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From: [REDACTED]

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To: [REDACTED]

Cc:

Bcc:

Subject: Application of section 905(c) to additional creditable tax paid by cash basis taxpayer

This confirms our oral advice as to the proper application of section 905(c) when an individual taxpayer that claims foreign tax credits on the cash basis is assessed and pays additional foreign income tax with respect to a prior taxable year. As explained in more detail below, for a cash basis taxpayer the additional foreign tax is creditable only in the taxable year in which the tax is actually paid, and not in the prior taxable year to which the foreign tax relates. The relation-back year would be the proper year to claim the credit only if the taxpayer had made a timely election under section 905(a) to claim foreign tax credits in the year the tax accrued, rather than in the later year in which the tax was paid. The law does not permit this election to be made or changed on an amended return.

A number of special rules govern the accrual of creditable foreign income tax liabilities and the year in which they may be claimed as a credit, owing to the special nature of the foreign tax credit as a dollar-for-dollar offset to U.S. tax and its statutory purpose to mitigate double taxation of foreign-source income. For example, under section 905(a), a cash basis taxpayer may elect to claim foreign taxes as a credit in the year in which the taxes accrue, rather than in the year in which they are paid; the statute provides that once this election is made, credits for all subsequent years must be taken on the accrual basis. In addition, creditable foreign taxes accrue in the year the “all-events” test is met, that is, in the taxable year in which all the events have occurred that establish the fact of the liability and permit the amount of the liability to be determined with reasonable accuracy. In contrast to the accrual rules for other types of tax liabilities, actual payment is not required in order for a creditable foreign tax liability to accrue for U.S. tax purposes. Treas. Reg. §§1.446-1(c)(1)(ii) and 1.461-4(g)(6)(iii)(B); see also section 461(f) (special rule permitting contested taxes to be deducted in the year paid, rather than in the year in which the contest is resolved, does not apply to creditable foreign income taxes). However, once the tax is properly accrued, it “relates back” and is considered to accrue, for purposes of claiming the foreign tax credit on the accrual basis, in the earlier tax year to which the foreign tax liability relates. See 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; Albemarle v. Commissioner, 118 Fed. Cl. 549 (2014).

Section 905(c)(1)(A) provides that if accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, the U.S. tax due for the affected years or years must be redetermined. Section 905(c)(1)(B) additionally provides that if accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, U.S. tax must be redetermined to reverse the credit for the accrued but unpaid tax. Section 905(c)(2)(B) provides that any such accrued but unpaid taxes that are subsequently paid shall be taken into account (other than in the case of taxes deemed paid under section 902 or section 960) for the taxable year to which such taxes relate, requiring a second redetermination of U.S. tax for the affected year or years. Finally, section 905(c)(1)(C) requires a redetermination of U.S. tax for the affected year or years if any tax paid is refunded, in whole or in part.

Sections 905(c)(1)(A), 905(c)(1)(B), and 905(c)(2)(B) address differences in the amount of foreign tax accrued and claimed as credits and the amount of tax ultimately owed and paid. For a cash basis taxpayer that has not made the election to claim foreign tax credits in the year the tax accrues, foreign tax is creditable only in the year in which it is paid, not in the year to which the tax relates and in which it is considered to accrue under the “relation-back” doctrine. Accordingly, the payment of additional tax with respect to a prior taxable year entitles the cash basis taxpayer to credit the tax only in the year the additional tax is paid. It does not change, or constitute a redetermination of, the cash basis foreign tax liability for the prior year to which the tax liability relates or for any other year in which foreign tax was paid and claimed as a credit on the cash basis. Accordingly, sections 905(c)(1)(A), 905(c)(1)(B), and 905(c)(2)(B) do not apply when a cash basis taxpayer pays foreign tax in one year that relates to a different taxable year.

In contrast, section 905(c)(1)(C) requires a redetermination of U.S. tax to reduce the foreign tax credit claimed if foreign tax paid is refunded in whole or in part. Therefore, a taxpayer claiming credits on the cash basis must file a U.S. amended return for affected years and pay the resulting U.S. tax deficiency when foreign taxes previously paid and claimed as a credit are refunded. This is because a refund, unlike an additional payment, results in a change to the cash basis foreign tax liability, i.e., a foreign tax redetermination, for the year in which the taxes were paid and claimed as a credit.

As noted above, a cash basis taxpayer may make a one-time election to claim credits on the accrual basis, but this election is irrevocable, so the taxpayer may not elect again to claim credits on the cash basis in a later year. Section 905(a). In addition, a change in election from the cash basis to the accrual basis cannot be made on an amended return. See Strong v. Commissioner, 36-1 USTC 9032; cf. Rev. Rul. 59-101, 1959-1 CB 189. For a taxpayer claiming credits on the cash basis, treating additional foreign tax payments as a redetermination of foreign tax that accrued in a prior year, and allowing the taxpayer to redetermine his or her U.S. tax by claiming additional credits in the prior year, would effectively permit the taxpayer to change his or her method of accounting for foreign taxes from the cash basis to the accrual basis on an amended return, which is not permitted by the case law and administrative rulings. Accordingly, for a taxpayer

claiming foreign tax credits on the cash basis, the payment of additional foreign tax does not constitute a foreign tax redetermination under section 905(c)(1)(A).

This rule accords with sound tax policy relating to the administration of the tax laws. Section 905(c) extends the statute of limitations on assessment only in the event of a change in a taxpayer's liability for foreign tax previously claimed as a credit. Foreign taxes claimed as a credit in the year paid often are allowable as a credit in a different year than the year in which the tax accrued under the all-events test and the "relation-back" doctrine. However, taxpayers are allowed a special 10-year period of limitations to claim refunds of U.S. tax attributable to increased foreign tax credits, regardless of whether the increased foreign tax credit results from choosing to claim a foreign tax credit rather than a deduction for foreign tax paid, an increase in the taxpayer's foreign tax liability, or the correction of an error in computing the allowable credit originally claimed. Section 6511(d)(3)(A); Rev. Rul. 68-150, 1968-1 C.B. 564; Rev. Rul. 77-54, 1977-1 C.B. 400. If an individual taxpayer was permitted to change his or her method of accounting for foreign taxes from the cash to the accrual basis on an amended return, duplicative claims for credit and, in some cases, time-barred U.S. tax deficiencies potentially necessitating application of the mitigation provisions of sections 1311-1314 might result with respect to foreign tax that would be considered to accrue in one year but that was originally claimed as a credit in the different year in which the tax was paid.

If the rules above result in economic double taxation not relieved by a relevant income tax treaty or the excess credit carryover rules of section 904(c), the U.S. competent authority might consider providing relief under the authority of an applicable treaty. See Rev. Proc. 2006-54, 2006-49 IRB 1035.

Please call _____ if you have additional questions.