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From:

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To:

Cc:

Subject: Foreign Tax Accrual & Foreign Tax Credit Carryovers

This confirms our oral advice that excess foreign income taxes that accrued in a taxable year in which the taxpayer had no foreign source general category taxable income may properly be carried back and utilized as a credit in the previous taxable year, in which the taxpayer had foreign source general category taxable income but paid no creditable foreign tax.

We understand that Taxpayer, a U.S. citizen who uses the calendar year as his U.S. taxable year, was granted compensatory stock options with respect to which the vesting period occurred while he was living and working in Hong Kong. Pursuant to an election under section 905(a), Taxpayer claims foreign tax credits (FTCs) on the accrual basis. The Hong Kong taxable year runs from April 1 through March 31.

Taxpayer exercised the compensatory stock options in April and August . The difference between the value of the shares and the option exercise price was reported as ordinary income on Taxpayer's Form W-2 and designated as foreign source general category income on Taxpayer's Form 1116, Foreign Tax Credit (Individual, Estate, or Trust). Taxpayer represents that he properly reported and accrued Hong Kong income tax on the same income on his Hong Kong income tax return for the Hong Kong taxable year ended March 31, .

Taxpayer claimed the FTC for the income tax paid to Hong Kong on his original U.S. income tax return and general category Form 1116. Taxpayer reported no foreign source general category income for U.S. tax purposes in and reported that his general category foreign tax credit limitation under section 904 and his allowable foreign tax credit were both zero. Accordingly, Taxpayer seeks to carry back the excess credits and use them to offset his U.S. tax on his foreign source general category income in , a year in which he had foreign source general category taxable income but accrued no foreign tax. You asked whether, in order to carry back excess foreign taxes, the year from which the taxes are carried must also have foreign source taxable income for U.S. tax purposes.

Section 905(a) provides that the FTC may, at the option of the taxpayer and irrespective of the method of accounting employed in keeping his books, be taken in the year in which the taxes of the foreign country of the United States accrued. Under Treas. Reg. §1.446-1(c)(1)(ii), under an accrual method, income generally is included for the taxable year when all events have occurred that fix the right to

receive the income and the amount of the income can be determined with reasonable accuracy. Under such method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance (payment) has occurred with respect to the liability. See section 461(h). However, under Treas. Reg. §1.461-4(g)(6)(iii)(B), if the liability of a taxpayer is to pay an income tax that is imposed by the authority of any foreign country and is creditable under section 901, economic performance occurs when the requirements of the all events test (as described in Treas. Reg. §1.446-1(c)(1)(ii)) other than economic performance are met. Although creditable foreign taxes ultimately must be paid as well as owed to be allowed as a foreign tax credit, see section 905(b), exempting creditable foreign taxes from the payment prong of the economic performance test permits the taxes to be accrued in the year the all-events test is met rather than in the year the taxes are paid, thus furthering the purpose of the foreign tax credit to mitigate double taxation by matching accrued foreign tax with the U.S. tax on the same income.

Rev. Rul. 61-93, 1961-1 C.B. 390, concerns a taxpayer who filed his U.S. income tax returns on the cash basis and elected to claim income taxes imposed by Hong Kong as a credit under section 901 on the accrual basis. The ruling concludes that, for the purpose of the FTC, foreign income taxes accrue in the U.S. taxable year in which the taxpayer's liability for such foreign taxes becomes fixed and determinable. Generally, such accrual occurs in the U.S. taxable year within which the taxpayer's foreign taxable year ends.

Under sections 904(a) and (d), the allowable FTC is limited to the lesser of the amount of creditable foreign tax paid or the pre-FTC U.S. tax on a taxpayer's foreign source income. A mismatch between the accrued amounts of U.S. and foreign tax may result, for example, if the taxpayer has a different taxable year for U.S. and foreign tax purposes, or if the foreign country and the U.S. recognize taxable income in different years. To assist in alleviating double taxation resulting from such a mismatch, section 904(c) was added to the Code in 1958. Section 904(c) provides rules for carrying back and carrying over excess foreign taxes, allowing a taxpayer in an excess credit position for a given year to carry over the excess of its foreign taxes paid or accrued in that year over the foreign tax credit limitation for the year. Under the statute, a taxpayer must carry back the excess to the first preceding year, then forward to the next 10 succeeding taxable years, in that order.

With respect to the source of income from the exercise of stock options, under sections 861(a)(3) and 862(a)(3), compensation for services is generally sourced to the place of performance. Treas. Reg. §1.861-4(b)(2)(ii)(F) provides that the source of multi-year compensation is determined generally on a time basis, as defined in Treas. Reg. §1.861-4(b)(2)(ii)(E), over the period to which such compensation is attributable. "In the case of stock options, the facts and circumstances generally will be such that the applicable period to which the compensation is attributable is the period between the grant of an option and the date on which all employment-related conditions for its exercise have been satisfied (the vesting of the option)." *Id.*

For U.S. income tax purposes, under the all-events test of section 446, Taxpayer properly reported the income from the exercise of the compensatory stock options in _____, when all events had occurred that

fixed the right to receive the income and the amount could be determined with reasonable accuracy. Assuming Taxpayer was working outside the United States during the period between the grant of the option and the vesting of the option, the income realized upon exercise of the options was foreign-source income. Under Rev. Rul. 61-93, since Taxpayer's Hong Kong income taxes on that income accrued on March 31, , the end of the Hong Kong taxable year, the foreign tax credit is allowable against the U.S. income tax for Taxpayer's U.S. taxable year, the U.S. taxable year within which the Hong Kong taxable year ends.

Because Taxpayer had foreign source general category taxable income in , but no foreign tax liability, he had excess foreign tax credit limitation in the general category for that year. In contrast, because he had no foreign-source general category taxable income in but accrued foreign income taxes in that year in that category, he was in an excess credit position for . Under section 904(c), Taxpayer can carry the excess general category foreign income taxes from back one year and use the credits to reduce the U.S. tax on his foreign-source general category taxable income in , because he had excess limitation for that year. The statute does not require that the year from which the taxes are carried must also have foreign source income subject to U.S. tax.

I hope this information is helpful to you. Please call me if you have any further questions.