Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit
Knowledge Base – International

Library Level	Number	Title
Shelf		Individual Outbound
Book	10	Foreign Tax Credit (Individual Outbound)
Chapter	10.1	Creditability of Foreign Tax Credit Claimed
Section		
Subsection		

Unit Name	Creditable Foreign Taxes	
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General Overview

Creditable Foreign Taxes

The United States (U.S.) taxes U.S. persons on their worldwide income. Therefore, income earned outside of the U.S. (foreign source income) may be subject to tax in both the U.S. and in the source country (double taxation). The Foreign Tax Credit (FTC) regime attempts to mitigate double taxation by providing a credit against the U.S. tax on foreign source income. The FTC is subject to limitations under IRC 904, which generally limit the amount of the FTC allowed to the amount of the pre-credit U.S. tax on specific categories of the taxpayer's foreign source income.

- IRC 901 provides a credit against U.S. tax, subject to certain limitations, for income tax, war profits tax, or excess profits tax (income tax) levied by a foreign country or U.S. possession. Whether a foreign tax (or levy) is an income tax under IRC 901 is determined independently for each separate foreign levy. For a foreign tax to be creditable under IRC 901, it must be an income tax in the U.S. sense.

- IRC 903 expands the credit in IRC 901 to include certain foreign taxes that are imposed in lieu of the normal income tax in that country. A foreign levy is a tax in lieu of an income tax only if the tax is imposed in place of, and not in addition to, an income tax otherwise generally imposed. See Treas. Reg. 1.903-1(b).

In order for a foreign income tax (or an in lieu of tax under IRC 903) to qualify for the FTC, all four of the following must be true:

1) The tax must be paid or accrued by the taxpayer.
2) The tax must be imposed on the taxpayer by a foreign country or possession of the U.S.
3) The tax must be compulsory (it must be a legal and actual tax liability).
4) The tax must be an income tax or a tax levied in lieu of an income tax.

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Detailed Explanation of the Concept

Creditable Foreign Taxes
Foreign Tax Must Be Paid or Accrued

Analysis	Resources
A taxpayer may only claim a FTC for a creditable foreign tax that has been paid or accrued. Individual taxpayers on the cash basis method of accounting will normally claim the FTC in the year that the foreign taxes are paid. However, a cash basis taxpayer may elect to claim FTC for foreign taxes in the year that they accrue. This election is made by marking the "accrued" box (i) in Part II of Form 1116. The election to accrue foreign taxes is irrevocable once made and applies to all subsequent tax years.	▪ Form 1116 ▪ IRC 905(a)
A foreign tax is creditable on the cash method in the year in which the foreign tax is actually paid to the foreign government or U.S. possession. This includes foreign taxes that relate to a different tax year, such as the pre-payments of a foreign tax through wage withholding or estimated tax, as long as the withholding or estimated tax is a reasonable approximation of the taxpayer's actual liability.	▪ Rev. Rul. 59-101
For taxpayers claiming the FTC for accrued foreign taxes, a foreign tax accrues when the first two prongs of the all events test are met (when all events have occurred to establish the fact of liability and the amount of the liability can be determined with reasonable accuracy). For purposes of the FTC, a foreign income tax typically accrues under the all events test at the close of the foreign tax year to which it relates. However, an accrued foreign tax may only be claimed as a credit in the year to which the foreign tax relates (even if the liability is contested and only accrues in a later year), due to the well-established relation-back principle.	▪ IRC 461(h) ▪ Treas. Reg. 1.461-4(g)(6)(iii)(B) ▪ Rev. Rul. 61-93

Detailed Explanation of the Concept (cont'd)

Creditable Foreign Taxes	
Analysis	**Resources**
<u>Foreign Tax Must Be Paid or Accrued (cont'd)</u> For example, if a taxpayer undergoes a foreign audit and is assessed additional foreign tax, the additional foreign tax may only be claimed as a credit in the prior year to which the tax relates (typically, the U.S. tax year in which the foreign tax year ends). Thus, a taxpayer claiming credit on the accrual basis must file an amended return for the year to which the foreign tax relates in order to claim additional FTC.	

Detailed Explanation of the Concept (cont'd)

Creditable Foreign Taxes	
Analysis	**Resources**
Foreign Tax Must Be Substantiated by the Taxpayer Upon Request	
Taxpayers generally bear the burden of substantiating that the amount of creditable foreign taxes, for which a FTC has been claimed, was both owed and actually paid, regardless of the taxpayer's method of accounting.	▪ IRC 905(a) ▪ IRC 905(c)
In order to substantiate the type and amount of creditable foreign tax paid, a taxpayer who claims FTC on the cash basis may be required to provide, upon request, a receipt or other credible evidence of the amount of foreign taxes paid. A copy of the foreign tax return (translated) may also be required in order to show that the tax was owed. If the taxpayer claims FTC for accrued foreign taxes (accrual basis taxpayer or taxpayer electing to accrue foreign taxes under IRC 905(a)), the taxpayer is generally required to provide, upon request, a copy of the foreign tax return (translated). Proof of actual payment such as a receipt may also be required, because an accrued foreign tax that is not paid within two years after the close of the year triggers a redetermination under IRC 905(c).	▪ Treas. Reg. 1.905-2(a) ▪ IRM 4.61.10.4 ▪ Treas. Reg. 1.905-2(b)
If it is impossible for the taxpayer to provide a receipt or a copy of a translated foreign tax return, the IRS has discretion to consider secondary evidence, such as a foreign transcript, payer documents, earning statements or paystubs. Depending on the country and the type of foreign taxes, there may be other types of supporting documents to verify the foreign taxes that were imposed on the taxpayer. The taxpayer should also supply certified translations of any foreign tax documents or foreign law necessary to verify the creditability and amount of a foreign tax for which credit is claimed.	

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Creditable Foreign Taxes</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Foreign Tax Must be Imposed on the Taxpayer by a Foreign Government (or U.S. Possession)</u>

In order for a tax to be creditable under IRC 901 or 903, the tax must be levied by a foreign state, any possession of the U.S (including Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, the U.S. Virgin Islands and American Samoa), or any political subdivision of any foreign state or of any possession of the U.S. For example, an income tax levied by Guam or by a Canadian province would generally be treated as a creditable foreign tax, assuming the tax meets all other requirements.</td><td>▪ Treas. Reg. 1.901-2(g)(2)
▪ IRC 901
▪ IRC 903
▪ Treas. Reg. 1.901-2(f)(1)</td></tr>
<tr><td>Generally, a FTC may only be claimed by the taxpayer on whom a foreign tax liability is imposed. However, the taxpayer does not have to be the person who remits the payment to the foreign government in order to claim the credit. For example, a personal income tax is generally considered to be a tax imposed on the person who earned the income, even if the tax is collected by withholding and remitted by the employer. The right to claim a FTC cannot be shifted by contract or other means to another person or entity. Thus, an employee, not the employer, would be eligible to claim a credit for an income tax on his or her wages, even if an employer agreed to pay the foreign tax as part of the employee's compensation.

Exceptions to the general rule:

▪ Joint return: Taxpayer can claim the credit based on the total foreign income taxes paid or accrued by the taxpayer and the taxpayer's spouse.</td><td>▪ Treas. Reg. 1.901-2(f)(3)</td></tr>
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Detailed Explanation of the Concept (cont'd)

<table>
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<tr><td>Foreign Tax Must be Imposed on the Taxpayer by a Foreign Government (or U.S. Possession) (cont'd)

Exceptions to the general rule (cont'd):

▪ Combined Income: If a foreign tax is imposed on the combined income of two or more persons (for example, spouses), the tax is allocated among, and considered paid by, these persons on a pro rata basis in proportion to each person's portion of the combined income. These rules apply to foreign taxes paid or accrued in tax years beginning after February 14, 2012.

▪ Partner or S Corporation Shareholder: If a foreign income tax is paid or accrued by a partnership or S corporation, the partners of a partnership or the shareholders in the S corporation can claim the FTC for a proportionate share of such foreign tax. These amounts will be shown on the Schedule K-1 received from the partnership or S corporation.

▪ Beneficiary: If the taxpayer is the beneficiary of an estate or trust, the taxpayer may be able to claim a FTC for a proportionate share of foreign income tax paid or accrued by the estate or trust. The amount of foreign tax will be shown on the Schedule K-1 received from the estate or trust. However, the tax must be imposed on the income of the estate and not on income received by the decedent.</td><td>▪ Treas. Reg. 901-2(f)(3)(ii)-(iii)

▪ Treas. Reg. 1.901-2(f)(4)

▪ IRC 901(b)(5)</td></tr>
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Detailed Explanation of the Concept (cont'd)

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<tr><td>
<u>Foreign Tax Must be Imposed on the Taxpayer by a Foreign Government (or U.S. Possession) (cont'd)</u>

Exceptions to the general rule (cont'd):

▪ Regulated Investment Company (Exchange-Traded Fund (ETF) or Mutual Fund) Shareholder: If the taxpayer is a shareholder of a mutual fund or other regulated investment company (RIC), they may be able to claim the credit based on their share of foreign income taxes paid by the fund if it chooses to pass the credit on to its shareholders. They should receive from the mutual fund or other RIC a Form 1099-DIV, or similar statement, showing their share of the foreign income, and their share of the foreign taxes paid.

▪ Controlled Foreign Corporation (CFC) Shareholder: If an individual taxpayer is a shareholder of a CFC and chooses to be taxed at corporate rates on the amount they must include in gross income from that corporation under subpart F, they can claim a deemed-paid credit based on the foreign taxes paid or accrued by the CFC on its income. If they make this election, they must claim the credit by filing Form 1118, Foreign Tax Credit—Corporations. It is very important they file Form 1118 (not Form 1116) and attach the Form 1118 to their Form 1040. Tax must be paid at individual rates on subsequent distributions of the previously-taxed subpart F income.
</td><td>
▪ IRC 853

▪ Pub. 514

▪ IRC 951(b)
▪ IRC 958(b)
▪ IRC 962
▪ Form 1118
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Detailed Explanation of the Concept (cont'd)

Creditable Foreign Taxes	
Analysis	**Resources**
<u>The Foreign Tax Must Be Compulsory (Legal and Actual Tax Liability)</u> The amount of foreign tax that qualifies is not necessarily the amount of tax withheld by or paid to the foreign country. Only the legal and actual foreign tax liability that the taxpayer paid or accrued during the year qualifies for the credit. For example, if it is reasonably certain the foreign income taxes paid or accrued would be refunded, credited, abated, rebated or forgiven if a claim was made, these foreign taxes are not creditable. The U.S. has tax treaties with many foreign countries. Under these treaties, the rate of foreign withholding tax may be reduced. Typically the reduced withholding rate under the treaty applies to investment income such as dividends and interest. In this case, the legal tax liability is not necessarily what was actually withheld by the foreign country. The legal tax liability is limited to the lower treaty rate. How tax treaties impact FTC will be discussed in a separate Practice Unit. It is the taxpayer's responsibility to take all necessary steps with the foreign country to properly resolve the final tax liability, otherwise, the tax is not really due or legally owed. The FTC should not be allowed if the taxpayer did not take all the necessary steps and exhaust all available remedies to minimize the final tax bill with the foreign country. The taxpayer needs to verify to the examiner the amount of his or her actual foreign tax liability. To verify, the taxpayer should provide copies of any original and amended foreign tax returns filed and receipts for taxes paid or other documentation to support the amount of taxes paid to the foreign country. A separate Practice Unit will discuss in detail the exhaustion of administrative remedies with a foreign country.	▪ Treas. Reg. 1.901-2(e)(2)

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Detailed Explanation of the Concept (cont'd)

Creditable Foreign Taxes

Analysis	Resources
<u>Foreign Tax Must Be an Income Tax or a Tax in Lieu of an Income Tax</u>	▪ Treas. Reg. 1.901-2(d)
In order for a foreign tax (or levy) to be creditable, it must be an income tax in the U.S. sense, or a tax in lieu of an income tax. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. Accordingly, each such levy must be analyzed separately to determine whether it is an income tax in the U.S. sense or a tax in lieu of an income tax as defined in the Treasury Regulations.	▪ Treas. Reg. 1.901-2(a) ▪ Treas. Reg. 1.903-1
A foreign levy is an income tax only if it meets both of the following requirements: 1) The payment is compulsory pursuant to the authority of a foreign government (or U.S. possession) to levy taxes and the taxpayer receives no specific economic benefit for paying it. 2) The predominant character of the tax is that of an income tax in the U.S. sense.	▪ Treas. Reg. 1.901-2(a)(2)
The term "specific economic benefit" means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the general population of the country. For example, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, not the former, is made generally available on substantially the same terms.	

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Creditable Foreign Taxes</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Foreign Tax Must Be an Income Tax or a Tax in Lieu of an Income Tax (cont'd)</u>

An economic benefit includes the following: a property; a service; a fee or other payment; a right to use, acquire or extract resources; patents or other property that a foreign country owns or controls or a reduction or discharge of a contractual obligation.</td><td>▪ Treas. Reg. 1.901-2(a)(2)(ii)(B)</td></tr>
<tr><td>A foreign tax imposed on an individual to pay for retirement, old-age, death, survivor, unemployment, illness, disability benefits or for substantially similar purposes is not payment for a specific economic benefit if the amount of tax does not depend on the age, life expectancy, or similar characteristics of that individual. The reason is that there is no direct relationship between the amount paid and the amount of economic benefit received by that individual.</td><td>▪ Treas. Reg. 1.901-2(a)(2)(ii)(C)</td></tr>
<tr><td>The second requirement for a levy to be an income tax is that the predominant character of a foreign levy is that of an income tax in the U.S. sense. In general, this test is met if the foreign tax is "likely to reach net gain" in the normal circumstances in which it applies and it is not a "soak-up" tax. A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts and net income requirements.</td><td>▪ Treas. Reg. 1.901-2(a)(1)(ii)
▪ Treas. Reg. 1.901-2(a)(3)
▪ Treas. Reg. 1.901-2(b)</td></tr>
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Detailed Explanation of the Concept (cont'd)

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<tr><td>
<u>Foreign Tax Must Be an Income Tax or a Tax in Lieu of an Income Tax (cont'd)</u>

Treas. Reg. 1.901-2(b)(2) - (4) provide examples of how the realization, gross receipts, and net income requirements are met. Here are two examples of the “net income” requirement:

▪ The net income requirement is satisfied if a foreign tax is computed on the net result after reducing gross receipts by the cost of producing the gross receipts, including recovery of capital expenditures, similar to a Schedule C self-employed individual reporting net income from self-employment activities.

▪ A foreign tax is imposed at the rate of 40 percent on the amount of gross wages realized by an employee; no deductions are allowed. Thus, the tax law neither provides for recovery of costs and expenses nor provides any allowance that effectively compensates for the lack of such recovery. However, because costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized, such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that, under the circumstances, after the tax is paid, employees subject to the tax are almost certain to have net gain. Accordingly, the tax satisfies the net income requirement.
</td><td>
▪ Treas. Reg. 1.901-2(b)(4)(iv) Example (3)
</td></tr>
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Detailed Explanation of the Concept (cont'd)

Creditable Foreign Taxes	
Analysis	**Resources**
Foreign Tax Must Be an Income Tax or a Tax in Lieu of an Income Tax (cont'd) A foreign tax does not qualify as an income tax in the U.S. sense if it is a "soak-up" tax. A soak-up tax is a tax that the U.S. taxpayer is liable for only if a credit is available to offset that tax. This rule applies only if, and to the extent that, the foreign tax would not be imposed if the credit were not available. An exception to this general rule is covered below in the context of a tax in lieu of an income tax. A foreign levy is a tax in lieu of an income tax only if 1) it is not a payment for a specific economic benefit (see previous discussion on specific economic benefit) and 2) the tax is imposed in place of, and not in addition to, an income tax otherwise generally imposed by the foreign country (substitution requirement). A tax in lieu of an income tax, meeting the substitution requirement, does not have to be based on realized net income. A foreign tax imposed on gross receipts or sales, gross income or the number of units produced or exported can qualify for the FTC, if imposed in lieu of an income tax.	▪ Treas. Reg. 1.901-2(c) ▪ Treas. Reg. 1.903-1(a)-(b) ▪ Treas. Reg. 1.903-1(a)(2)

Detailed Explanation of the Concept (cont'd)

Creditable Foreign Taxes	
Analysis	**Resources**
Foreign Tax Must Be an Income Tax or a Tax in Lieu of an Income Tax (cont'd) The general rule is that a soak-up tax does not qualify as an income tax for FTC. However, there is an exception to this general rule under Treas. Reg. 1.903-1(b)(2). The exception is that if the soak-up tax is a tax that is in lieu of an income tax, the non-creditable part is the lesser of 1) the soak-up tax or 2) the foreign tax the taxpayer paid that is in excess of the income tax generally imposed if the taxpayer was subject to the income tax. For example, a taxpayer paid $10 foreign tax in lieu of an income tax, and $2 of the $10 is considered a soak-up tax. If the taxpayer had been subject to the generally imposed income tax of this particular foreign country, he or she would have paid $7. The non-creditable portion is $2, the lesser of the soak-up tax ($2) or the excess of what the taxpayer paid over the generally imposed income tax ($3).	▪ Treas. Reg. 1.903-1(b)(2)

Detailed Explanation of the Concept (cont'd)

Creditable Foreign Taxes	
Analysis	**Resources**
<u>Foreign Taxes Not Creditable</u> As a general rule, the following foreign taxes are not creditable or eligible for the FTC:	
▪ Taxes on excluded income, such as the foreign earned income exclusion or foreign housing exclusion under IRC 911.	▪ IRC 911(d)(6)
▪ Taxes for which a taxpayer can only take an itemized deduction under IRC 164 because credit is disallowed for tax paid to sanctioned countries, certain withholding tax where taxpayer makes related payments or does not meet a minimum holding period, or tax related to covered asset acquisitions.	▪ IRC 901(j), (k), (l), (m) ▪ IRC 164
▪ Non-income taxes, such as value-added tax (VAT), sales tax, excise tax, property tax, wealth and inheritance taxes.	
▪ A portion of certain taxes on foreign mineral income or payments for oil and gas.	▪ IRC 901(e), (f)
▪ Taxes from international boycott operations.	▪ IRC 908
▪ Tax used to provide a subsidy to the taxpayer or a related person.	▪ IRC 999
▪ Taxes of U.S. persons controlling foreign corporations and partnerships who fail to file required information returns.	▪ IRC 901(i) ▪ IRC 6038(c)(1)(A)
▪ Taxes related to a foreign tax credit splitting event.	▪ IRC 909

Index of Referenced Resources

Creditable Foreign Taxes
IRC 164
IRC 461
IRC 853
IRC 901
IRC 903
IRC 904
IRC 905
IRC 908
IRC 909
IRC 911
IRC 951
IRC 958
IRC 962
IRC 999
IRC 6038

Index of Referenced Resources (cont'd)

Creditable Foreign Taxes
Treas. Reg. 1.461-4
Treas. Reg. 1.901-2
Treas. Reg. 1.903-1
Treas. Reg. 1.905-2
Rev. Rul. 59-101
Rev. Rul. 61-93
IRM 4.61.10.4
Form 1116
Form 1118
Pub. 514

Training and Additional Resources

Creditable Foreign Taxes	
Type of Resource	**Descriptions**
Saba Meeting Sessions	▪ *How to Audit FTC - Form 1116, Part 3* – 2015 CPE Saba Meeting. This lesson explains what constitutes a creditable foreign tax.
Databases / Research Tools	▪ *Kuntz & Peroni – U.S. Int'l Tax* Para B4.04 - Specific Foreign Taxes That Have (or have not) Qualified for Foreign Tax Credit. ▪ *BNA Tax Management Int'l Portfolios* 900-2nd Sec. III - Foreign Income Series, Provisions Applicable to U.S. and Foreign Persons, Foundations of U.S. International Taxation, the Foreign Tax Credit in Overview. ▪ *CCH International Taxation* - Corporate and Individual, The Foreign Tax Credit in Overview available through LexisNexis Tax Center – February 2016.

Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
ETF	Exchange-Traded Fund
FTC	Foreign Tax Credit
IRC	Internal Revenue Code
RIC	Regulated Investment Company
VAT	Value-Added Tax

Index of Related Practice Units

Associated UIL	Related Practice Unit	DCN
9432.01	FTC General Principles	FTC/C/10_01-05