Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit

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General Overview

Foreign Tax Redeterminations

The United States (U.S.) taxes U.S. taxpayers on their worldwide income. Thus, 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, resulting in double taxation on the same income. The Foreign Tax Credit (FTC) attempts to mitigate double taxation by providing a credit against the U.S. tax on foreign source income. The FTC is generally limited to the lesser of 1) the foreign taxes paid or accrued for a tax year, or 2) pre-credit U.S. tax multiplied by a fraction, the numerator of which is the foreign source taxable income in a particular category of income, and the denominator is the taxpayer's worldwide taxable income. IRC 904(a).

A foreign tax redetermination occurs when there is a change in a taxpayer's foreign tax liability that affects the taxpayer's FTC previously claimed. For example, a taxpayer claims an FTC in year 1 based on foreign taxes paid or accrued in that year. Subsequently in year 3, the taxpayer is audited by the foreign country and the original tax liability for year 1 either increases or decreases. This redetermination impacts the FTC claimed in year 1.

IRC 905(c)(1) specifies three main types of foreign tax changes that result in a foreign tax redetermination:

1. if taxes when paid or later adjusted differ from amounts accrued by the taxpayer and claimed as a credit;
2. accrued taxes that are not paid within 2 years after the close of the taxable year to which the taxes relate; or
3. refund of foreign taxes.

This Practice Unit discusses the responsibility of the taxpayer to report a foreign tax redetermination and the time frame within which to report such an event.

Detailed Explanation of the Concept

Foreign Tax Redeterminations
Rules for foreign tax redeterminations and applicable statute of limitations.

Analysis	Resources
<u>Taxes Later Paid or Adjusted Differ From Taxes Claimed as Credit</u> ▪ An FTC is redetermined if a taxpayer takes credit for accrued taxes but later determines that the accrual was overstated and pays less than the amount accrued. The taxpayer, in this case, must amend the tax return to reflect the corrected accrual and amount paid. If the taxpayer does not proactively notify the IRS and correct any overstated foreign taxes on the original return, the statute of limitation remains open indefinitely for assessment. For example, a taxpayer accrued $120 of foreign taxes when computing the FTC on their 2018 tax return, but determined on filing the 2018 foreign tax return in 2019 that the liability was only $100. In this case, the taxpayer overstated the FTC and must amend the U.S. tax return, in addition to other reporting requirements. ▪ If the taxpayer uses the accrual method to claim the FTC and later paid more foreign taxes than originally accrued (e.g., resulting from a foreign tax audit), the taxpayer can amend the original year tax return to redetermine the FTC and claim a refund. In general, the taxpayer has 10 years from the original filing due date (without regard to any extension(s)) to submit a refund claim for the year in which the foreign taxes were accrued. However, if the taxpayer uses the paid or cash method of claiming the FTC, the taxpayer can not relate the additional foreign taxes back to the original credit year and claim a refund. The relation-back doctrine only applies to a taxpayer using the accrual method to claim the FTC. In the case in which the taxpayer uses the paid or cash method in the original tax year, any additional foreign taxes paid in a subsequent year can only be claimed in the year paid. Note: A change in election from the cash basis to the accrual basis cannot be made on an amended return.	▪ IRC 905(c)(1)(A) ▪ IRC 905(c)(3) ▪ Treas. Reg. 1.905-3 ▪ Treas. Reg. 1.905-4(b)(1)(i)

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Detailed Explanation of the Concept (cont'd)

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Taxes Later Paid or Adjusted Differ From Taxes Claimed as Credit (cont'd) ▪ Example 1: Taxpayer used the paid method to claim the FTC in year 1. In year 4, foreign country Z audited the taxpayer's year 1 tax return and assessed $100 of additional taxes, which the taxpayer duly paid in year 4. Because the taxpayer used the paid method in year 1, they can not go back to year 1 and claim the additional $100 of foreign taxes on an amended return. The taxpayer, however, can claim the $100 for FTC purposes on the year 4 tax return. If, however, the taxpayer used the accrual method in year 1, they can amend the year 1 tax return to claim the $100 additional foreign taxes. The taxpayer is not allowed to change the method from paid to accrued on an amended return. ! **CAUTION:** Whether the taxpayer's efforts to contest a foreign audit assessment were adequate and comprehensive is a factual determination. See the Practice Unit titled *Exhaustion of Administrative Remedies*.	▪ IRC 6511(d)(3)(A) ▪ *Strong v. Willcuts* - 17 AFTR 1027 (D.C. mn. 1935)

Detailed Explanation of the Concept (cont'd)

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<u>Accrued Taxes That Are Not Paid Within 24 Months After the Close of the Taxable Year To Which the Taxes Relate</u> ▪ In general, when a taxpayer uses the accrual method to compute the FTC but has elected or is otherwise required to translate the tax into dollars on the date paid rather than at the average exchange rate for the year of accrual, any difference between the dollar value of the accrued foreign tax and the dollar value of the subsequent payment of the tax may be taken into account by adjusting the U.S. tax liability in the year of the foreign tax redetermination rather than by amending the return for the relation-back year, provided the net dollar amount of the currency fluctuations attributable to the foreign tax redeterminations is less than the lesser of $10,000 or two percent of the total dollar amount of the foreign income tax initially accrued with respect to that foreign country for the taxable year. This assumes the taxpayer paid the amount accrued within 24 months after the close of the tax year.	▪ Treas. Reg. 1.905-3(a)-(b)(1) ▪ Treas. Reg. 1.986(a)-1(a)(2) ▪ Treas. Reg. 1.988-1(a)(2)(ii)
▪ However, if accrued foreign income taxes are not paid on or before the date that is 24 months after the close of the taxable year to which they relate, the resulting foreign tax redetermination is accounted for as if the unpaid portion of the foreign income taxes were refunded on such date. The credit is eliminated as of the end of the two-year period. The taxpayer in this case must amend the tax return to eliminate the credit for the unpaid portion of the tax. If the taxpayer does not proactively notify the IRS and correct any overstated foreign taxes on the original return, the IRS has an unlimited statute of limitations to redetermine the FTC and make any tax assessment. However, if the foreign taxes are subsequently paid, credit is again allowed for the year of the original accrual. The caveat is that the taxes subsequently paid shall be translated into dollars using the exchange rate as of the time such taxes were paid to the foreign country or possession of the U.S., rather than the average exchange rate of the year of the accrual.	▪ IRC 905(c)(1)(B) ▪ IRC 905(c)(2) ▪ IRC 986(a)(2)(A)

Detailed Explanation of the Concept (cont'd)

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<u>Accrued Taxes That Are Not Paid Within 24 Months After the Close of the Taxable Year To Which the Taxes Relate (cont'd)</u> ▪ Example 2: Taxpayer D claims credit for year 1 for 1,000u (country Z currency) of tax that it accrues to country Z. The 1,000u is properly translated into dollars at the average exchange rate for year 1. If D pays the tax in year 2 or 3 (within 24 months of the close of year 1), the credit for year 1 is not adjusted solely to reflect any difference between the amount claimed as credit and the dollar value of the tax payment. On the other hand, if D pays the 1,000u in, say, year 4 or later, credit for the accrued tax is denied as of the end of year 3, and D has to notify the IRS by filing an amended return. If D pays the tax at a later date, D can reclaim the year 1 credit, this time in a dollar amount determined by the exchange rate on the date of payment.	▪ Treas. Reg. 1.905-3(b) ▪ IRC 905(c)(2) ▪ IRC 986(a)(2)(A) ▪ Treas. Reg. 1.988-1(a)(2)(ii)

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<u>Refund of Credited Tax</u> ▪ When a credited foreign tax is refunded, a foreign tax redetermination results and a U.S. tax redetermination is required, regardless of the reason for the refund. ▪ Example 3: A taxpayer pays taxes to foreign country Y for year 1, but a loss sustained in year 3 is carried back under country Y's tax law to year 1 and causes the year 1 tax to be refunded in whole or in part. FTC for year 1 must be recomputed by excluding the year 1 country Y tax that is refunded in year 3 on account of the loss carryback. ▪ Example 4: A U.S. taxpayer earns interest income in a bank located in country X. In accordance with country X tax law, the bank withholds 35% in taxes on the interest income. The taxpayer then claims an FTC with the U.S. based on the 35% withholding tax. Country X has a tax treaty with the U.S., which stipulates a 0% withholding tax on interest income earned by U.S. taxpayers in country X. Therefore, the taxpayer improperly claimed the credit. In addition, if taxpayer files for a refund with country X and receives a refund from country X, the taxpayer must notify the IRS of such refund and recompute the FTC. ! **CAUTION:** This example is illustrating a case where a U.S. tax redetermination is required. However, it is not suggesting that the U.S. taxpayer is allowed to claim the FTC in the first place when a tax treaty is in place to either mitigate or eliminate the tax withholding. Tax in excess of the treaty rate is not considered paid and may not be claimed as a credit. In addition, the unlimited statute of section 905(c) applies if the taxpayer later actually receives a foreign tax refund.	▪ IRC 905(c)(1)(C) ▪ Treas. Reg. 1.905-3 ▪ Treas. Reg. 1.901-2(e)(5) ▪ Treas. Reg. 1.905-4

Detailed Explanation of the Concept (cont’d)

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<u>Refund of Credited Tax (cont’d)</u> ▪ Notification: In general, the taxpayer must file an amended return with an accompanying amended Form 1116 or 1118 with additional information required to support the U.S. tax redetermination for each affected taxable year with respect to which a foreign tax redetermination results in additional U.S. tax liability. The taxpayer must file an amended return for each affected taxable year by the due date (with extensions) of the original return for the taxpayer’s taxable year for which the foreign tax redetermination is required. If the foreign tax redetermination does not increase U.S. tax (e.g., because the U.S. tax deficiency is offset with available FTC carryovers), the required statement is made with Form 1116 or 1118 filed for the taxable year in which the foreign tax redetermination occurred. This is a required notification. IRC 6501(c)(5) in conjunction with IRC 905(c) provides an exception to the normal assessment statute and allows the IRS to assess additional tax if the redetermination results in additional tax due. If the taxpayer fails to notify the IRS, and the IRS makes the discovery during an examination, it would have unlimited statute of limitations to make an adjustment related to the foreign tax redetermination. Even if the taxpayer informs the IRS (or the IRS discovers the foreign tax redetermination) after the normal statute has expired, the IRS is still allowed to make any tax assessment.	▪ Treas. Reg. 1.905-4(b) ▪ IRC 6501(c)(5) ▪ IRC 905(c) ▪ IRM 4.61.10.8 - *Changes in the Amount of Foreign Taxes Claimed*

Index of Referenced Resources

Foreign Tax Redeterminations
IRC 904(a)
IRC 905(c)
IRC 986(a)(2)(A)
IRC 6501(c)(5)
IRC 6511(d)(3)(A)
IRM 4.61.10.8 - *Changes in the Amount of Foreign Taxes Claimed*
Treas. Reg. 1.905-3
Treas. Reg. 1.905-4
CCA 201534013 - IRC 905(c)
Strong v. Willcuts - 17 AFTR 1027 (D.C. mn. 1935)

Training and Additional Resources

Foreign Tax Redeterminations	
Type of Resource	**Description(s)**
Databases / Research Tools	▪ *Bittker & Lokken Fed. Tax'n Inc, Est and Gift* Para 72.14 ▪ *Mertens Law of Fed. Income Tax'n* Section 45D:29 ▪ *BNA Tax Management Portfolio Foreign Income Series* 6020-1st VI

Glossary of Terms and Acronyms

Term/Acronym	Definition
CCA	Chief Counsel Advice
FTC	Foreign Tax Credit
IRC	Internal Revenue Code
Treas. Reg.	Treasury Regulation

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9432.01	*Creditable Foreign Taxes*
9432.01-02	*Exhaustion of Administrative Remedies*
9432.02-06	*Foreign Currency Translation*