Hello Credits, My Old Friend. I've Come to Analyze You Again

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2015-Issue 27—In the years since the economic downturn, many U.S.-based multinational companies have been utilizing their large net operating losses to fully offset taxable income. However, as these companies utilize their NOLs and return to their status as "U.S. taxpayers," many tax directors are being forced to reignite their relationship with a long-forgotten friend: foreign tax credits (FTCs). As the September 15 tax return deadline for many U.S. corporate taxpayers approaches, now is an opportune time for a refresher on the intricacies of the FTC rules and to consider what analyses (if any) your company should undertake to understand its FTC profile for the 2014 filing season.

Where Do I Stand Today?

Before analyzing the FTC implications on this year's tax return, U.S. multinationals must first understand their historical FTC profile. In recent years, Form 1118 may have been an afterthought for U.S.-based multinationals that have fully offset their taxable income with NOLs. In many cases, it may have simply been disregarded. However, in order to take FTCs in the current year, it is critical to dust off prior year information and review historical FTC calculations. Below is a non-exhaustive list of historical tax attributes and prior tax positions that U.S. multinationals will want to understand if they plan on taking FTCs on their 2014 return.

1. Prior Year FTC Carryforwards

U.S. multinationals must remind themselves of whether or not, in prior years, they elected an FTC and how many (if any) of those credits remain unused. Unused FTCs can be carried forward up to 10 years and carried back one year. Please note that if the taxpayer did not elect to use FTCs in a prior year, those credits may not be available without the taxpayer filing an amended return.

2. FTC Substantiation

Having pulled prior year returns (to the extent that Form 1118 was prepared) to determine what FTC carryforwards may be available, U.S. multinationals may be fooled into a false sense of confidence that they can actually utilize these credits. However, the IRS has stringent rules requiring taxpayers to substantiate payments to foreign jurisdictions in order to claim a credit for them. This often means searching for receipts of payment and copies of prior year foreign tax returns. Once found, these documents often need to be translated into English. If the IRS asks for substantiating documents on audit and they are not provided, the IRS retains the right to deny the FTC for any foreign taxes paid that are not substantiated. A best practice is to maintain contemporaneous documentation of the foreign taxes paid for both the IRS and your financial statement auditor, as taxes paid are generally a required financial statement disclosure.

3. Foreign Earnings and Profits Calculations

Having properly substantiated foreign tax payments, companies must next determine where in the structure those taxes sit (in tax parlance, we refer to “tax pools” — a system used to track and determine the amount of indirect foreign taxes that may attach to an actual and/or deemed dividend). Generally, foreign taxes are attached to underlying earnings and profits (E&P). E&P, which serves as a measure of a corporation’s ability to pay dividends (an economic concept), is an essential component in accurately measuring what can be deemed distributed. While the IRS has provided little guidance on calculating E&P, the starting point is generally net income, plus or minus certain adjustments made to properly reflect dividend payment ability. A distribution of E&P from one entity to another generally carries a proportional percentage of the distributing entity’s tax pool.

E&P calculations are easy to ignore in years without U.S. tax liability, and often companies simply assume E&P to be equal to the net income of foreign subsidiaries. However, when FTC analyses become pertinent, it is important to return to historical E&P calculations to ensure that proper and consistent adjustments to E&P have been recognized. Otherwise, taxpayers seeking to make distributions out of foreign subsidiaries may face a great deal of uncertainty as to the size of their tax pools.

4. Overall Domestic Losses/Overall Foreign Losses

Dusting off the credit history, substantiating payments, and refining E&P calculations are hardly the only steps for a U.S. multinational to get up to speed on its foreign tax credit profile. In determining their FTC limitation, taxpayers must determine whether they have built up any overall foreign losses (OFLs) or overall domestic losses (ODLs). These mechanisms serve to reclassify domestic source income as foreign, or vice versa. Consider the foreign tax credit limitation formula:

$$\frac{\text{Foreign source income}}{\text{Worldwide income}} \times \text{U.S. tax on worldwide income} = \text{FTC limitation}$$

As the equation demonstrates, more foreign source income generally translates to a greater FTC limitation. However, without the ODL/OFL rules, inequitable results for either the taxpayer or the government come about.

Consider the following example of an ODL scenario: In Year 1, Taxpayer incurs a $100 U.S. source loss and $200 in foreign source income, resulting in total taxable income of $100. Taxpayer is subject to a 50 percent foreign tax rate and 35 percent U.S. tax rate. Taxpayer’s FTC limitation is $35 (as the ratio in the above FTC limitation formula cannot exceed 100%), resulting in U.S. tax liability of zero and a worldwide liability of $100. In Year 2, Taxpayer earns $100 in U.S. source income and $100 in foreign source income, resulting in $200 of total taxable income. Taxpayer’s FTC limitation for Year 2 would appear to be $35, resulting in a U.S. tax liability of $35 and worldwide liability of $85. However, consider the combined two-year result. Taxpayer incurred zero U.S. source income and $300 of foreign source income. Given that the foreign tax rate exceeds the U.S. tax rate, one would expect a full FTC offset across both years, and yet the actual result has a U.S. tax liability of $35 and foreign liability of $150 ignoring any ODL recapture limitations.

The ODL mechanism allows for a reclassification of U.S. source income as foreign source income, allowing for a greater FTC limitation. In Year 1, Taxpayer’s U.S. loss offsets foreign income, generating an ODL. In later years, the ODL will be “recaptured,” subject to a limitation equal to the lesser of the taxpayer’s ODL account or 50% of the taxpayer’s U.S. source income in the year of recapture, and U.S. source income may be converted into foreign source income for purposes of determining the FTC limitation. OFLs work similarly, but in the opposite direction, recapturing foreign source income as U.S. source income. In performing this year’s foreign tax credit analysis, taxpayers must determine whether their U.S. or foreign source income is subject to recapture, and if they are currently generating an ODL or OFL. It is important to note that an ODL balance can only be generated if the taxpayer elects to credit during taxable years beginning after December 31, 2006. Conversely, OFL balances may be generated regardless of whether the taxpayer credits or deducts.

What Is My Current Year Profile?
Now that you have reviewed your prior year calculations, you are ready to begin the current year FTC analysis. Below is a non-exhaustive list of the current year analyses that may need to be undertaken by U.S. multinationals in order to claim FTCs for 2014.

1. Deduct Versus Credit

After analyzing historical calculations and understanding their current foreign tax credit posture, U.S. multinationals must finally decide whether to claim foreign tax credits or not. If a credit is elected, the taxpayer must “gross up” its foreign source income for the amount of foreign taxes carried by that income. This gross-up results in an increase to taxable income on the company’s tax return equal to the foreign taxes available for credit on the current return.

If a U.S. multinational chooses not to elect the credit, no such gross-up is required. While on its surface this appears to be a simple analysis ("Which route leaves me with less tax liability?"), the decision should not be made within the vacuum of a single year. Taxpayers must consider whether prior year tax credit carryforwards are available and, if not, whether prior year returns where credits were not elected should be amended to make those credits available. While taxpayers are generally limited to amending federal tax returns filed in the past three years, the statute is extended for 10 years on elections to credit or deduct foreign taxes.[1] The analysis of whether to amend a prior year return can be highly complex: electing to credit requires a gross-up, triggering higher taxable income and potential tax due for that year, while possibly altering NOLs and credits that carry forward to the current year. Expand this analysis across 10 potential years of carryforward, and it becomes an extremely arduous undertaking.

2. 2014 Foreign Tax Credit Limitation

Having decided whether or not to elect a credit, taxpayers must determine the amounts of foreign source income generated during the year. Foreign source income includes, but is not limited to, dividends, interest, and certain sales proceeds received from foreign persons, as well as Subpart F income incurred during the year. It is important to note that different types of foreign source income carry different types of foreign tax credits. Taxes paid directly to a foreign jurisdiction by a U.S. multinational, such as withholding taxes on dividends, are considered direct foreign taxes. Contrarily, when a foreign subsidiary of a U.S. multinational generates Subpart F income, the resulting deemed dividend may carry foreign tax credits that were actually paid by the subsidiary. These indirect foreign taxes lend E&P calculations their importance, as the percentage of E&P distributed determines the percentage of indirect foreign taxes that are carried with the distribution.

Once gross foreign source income has been identified, U.S. multinationals must allocate and/or apportion certain deductions against that income. For many companies that have not performed an FTC analysis in several years (or ever), this may prove to be a difficult task. Generally, interest and certain other expenses must be properly allocated between U.S. and foreign source income. Several methodologies for allocating expenses are available to taxpayers, and where an FTC analysis has not been recently performed, these calculations can prove particularly burdensome. For more information on these methodologies, please refer to a recent Alvarez & Marsal Taxand presentation on interest expense allocation.

Please note that the perceived current year FTC limitation may be altered by previously generated ODL and/or OFL balances, and foreign taxes paid will need to be substantiated in the case of IRS audit as discussed above.

Alvarez & Marsal Taxand Says:
Do not wait until the crush of compliance season; dust off prior year returns now and understand your company's current foreign tax credit profile. Determining credit carryforwards, substantiating credits, refining E&P calculations, and calculating OFL and ODL balances today will give you the resources to tackle the current year calculation efficiently. More importantly, understanding your current foreign tax credit posture opens up the opportunity to unlock credits that were not previously recognized and maximize the cash tax benefit on the current year return. And don't forget: all of these analyses will prove equally pertinent come provision time. Proving out FTC availability can impact the realizability of sizable assets on the balance sheet. For example, the presence of items such as OFL and ODL balances could impact the company's assessment of the need for a valuation allowance on its FTC carryforwards.

Footnote:

1. Note that the I.R.S. has taken the position in CCA 201204008 that the statute extension is not available for taxpayers who have previously elected to credit but wish to amend and deduct foreign taxes instead.

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Electing the FMV Method for Interest Expense Allocation: Does It Make Sense?

A common structure for U.S.-based multinationals entails the use of holding companies in certain jurisdictions such as Ireland, the Netherlands, Switzerland or Luxembourg.

Build a Better System for Foreign Tax Credit Substantiation

Foreign tax credits (FTCs) aim to alleviate double taxation by providing a dollar-for-dollar reduction of U.S. tax liability. U.S. multinationals rely on FTCs to reduce cash tax, improve their effective tax rate and optimize earnings per share. They can be highly valuable tax attributes.

So You Think You Have an Overall Foreign Loss?

Many taxpayers have found themselves saddled with the inability to claim foreign tax credits. In large part, taxpayers who have an overall foreign loss (OFL) are subject to double taxation on any foreign earnings that become subject to U.S. taxation. Not only do lower tax rates abroad encourage foreign investment, but the inability to achieve relief under the U.S. foreign tax credit regime makes it prohibitively expensive for companies to repatriate such earnings.

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