempt income, and the TCJA did not change or otherwise directly affect that section. However, section 265 has no importance for the FTC limitation. It is concerned with income that the code does not recognize as gross income (primarily municipal bond income addressed in section 103, which makes only rare appearances in international taxation). In contrast, the TCJA addressed several other flavors of "exempt" income, including income qualifying for a full dividends received deduction (section 245A), income qualifying for a special partial deduction (section 250), and income shielded by the FTC. In all those cases, the income in question enters the computation of gross income; in none of them is any deduction disallowed. Section 265 has no application. Deductions that are factually and economically associated with income that is effectively exempt in whole or part because of deductions or credits are never disallowed.

In our example, interest apportioned to foreign-source gross income and wages for stewardship of the activities that produce foreign-source gross income will reduce unrelated gross U.S.-source income if they are not used to reduce the numerator of the FTC limitation fraction. That is demonstrated by a situation in which there is no FTC calculation to make, and therefore no FTC limitation to apply. If our taxpayer's foreign-source income were entirely exempt — for example, because it is a dividend qualifying for the 100 percent dividends received deduction in section 245A — the result would be taxable income of 140X (200X of U.S.-source gross income minus 10X of stewardship expense minus 50X of interest expense) multiplied by the tax rate of 21 percent, or 29.4X. The deductions incurred to earn foreign-source gross income are thus applied to reduce the taxpayer's U.S.-source gross income, which is the only income subject to U.S. tax. (See Table 3.)

If deductions associated with foreign-source gross income are not applied to reduce that income with which they are factually and economically associated, they will reduce domestic-source gross income with which they are not associated. No code provision denies the deduction of expenses incurred to earn any variety of exempt income except for truly exempt income addressed by section 265.

In enacting the TCJA, Congress recognized that income fully offset by deductions is effectively exempt. The heading of section 965 refers to "treatment of deferred foreign income

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Table 3. U.S. Foreign Tax Credit Limitation for Section 245A Foreign Dividends

		<A>	<B>	<C>	<D>
		Total	U.S. Source	Section 245A Foreign Dividend	Explanation
1	Gross income	500X	200X	300X	Assumed values
2	Stewardship expense	10X		10X	Proper allocation of Column <A> Total
3	Interest expense	50X	20X	30X	Proper allocation and apportionment of Column <A> Total
4	Dividends received deduction	300X		300X	Section 245A
5	Total deductions	360X	20X	340X	Sum (#2:#4)
6	Taxable income	140X	180X	-40X	#1 - #5
7	Tentative U.S. tax (21%)	29.4X			21% of #6
8	Numerator of section 904 fraction	0X			Column <C>, #1 - #4
9	Section 245A disregarded deductions	40X			Column <C>, Sum (#2:#3)
10	Denominator of section 904 fraction	180X			#6 + #9
11	U.S. foreign tax credit limitation	0X			#7 * (#8/#10)
12	Foreign tax available for credit	0X		0X	No credit allowed for foreign tax on section 245A foreign dividend
13	U.S. foreign tax credit	0X			Lesser of #11 or #12
14	U.S. tax after foreign tax credit	29.4X			#7 - #13

upon transition to participation exemption system of taxation." In section 904(b)(4), the TCJA took an unusual step toward addressing the anomaly of applying deductions productive of effectively exempt foreign-source income to reduce entirely non-exempt U.S.-source income. It provides that deductions associated with income offset by the 100 percent dividends received deduction of section 245A[1] would reduce both the numerator and the denominator of the FTC limitation fraction.

To see how that unprecedented calculation operates, assume our U.S. taxpayer's 300X of foreign-source gross income is composed of 200X of income whose distribution qualifies for the section 245A 100 percent dividends received deduction plus 100X of foreign-source subpart F income. Assume the foreign tax applies uniformly to both categories of income so that the effectively exempt income is subject to 50X of foreign tax and the subpart F income is subject to 25X of foreign tax. Assume two-thirds of the interest expense apportioned to foreign-source gross income is attributable to the exempt income and one-third to the subpart F income. Assume the stewardship expense is similarly divided. The taxpayer would then have 500X of gross income, U.S. taxable income of 240X (500X - 200X - 60X), tentative U.S. tax of 50.4X (240X * 0.21), and foreign-source gross income of 100X. The FTC limitation for the 100X of subpart F income would be 86.7X (100X - 13.3X (10X of apportioned interest expense plus one-third of 10X of stewardship expense)) divided by

[1]The text does not refer to the dividends received deduction, but the heading of section 904(b)(4) does.

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Table 4. U.S. Foreign Tax Credit Limitation for Subpart F Income (when there are also section 245A foreign dividends)

		<A>	<B>	<C>	<D>	<E>
		Total	U.S. Source	Section 245A Foreign Dividend	Subpart F	Explanation
1	Gross income	500X	200X	200X	100X	Assumed values
2	Stewardship expense	10X		6.7X	3.3X	Proper allocation and apportionment of Column <A> Total
3	Interest expense	50X	20X	20X	10X	Proper allocation and apportionment of Column <A> Total
4	Dividends received deduction	200X		200X		Section 245A
5	Total deductions	260X	20X	226.7X	13.3X	Sum (#2:#4)
6	Taxable income	240X	180X	-26.7X	86.7X	#1 - #5
7	Tentative U.S. tax (21%)	50.4X				21% of #6
8	Numerator of section 904 fraction for subpart F income	86.7X				Column <D>, #6
9	Section 245A disregarded deductions	26.7X				Column <C>, Sum (#2:#3)
10	Denominator of section 904 fraction for subpart F income	266.7X				#6 + #9
11	U.S. foreign tax credit limitation for subpart F income	16.4X				#7 * (#8/#10)
12	Foreign tax available for credit (25%)	25X			25X	25% of Column <D>, #1
13	U.S. foreign tax credit	16.4X				Lesser of #11 or #12
14	U.S. tax after foreign tax credit	34X				#7 - #13

266.7X (240X + 26.7X (20X of interest plus 6.7X of stewardship)), with the product multiplied by 50.4X, or 16.4X. (See Table 4.)

The statute provides that both taxable income from non-U.S. sources (the numerator) and all taxable income (the denominator) are determined without regard to deductions allocable or apportionable to the income qualifying for the 100 percent dividends received deduction. The disregard of those deductions in the numerator seems superfluous, except perhaps in the case of a domestic loss because the deductions in question are allocable or apportionable to section 245A income and not to other foreign-source income, and because there is no limitation for section 245A income since section 245A(d) denies an FTC.

The disregard of the deductions in the denominator is another story. Disregarding a negative number (deductions) increases the denominator of the FTC limitation fraction and thus reduces the limitation or, rather, prevents the deductions from increasing the limitation for other income. For this computation only, the taxpayer's entire taxable income is increased. In

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the absence of this rule increasing the denominator, the taxpayer's limitation for subpart F income would be 18.2X ((100X - 10X - 3.3X)/240X) * 50.4X), rather than 16.4X.

In practice, the computation of the section 904(a) limitation is far more complicated than this essay suggests. The typical U.S. corporate taxpayer has more than one category of section 904 income and many tiers of foreign affiliates. Even so, the computation's underlying mechanics are fully illustrated by my much-simplified example. A clear understanding of the limitation may be of use to persons seeking to understand the policies and choices at play in this area of international tax law. Of course, when there are no foreign taxes to credit or no FTC is allowed — for example, when all foreign-source income qualifies for the 100 percent dividends received deduction — the FTC limitation has no application. It does not and cannot operate as a denial of deductions for expenses incurred to earn income that is effectively exempt from U.S. taxation. ■

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