

Parker Fielder oil & gas tax conference

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ODLs, OFLs, Deduction vs. Credit of Foreign Taxes

Credit vs. deduction

▶ General rules

- ▶ Foreign taxes are deductible business expenditures, §164
- ▶ The foreign tax credit regime is elective, §§27 and 901
- ▶ FTC is generally preferable
 - ▶ After-tax value of credit greater than pre-tax value of deduction
 - ▶ Credit puts taxpayer, at least theoretically, in same position as if US exempted foreign income or taxed the taxpayer only on a territorial basis
 - ▶ Assuming foreign jurisdiction ETR is equal to US rate

▶ Deduction may be preferable if:

- ▶ FTC limitation significantly reduces benefit of the credit
- ▶ Taxpayer is in an NOL position that is expected to last beyond the 10-year FTC carry-forward period

Credit vs. other methods compared

- ▶ Example: USACo operates a foreign branch that has \$100 of foreign earnings. Foreign tax rate is 20%, US rate is 35%

Methods of mitigating double taxation	Foreign tax	+	US tax	=	Effective tax rate
None	\$20		\$35		55%
Deduction for foreign tax	\$20		\$28		48%
Credit for foreign tax	\$20		\$15		35%
Exemption for foreign income	\$20		\$0		20%

FTC limitation – In general

- ▶ Section 904(a): FTC may not exceed the US tax (before credit) on income from foreign sources
- ▶ Credit is lesser of:
 - ▶ US tax on net foreign source income; or
 - ▶ Foreign taxes paid or accrued
- ▶ Credit cannot offset US tax on US-source income

FTC limitation formula

$$\text{Pre-credit US Tax} \times \frac{\text{Foreign Source Net Income}^*}{\text{Total Taxable Income}}$$

*Foreign Source Gross Income
– Foreign Source Expenses
= Foreign Source Net Income

Applied on Basket-by-Basket Basis (§ 904(d); **Treas. Reg. Section 1.904-4(m)**)

Background

- ▶ 1976 – Enactment of §904(f) – OFL Recapture
- ▶ 1986 – Introduction of SLL Provisions
- ▶ 1987 – Regulations Under §904(f)
- ▶ 1989 – Notice 89-3 Ordering Rules
- ▶ 2004 – AJCA
 - ▶ Section 904(f)(3)(D) – Disposition of Stock of CFC
 - ▶ Overall domestic loss provisions
- ▶ 2007 – Temporary Regulations Under §904(f) and (g)
 - ▶ Updating OFL, SLL and Ordering Rules
 - ▶ Providing ODL guidance

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