Foreign tax credit

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A credit allows U.S. residents (individuals and companies) to subtract foreign income taxes paid from the U.S. income tax due on income earned abroad.

The U.S. foreign tax credit is simple in concept. The United States employs a global tax system and, under the residence principle, taxes the income earned abroad by its residents. This foreign source income generally is also subject to tax in the foreign country under the source principle. To avoid double taxation of the foreign source income, a credit is given for foreign income taxes. That is, the taxpayer is allowed to subtract the foreign income tax from the tentative U.S. tax on the income (the U.S. tax before any allowance for foreign income taxes) and is required to remit only the difference (the residual tax) to the U.S. Treasury. The credit for foreign income taxes is limited to the tentative U.S. tax: The U.S. Treasury does not give a refund when the foreign income tax exceeds the tentative U.S. tax.

Foreign taxes other than income taxes (such as property taxes, excise taxes, payroll taxes, or value-added taxes) are deducted in deriving the taxable foreign source income, rather than being credited against the U.S. tax. All foreign income taxes can be credited against the tentative U.S. tax, including income taxes levied by local governments below the national level, such as by a province in Canada or by a canton in Switzerland. In contrast, income taxes imposed by U.S. states cannot be credited against the federal income tax; instead, they are deducted in deriving the income subject to the federal tax.

The corporate foreign tax credit

The foreign tax credit is available to individuals with foreign source income, including wages earned abroad, but the great bulk of foreign tax credits goes to U.S. corporations with operations abroad. U.S. corporations earn foreign source income by operating branches abroad and by operating or investing in affiliates incorporated abroad. If the foreign source income is earned through a foreign branch, it is subject to U.S. tax in the same year in which it is earned. The tentative U.S. tax is simply the U.S. tax rate times the income of the branch. A credit is given for foreign income taxes and for any foreign withholding taxes that are levied when the branch remits the income to the U.S. parent. Losses incurred by a foreign branch can be deducted from the corporation’s domestic source income to reduce the corporation’s U.S. income tax. In succeeding years, however, if the branch becomes profitable, its income is treated as U.S. source income and no foreign tax credit can be claimed on it until the U.S. Treasury recovers the reduction in tax revenue caused by the branch’s initial losses.

If the foreign source income is earned through a foreign affiliate that is a separate company incorporated abroad, the income generally is subject to U.S. tax only when it is remitted as dividends to the U.S. parent corporation. The U.S. tax on unremitting earnings is thus deferred until the earnings are repatriated. This is advantageous to the corporation because of the benefits associated with deferral of tax.

To be eligible for a credit for foreign taxes on the affiliate’s income, the U.S. parent must own at least 10 percent of the affiliate. A foreign affiliate that is separately incorporated abroad and that is at least 10 percent owned by the U.S. parent is called a foreign subsidiary. A subsidiary distributes dividends to the U.S. parent from earnings and profits after foreign income taxes. To determine the tentative U.S. tax and the foreign tax credit for the dividends, it is necessary to construct the underlying foreign source income from which the dividends were derived.

The formula for the tentative U.S. tax ($T_A$) on the underlying foreign source income is $T_A = t_{US} D (1 - t_f)$, where $D$ is dividends, $t_{US}$ is the U.S. tax, and $t_f$ is the foreign income tax rate used for purposes of calculating the foreign tax credit (foreign income taxes paid divided by the subsidiary’s earnings and profits as measured using the U.S. definition of taxable income). From the tentative U.S. tax, the U.S. corporation subtracts the sum of the foreign income taxes paid on the income underlying the dividends plus the foreign withholding taxes on the dividends. If the difference is positive, the U.S. corporation owes a residual U.S. tax. If the difference is negative, the U.S. corporation is said to have excess foreign tax credits.

In general, the U.S. parent corporation is allowed to sum the foreign source income and foreign taxes from all of its foreign operations, both branches and subsidiaries, when calculating the foreign tax credit and the residual U.S. tax. To be lumped together, however, the foreign source income must be within the same category of income (or income “basket”), as defined by the Internal Revenue Code. The main income baskets are for passive income (primarily interest, dividends, royalties, rents, or annuities received by the subsidiary), financial services income (income earned in banking, insurance, or finance), shipping income (income earned in international shipping), and general limitation income (primarily income earned abroad in
the active conduct of a trade or business other than financial services, shipping, or income in the passive basket). Income in each of these baskets is subject to a separate foreign tax credit limitation. The maximum foreign tax credit that can be claimed in any basket (the foreign tax credit limitation) is the tentative U.S. tax. Any excess credits can be applied to offset the residual U.S. tax on foreign source income earned during the previous two years or the following five years, but if the credits cannot be used within that period, they are lost.

The separate income baskets help discourage U.S. corporations from moving offshore some types of highly mobile investments (such as international shipping, financial services, and portfolio loans) that can easily be located in low-tax countries. Subpart F of the Internal Revenue Code denies deferral for income from such investments, but U.S. corporations might still have a tax incentive to locate these activities abroad if they were allowed to combine the income and foreign taxes from these investments with those from other, less mobile, business activities that often generate excess foreign tax credits. The separate income baskets remove this incentive.

The foreign tax credit offsets most of the U.S. tentative tax on foreign source income. For example, in 1990 (the latest year for which tax data are available), total taxable foreign source income of U.S. corporations was about $89.7 billion. Foreign taxes on this income (income taxes and withholding taxes) amounted to about $27.4 billion, of which about $25 billion was creditable against the tentative U.S. tax. The residual U.S. tax on the income was about $4.7 billion.

Credit versus deductions for foreign taxes
Taxpayers prefer receiving a credit for foreign taxes rather than a deduction, even if the foreign tax rate exceeds the U.S. rate and they are unable to credit all of the foreign taxes they pay. A simple example shows why. Denote foreign source income as \( Y \), the U.S. tax rate as \( t_{US} \) and the foreign tax rate as \( t_F \). With a deduction for foreign income taxes, the U.S. tax is \( t_{US}(1 - t_F)Y \), whereas with a credit the residual U.S. tax is \( (t_{US} - t_F)Y \). From these formulas, we see that if foreign income taxes are deducted, the rate of U.S. tax on the income would equal \( t_{US}(1 - t_F) \), which always exceeds the rate of residual U.S. tax after the foreign tax credit, \( (t_{US} - t_F) \). If \( t_F \) is greater than \( t_{US} \), there is no residual U.S. tax after the credit, but a U.S. tax payment would be required if the foreign income taxes were deducted.

The foreign tax credit and economic efficiency
According to conventional wisdom, for a capital-exporting country (a country that invests more abroad than it receives as inward foreign investment), a deduction for foreign taxes promotes national neutrality and maximizes the domestic income, whereas a foreign tax credit promotes capital export neutrality and maximizes the global income. Early statements of the conventional wisdom can be found in Richman (1963), Musgrave (1969), and Feldstein and Hartman (1979) (among others). More recently, Feldstein (1994) has challenged the view that national neutrality maximizes the domestic income: he concludes that it might well be in the national interest to tax foreign source income more lightly than domestic income, particularly when the foreign investment is highly leveraged through borrowing in foreign credit markets.

Additional readings


Cross references: capital export neutrality; deferral of tax; national neutrality.