This memorandum addresses the year in which a taxpayer who uses a cash receipts and disbursements method of accounting (a “cash basis taxpayer”) may claim a foreign tax credit for foreign income tax withheld from wages. This advice may not be used or cited as precedent.

ISSUES

1. Are foreign income taxes withheld from wages of a cash basis taxpayer creditable in the taxpayer’s U.S. tax year in which the taxes are withheld or in the taxpayer’s U.S. tax year with or within which the taxpayer’s foreign tax year ends?

2. If a cash basis taxpayer elects under I.R.C. § 905(a) to take foreign tax credits in the year in which foreign income taxes accrue, are foreign income taxes withheld from the taxpayer’s wages creditable in the taxpayer’s U.S. tax year in which the taxes are withheld or in the taxpayer’s U.S. tax year with or within which the taxpayer’s foreign tax year ends?

CONCLUSIONS

1. Foreign income taxes withheld from wages of a cash basis taxpayer are creditable in the taxpayer’s U.S. tax year in which the taxes are withheld, to the
extent the tax withheld does not exceed, at the time the taxes are withheld, a reasonable approximation of the final amount of foreign income tax that is owed for the taxpayer’s foreign tax year or years to which the withheld taxes relate. Foreign tax liabilities of a taxpayer claiming credits on the cash basis are creditable in the year paid, even if the allowable amount is not finally determined until a subsequent U.S. tax year in which the foreign tax year ends.

2. If a cash basis taxpayer elects under I.R.C. § 905(a) to take foreign tax credits in the year in which the foreign income taxes accrue, foreign income taxes withheld from his or her wages are creditable in the taxpayer’s U.S. tax year with or within which the taxpayer’s foreign tax year ends, to the extent the tax withheld does not exceed the amount of foreign tax that is owed for such foreign tax year. Foreign tax liabilities of a taxpayer claiming credits on the accrual basis are creditable in the year accrued, even if the allowable amount is paid in an earlier or subsequent U.S. tax year.

FACTS

TP, a U.S. citizen and cash basis taxpayer, resides and works in Country A. TP uses the calendar year as her U.S. taxable year. TP’s employer in Country A withholds Country A income taxes from her monthly wages. Country A’s tax year runs from April 6 to the following April 5. TP filed her Country A tax return for the Country A tax year ending on April 5, 2007, by the due date of September 30, 2007. TP offset the tax withheld from her wages from April 6, 2006, through April 5, 2007, against her Country A tax liability for the same period. Country A assessed TP’s income tax liability for that tax year based on the tax return filed by TP. On January 30, 2008, TP paid the balance due (or, alternatively, received a refund attributable to an overpayment of tax) with respect to her Country A tax year ending on April 5, 2007.

LAW AND ANALYSIS

A taxpayer may elect to take a credit against his or her U.S. income tax liability for income taxes paid or accrued to a foreign country or U.S. possession. I.R.C. § 901(a). The amount of the credit is “[i]n the case of a citizen of the United States * * *, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country.” I.R.C. § 901(b)(1). The foreign tax credit may be taken in either the return for the year the taxes accrued or the year in which the taxes were paid, depending on whether the accounts of the taxpayer are kept and returns filed using the accrual method or the cash basis method of accounting. I.R.C. § 461(a); Treas. Reg. § 1.905-1(a). However, a cash basis taxpayer may make an irrevocable election to take foreign tax credits in the year in which the foreign taxes accrue, rather than in the year in which the taxes are paid. I.R.C. § 905(a).

Regardless of the method used to determine the year in which the taxpayer claims the foreign tax credit, taxes must be both owed and paid to be eligible for the credit. In limiting credits to the amount of foreign tax owed, including taxes claimed as a credit in the year paid, Treas. Reg. § 1.901-2(e)(5) provides that taxes are considered paid only
to the extent of the amount of liability under foreign law for tax, determined in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law in such a way as to reduce, over time, the taxpayer’s reasonably expected liability under foreign law for tax. Similarly, Treas. Reg. § 1.901-2(e)(2) provides that tax is not considered paid to the extent it exceeds a reasonable approximation of final tax liability to the foreign country, so that the amount is reasonably certain to be refunded. The requirement that foreign taxes actually be paid to be eligible for credit, including taxes claimed as a credit in the year accrued, is reflected in I.R.C. § 905(b)(2) and Treas. Reg. § 1.905-2, providing substantiation requirements for both cash and accrual basis taxpayers to establish proof of payment of the foreign tax.

I.R.C. § 905(c)(1) provides that if accrued taxes when paid differ from amounts claimed as credits by the taxpayer, if accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary, who shall redetermine the amount of U.S. tax due for the year or years affected. Treas. Reg. §§ 1.905-3T and 1.905-4T generally provide that this notification is made by filing an amended U.S. tax return for the year or years affected. The amended return or returns generally must be filed by the due date of the taxpayer’s U.S. tax return for the year in which the events covered by I.R.C. § 905(c)(1), referred to as foreign tax redeterminations, occurred.

**Situation 1: Creditable taxes claimed on the cash basis, no election under I.R.C. § 905(a).**

Under the cash basis method, amounts representing allowable deductions or credits shall, as a general rule, be taken into account for the taxable year in which paid. I.R.C. § 461(a); see also Treas. Reg. § 1.461-1(a)(1). Accordingly, TP may claim a foreign tax credit in each calendar year for income taxes withheld from wages during that year, to the extent such withheld tax does not exceed TP’s legal liability for tax under Country A law. Treas. Reg. § 1.901-2(e). Creditable taxes withheld at any time in calendar year 2006 may be claimed as a credit in TP’s return for 2006, the year paid, even though the creditable amount may not be finally determined until after the close of 2006.

For example, TP’s right to claim the credit for Country A income taxes withheld between April 6 and December 31, 2006, is not perfected until the close of TP’s foreign tax year on April 5, 2007, at which time TP’s taxable income and Country A tax liability for that foreign tax year can be determined with reasonable certainty. However, because TP claims credits on the cash basis, TP may claim the credit for those withheld taxes (as well as for the Country A taxes withheld between January 1, 2006, and the close of TP’s foreign tax year on April 5, 2006) on her 2006 return, to the extent such taxes do not exceed a reasonable approximation of her final Country A tax liability for her Country A tax year ending April 5, 2007 (or April 5, 2006, as the case may be). Similarly, taxes withheld between January 1 and April 5, 2007, may be claimed as a credit in 2007, to
the extent such taxes represent a reasonable approximation of TP’s remaining final Country A tax liability for her Country A tax year ending April 5, 2007.

If TP receives a refund from Country A because the taxes withheld from her wages between April 6, 2006, and April 5, 2007, exceed her final tax liability for that Country A tax year, TP must reflect the corrected amounts on her original returns for 2006 and 2007, or file amended returns and redetermine her U.S. tax liability for those years. I.R.C. § 905(c)(1)(C); Treas. Reg. §§ 1.905-3T(d)(1) and 1.905-4T(b). If TP receives a refund of Country A tax for her foreign tax year ending on April 5, 2007, and the refund relates to Country A taxes paid on more than one date, the refund is deemed to be derived from, and shall reduce, the last payment of Country A taxes first, to the extent thereof. Treas. Reg. § 1.905-3T(b)(3). If TP owes additional Country A tax for her foreign tax year ending on April 5, 2007, such additional tax may be claimed as a credit in her U.S. tax year when she pays the additional tax.

Rev. Rul. 57-516, 1957-2 C.B. 435, states that the foreign tax credit “is not based on tax withheld by a foreign country ***, since tax withheld is merely an advance collection of what may or may not be an actual tax liability.” However, the revenue ruling further provides that income tax withheld at the source from dividends may be claimed as a foreign tax credit “if such tax withheld represents a legal and actual tax liability.” The ruling confirms that entitlement to credit is based on legal liability under foreign law for tax, and not the mere fact of withholding, so that credit is not allowed for tax withheld from dividends that exceeds the taxpayer’s final tax liability. However, Rev. Rul. 57-516 addresses the extent to which credit may be claimed for an amount of tax withheld, not the time at which the credit may be claimed, which in the case of a dividend withholding tax would be in the year withheld, regardless of the taxpayer’s method of accounting for foreign taxes. Rev. Rul. 59-101, 1959-1 C.B. 189, clarifies that a foreign wage withholding tax paid by a taxpayer claiming credits on the cash basis is creditable in the year the tax is withheld, provided that the tax withheld represents a legal and actual tax liability.

Situation 2: Creditable taxes claimed on the accrual basis pursuant to election under I.R.C. § 905(a).

A cash basis taxpayer may elect under I.R.C. § 905(a) to take foreign tax credits in the year in which foreign income taxes accrue, rather than the year in which the taxes are paid. In general, under an accrual method of accounting, a liability is incurred, and taken into account for federal income tax purposes, in the taxable year in which all of the events have occurred that establish the fact of liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2)(i). With respect to the economic performance requirement, Treas. Reg. § 1.461-1(g)(6)(i) provides that if the liability is to pay tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax. However, with respect to foreign income taxes that are creditable under I.R.C. § 901, such as the wage withholding taxes paid by TP to Country A,
economic performance occurs when the requirements of the all events test other than economic performance are met. Treas. Reg. § 1.461-1(g)(6)(iii)(B).

It is well established that under the all events test, TP’s liability for Country A income tax accrues on the last day of TP’s Country A tax year, or April 5 of each year. See Rev. Rul. 61-93, 1961-1 C.B. 390. If TP elects under I.R.C. § 905(a) to take foreign tax credits on the accrual basis, TP’s entire Country A tax liability for the Country A tax year ending April 5, 2007, is creditable in 2007, TP’s U.S. tax year with or within which her foreign tax year ends, regardless of the year or years in which the taxes are paid. The amount of the allowable credit in 2007 equals the total amount of Country A income taxes owed and paid with respect to TP’s Country A tax year ending on April 5, 2007, which include taxes withheld from April 6, 2006, through April 5, 2007, increased by any additional assessment subsequently paid or reduced by any refund subsequently received. Also, Country A tax owed with respect to TP’s income from April 6 through December 31, 2007, including taxes withheld from wages paid during that time, are creditable only in 2008, TP’s U.S. tax year within which Country A’s April 6, 2007, through April 5, 2008, tax year ends and the taxes accrue. Because the credit is allowed in the year the foreign taxes accrue, and not in the year the taxes are paid or the year the related income is subject to U.S. tax, there is no “pro rata” division of the foreign tax liability over TP’s two U.S. tax years.

If TP receives a refund from Country A for her Country A tax year ending April 5, 2007, because the taxes withheld exceed TP’s liability for Country A tax, or if TP is required to pay additional amounts of Country A tax, TP must reflect the corrected amounts on her original return for 2007 or file an amended return and redetermine her U.S. tax liability for 2007, the taxable year to which the Country A taxes relate. I.R.C. § 905(c)(1)(C); Treas. Reg. §§ 1.905-3T(d)(1) and 1.905-4T(b).

Please call Richard Chewning at (202) 622-3850 if you have any further questions.

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1 In the case of contested foreign taxes, the all events test is not met until the contest is resolved and the amount of liability can be determined with reasonable certainty. However, once the foreign tax accrues, it is considered to “relate back” and accrue in the year to which the tax relates. Cuba Railroad Co. v. United States, 124 F. Supp. 182 (S.D.N.Y. 1954), aff’d, 254 F.2d 280 (2d Cir. 1958); Rev. Rul. 84-125, 1984-2 C.B. 125. By matching the U.S. and foreign tax on income accrued in a particular year, the “relation-back” doctrine promotes the purpose of the foreign tax credit to relieve double taxation of foreign-source income.