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Timing the Creditability of Accrued Foreign Taxes

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Introduction

Compliance-oriented tax professionals are – in many cases, for very good reason – most likely to first turn toward material published by the Internal Revenue Service ("IRS") via instructions to tax forms and various handbooks in the resolution of queries germane to their clients' reporting requirements. While the purpose of such material is undoubtedly to lead return preparers step-by-step to accurately report information required by the law, it is no secret that it often fails to provide appreciable instruction. One such instance has to do with taxpayers claiming a credit for, pursuant to an election under Internal Revenue Code ("IRC" or "Code") Section 905(a), accrued foreign tax on Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)*. The incomplete guidance offered through the IRS's relevant published material can, unless the return preparer is an experienced international tax specialist or a genuinely inquisitive tax professional skilled in legal research, lead to a misunderstanding and misapplication of the rules.

In the ensuing sections of this paper, we will first examine the non-authoritative guidance on this issue as provided through material developed by the IRS that is specifically directed toward the public for promoting, and assisting in, tax compliance—we will not review any relevant guidance that may be contained within material developed by the IRS for internal employee training and guidance (e.g., Audit Technique Guides, Practice Units, Internal Revenue Manual etc.) that the IRS is obligated to electronically publish pursuant to disclosure laws generally applicable to federal agencies.[1] Once we reach the limits of what one can reasonably and responsibly discern therein, we will then turn to the completeness and specificity of the guidance contained within the law. What will follow is a general discussion regarding authoritative sources of tax guidance addressing common timing issues of accrued foreign tax for creditability purposes.

Review of the Relevant IRS Material

Turning first to Form 1116 itself, the heading for Part II, *Foreign Taxes Paid or Accrued*, prominently refers return preparers to the Instructions to Form 1116, which in their most essential guidance on this matter read only the following: "Generally, you can take a foreign tax credit in the year you paid or accrued the foreign taxes, depending on your method of accounting. If you report on the cash basis, you can choose to take the credit for accrued taxes by checking the "accrued" box in Part II… Generally, you must enter in Part II the amount of foreign taxes... that relate to the category of income[2] checked above Part I. Taxes are related to the income if the income is included in the foreign tax base on which the tax is imposed."[3] As is obvious from a reading of the foregoing portion of the Instructions, they leave unaddressed a core element of the issue, i.e., the determination of the annual accounting period under U.S. tax principles within which the creditable tax accrues.

As we will discover, particularly once we turn to the authoritative sources of tax guidance on this issue, this determination requires an understanding of certain technicalities that modify the standard tax accounting rules in two significant respects.[4] These technicalities are flatly unmentioned in the Instructions to Form 1116. Moreover, the Instructions, due to their unfortunate usage of both verbiage and syntax, can also be easily misconstrued to mean that the foreign source income to which the reportable accrued tax relates is to be reported on the U.S. tax return for the same year, i.e., there is to be no timing difference between the recognition of income and the accrual of the related tax.[5] This confusion can come about because as the Instructions direct the return preparer to report in Part II of Form 1116 the amount of the foreign tax that "relate[s] to the category of income checked above Part I" and line 1a of Form 1116 itself directs the preparer to report in Part I of Form 1116 "gross income… of the type checked above" Part I, the return preparer, in comprehending the textual instruction through the lens of that which has just been comprehended, may reasonably conclude this to mean that one must report in Part II of Form 1116 the amount of accrued foreign tax that relates to the amount of the category of income that is reported above on that very same Form 1116. It is not at all obvious from the Instructions that the properly reportable amount of accrued foreign tax may relate to income that may be reportable on a tax return for an entirely different year. Thus the Instructions' lack of clarity and specificity leaves considerable room for error.

Fortunately, however, Publication 514, *Foreign Tax Credit for Individuals*, at least partially addresses both issues. It first spells the general rule for determining the U.S. annual accounting period in which the foreign tax accrues in the following manner: "In most cases, foreign taxes accrue when all the events have taken place that fix the amount of the tax and your liability to pay it. Generally, *this occurs on the last day of the tax year for which your foreign return is filed.*"[6] Publication 514 does not expand on this further but

nonetheless, in saying as much, specifies that the timing of the accrual of foreign tax is contingent upon the taxpayer's foreign fiscal year, not the taxpayer's U.S. annual accounting period. As we will see ahead, this is an important piece of information. Publication 514 later also partially resolves the second issue by highlighting the normalcy of timing mismatches between the recognition of foreign source income and the payment – although not accrual, incidentally the topic of this discussion – of the tax thereon: "If, in earlier years, you took the credit based on taxes paid, and this year you choose to take the credit based on taxes accrued, you may be able to take the credit this year for taxes from more than [one] year."[7]

This is immediately followed by a realistic example that helps concretize the guidance: "Last year, you took the credit based on taxes paid. This year, you choose to take the credit based on taxes accrued.

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During the year, you paid foreign income taxes owed for last year. You also accrued foreign income taxes for this year that you did not pay by the end of the year. You can base the credit on your return for this year on both last year's taxes that you paid and this year's taxes that you accrued."[8]

There are a couple of things to note in this example, the first of which definitively clarifies the meaning of the portion of the Instructions considered earlier: the amount of the creditable foreign tax reportable on Form 1116 for a given year need not relate to the foreign source income in the sense that such income must be included in the foreign tax base on which such tax is imposed in the same U.S. annual accounting period. Rather, the income may be recognized in a U.S. annual accounting period which may be different from that in which the related tax may be paid. The second thing to note in this example is that no such timing difference exists between the recognition of the current year's foreign source income and the accrual of the portion of the tax thereon, i.e., both the recognition of the income and the accrued tax occur during the same U.S. annual accounting period. The remainder of Publication 514 remains silent on this very issue leaving taxpayers making an election under Code Section 905(a) uncertain as to how to comply with the law in the event of timing differences.

Overview of the Relevant Law

Fortunately, the well-developed body of law in this area can be relied upon to provide comprehensive guidance. In this section, we will first explore the general rules regarding the accrual of foreign tax. In doing so, we will ground the hitherto considered non-authoritative guidance in actual law. We will then consider a few exceptional situations wherein the accrual of foreign tax may be contingent upon its payment. Lastly, we will also look at a couple of noteworthy instances of contradictory guidance issued by the IRS to gain a

1 *Freedom of Information Act*, 5 U.S. Code § 552.

2 Referring to the various categories of income prescribed by IRC § 904(d) for purposes of applying the overall method of limiting the calculation of the foreign tax credit.

3 Instructions, Form 1116 (December 3, 2020), pg. 17.

4 IRC § 905 modifies, as discussed in the following section of this paper, the general rules of § § 446 and 461.

5 This is not to mean that the Instructions are hopelessly or, for that matter, even solely prone to misinterpretation. Indeed, there are instances wherein the underlying law is itself suggestive that income and the related tax liability are meant be taken into account in the same year. For an example, see the creditability limitation rules under IRC § 904(d).

6 Publication 514 (February 25, 2021), pg. 3.

7 Ibid.

8 Ibid.

greater understanding of, and appreciation for, the dynamic nature of U.S. income tax law.

A. General Rules Regarding the Accrual of Foreign Tax. While individual taxpayers ordinarily, if not always, file tax returns using the cash basis method of accounting,[9] Code Section 905(a) allows cash basis taxpayers to elect to claim the foreign tax credit on an accrual basis regardless of their general method of accounting.[10] This is the first significant respect in which Code Section 905(a) modifies the standard tax accounting rules. This modification can potentially cause confusion in ascertaining the year of accrual when matching income earned on the cash basis method of accounting with the related tax incurred on the accrual basis method of accounting. Under the standard tax accounting rules, a liability does not accrue until the *all events test*[11] is met, i.e., (i) the amount and the fact of the liability is determined with reasonable accuracy and (ii) there is *economic performance.* In the case of a tax liability, the economic performance requirement is essentially an obviating provision; under the regulations, economic performance occurs when a tax liability is actually paid.[12] However, per an exception, if the tax liability is for a foreign tax that is creditable under Code Sections 901 or 903, the economic performance requirement of the all events test is waived.[13] This exception is ineluctably integrated into the broader regulations governing tax accounting methods thereby characteristically modifying the all events test for purposes of determining the amount of accrued but unpaid creditable foreign tax. The importance of this exception is such that without it the election handed by Code Section 905(a) would be rendered inoperative.

Court cases and administrative rulings addressing this issue, in addition to requiring a reasonably accurate determination of the amount and the fact of the liability, also emphasize that foreign tax does not accrue unless there is a strong certainty of collection by the relevant foreign governmental tax agency. For example, in Revenue Ruling ("Rev. Rul.") 60-146,[14] the IRS ruled that the liability for tax accrued in the year in which the income on which the tax was computed was recognized, even though the liability would be assessed in a later year. Rev. Rul. 60-146, in citing a consequential earlier case, strongly suggested that its rationale was that the tax would be imposed on the taxpayer's profits whether or not it liquidated prior to the time of actual collection. That case, *Universal Winding Co. v. Commissioner*,[15] held that the tax accrued on the last day of the tax year for which the taxpayer's UK tax return was filed because the taxpayer would be taxed on the income earned through the end of the UK fiscal year either in the year of assessment if it were to remain in business until such time or, pursuant to the termination provisions of UK law, at a time prior to actual assessment if it were to liquidate.

The Government's concern in conditioning the strong certainty of collection for the recognition of accrual of a creditable foreign tax is highlighted by the fact that *Universal Winding Co.* reached a conclusion that was opposite from the one reached in an earlier case[16] that considered the same question but in the context of different UK law as was in effect at the time. In *Columbia Carbon Inc. v. Commissioner*[17] the Court held that the UK tax did not accrue until the year of assessment because, under pre-1926 UK law, no tax would be due if the taxpayer liquidated before such time.

In addition to emphasizing certainty of collection, *Universal Winding Co.* also established the year of accrual of UK tax with respect to the taxpayer's UK source earnings for a fiscal year (July 1, 1933 – June 30, 1934). In doing so, it effectively provided that foreign tax accrues at the end of the foreign fiscal year that ends with or within the taxpayer's U.S. annual accounting period. Along the same vein, the IRS eventually issued Rev. Rul. 61-93[18] which went a step further in providing that taxpayers cannot prorate accrued foreign tax liabilities between two U.S. annual accounting periods over which two portions of a foreign fiscal year fall. Rather, the entire amount of the accrued foreign tax is to be factored into the singular U.S. annual accounting period within which the foreign fiscal year ends.[19] A common consequence of this guidance for taxpayers earning foreign source income in a country that has a fiscal year at odds with their U.S. annual accounting period is that for the portion of their first U.S. annual accounting period over which their foreign fiscal year falls, such taxpayers will be required to recognize income when earned[20] but will be prevented from claiming a corresponding credit for the taxes attributable thereto, unless the excess foreign tax amount accrued in the following U.S. annual accounting period can later be carried back.[21]

B. Accrual of Foreign Tax Upon Payment. Taxpayers making, or who have previously made,[22] a Code Section 905(a) election generally cannot claim a credit for foreign tax paid, either via withholding-at-source or by voluntarily remitting estimated tax payments, until such time that the tax accrues. Also, per the guidance hitherto considered, the payment of a tax is not

tantamount to its accrual.[23] Notwithstanding, there are some possible situations in which an exception applies, i.e., the foreign tax may accrue upon payment. These situations involve (1) tax disputes, (2) delays in the payment of tax, and (3) substantial noncompliance. Let us now look at each situation more carefully.

1. Disputed Foreign Tax. A disputed foreign tax necessarily fails the modified all events test required for its accrual.[24] However, the payment of a creditable disputed foreign tax allows for its accrual, to the extent paid, prior to its final determination.[25] In such cases, if the amount of the foreign tax taken as a credit differs from its ultimately settled (i.e., accrued) liability, then the taxpayer must adjust the initially claimed credit for the year in which the liability arose.[26] This is the second significant respect in which Code Section 905 modifies the standard tax accounting rules. The regulations term any such event a *foreign tax redetermination.*[27]

The foreign tax redetermination rules modify the standard tax accounting rules by requiring that a foreign tax that accrues after the year in which the tax is credited must be reflected by amending the return for the year in which the credit was claimed, rather than by reporting it in the year in which the correct amount of the

9 See *Brander v. Commissioner*, 3 B.T.A. 231 (1925); *Marks v. Commissioner*, 6 B.T.A. 729 (1927); and *Perry v. Commissioner*, 19 T.C.M. 540 (1960).

10 This precept is incorporated in IRC § 446 and the regulations thereunder.

11 IRC § 461(h)(4) and Treas. Reg. § 1.461-1(a)(2).

12 Treas. Reg. § 1.461-4(g)(6)(i).

13 Treas. Reg. § 1.461-4(g)(6)(iii)(B).

14 Rev. Rul. 60-146, 1960-1 C.B. 276.

15 *Universal Winding Co. v. Commissioner*, 39 B.T.A. 962 (1939).

16 *Columbia Carbon Inc. v. Commissioner*, 25 B.T.A. 456 (1932).

17 Ibid.

18 Rev. Rul. 61-93, 1961-1 C.B. 390.

19 See also Chief Counsel Advice Memorandum 2008-005 (May 9, 2008) which considers the year in which a U.S. citizen can claim a credit for withheld foreign taxes where the taxpayer has different U.S. and foreign tax years.

20 Income is reported when received, regardless of when earned. Treas. Reg. § 1.446-1(c)(1)(i).

21 As provided by the rules under IRC § 904(c) and Treas. Reg. § 1.904-2.

22 Per IRC § 905(a), once a taxpayer elects to claim foreign tax credits on the basis of foreign taxes accrued, "the credits for all subsequent years shall be taken on the same basis."

23 Ibid.

24 Ibid.

25 Rev. Rul. 58-55, 1958-1 C.B. 266; Rev. Rul. 84-125, 1984-2 C.B. 125; and *Cuba R.R. Co. v. United States*, 124 F. Supp. 182 (S.D.N.Y. 1954).

26 IRC § 905(c)(1).

27 See Treas. Reg. § § 1.905-3 and 1.905-4.

tax ultimately accrues.[28] Thus although the final amount of a foreign tax may accrue at a point later in time, as a function of the foreign tax redetermination rules, it relates back to the year in which the liability initially arose. The apparent rationale for the foreign tax redetermination rules is to eliminate the timing difference between the recognition of income and the tax calculated thereon so as to ensure that the foreign tax credit mechanism functions to prevent double taxation of the same income.

2. Two-Year Rule. In order to avoid unnecessary compliance headaches, it is particularly important for tax practitioners to consult their clients regarding this rule because any credit claimed for accrued foreign tax is eliminated if a taxpayer does not pay such tax within two years after the end of the tax year in which the credit was claimed.[29] As a result, taxpayers running afoul of the two-year rule may find themselves in a position wherein they must file an amended U.S. tax return to pay tax due to the reduction or elimination of their foreign tax credit amount. While the accrual of the creditable foreign tax is subsequently restored once it is paid,[30] it is nonetheless still an unenviable position for taxpayers to be in because of the extra administrative and compliance costs they would incur for filing multiple U.S. tax returns for the same year.

Treasury Regulation ("Treas. Reg." or "Regulation") Section 1.905-3(a) classifies both of the above instances of accounting adjustments to the accrued foreign tax, i.e., the revocation of its accrual due to nonpayment and the subsequent restoration of its accrual upon payment, as foreign tax redetermination events which, as already discussed, require adjustments to the credit claimed in the year to which the liability relates.[31] It should also be noted that the latter foreign tax redetermination event is subject to a special currency translation rule. Though taxpayers claiming an accrual basis foreign tax credit must ordinarily translate the amount of their foreign tax paid in the currency of denomination into U.S. dollars using the average exchange rate for the year to which the tax relates (i.e., the year of accrual),[32] taxpayers enjoying a retroactive restoration of the accrual of their foreign tax must retranslate such tax into U.S. dollars using the exchange rate as of the date they were paid.[33]

3. Noncompliance with Foreign Tax Laws. Foreign tax also seemingly does not accrue if the taxpayer makes no effort to comply with foreign tax laws. *Cruz*[34] was an interesting criminal tax evasion case wherein the taxpayer had deficiencies for the years 1975 through 1978, inclusive. The taxpayer had claimed a foreign tax credit for accrued Dominican Republic tax but he neither filed a Dominican Republic tax return nor otherwise paid any Dominican Republic tax. Code Section 905, as was in effect at the time, did not contain the two-year rule discussed directly above. Nonetheless, after careful deliberation, the Court reached a conclusion that would not have been dissimilar to one had the two-year rule been in effect at the time (considering the Dominican Republic tax owed in this case was delinquent by more than two years after the end of the taxable year for which the taxpayer claimed a foreign tax credit)—the Court decided that, if the taxpayer fails to comply with foreign tax laws, foreign tax accrues only once the tax is levied or paid.

While the two-year window eventually handed by Code Section 905(c) is relatively short, the implication of *Cruz* can nonetheless be correctly understood to be such that taxpayers should, during the two-year window, if not remit payment to secure the accrual of their foreign tax to the extent paid, make at least a demonstrable effort toward fulfilling their foreign tax obligations (e.g., obtain a foreign taxpayer identification number, retain local tax counsel, budget or set aside funds for eventually paying the accrued foreign tax, etc.) or otherwise risk a possible foreign tax redetermination before the expiration of the two-year period.

C. Noteworthy Contradictory Guidance. Something that potentially turns the door knob to uncertainty is that there are at least a couple instances wherein the IRS, to one degree or another, deviated from established principles in its judgment. In the first, and more important, example, Rev. Rul. 288[35] held that foreign tax was to accrue under foreign legal rules instead of under previously established U.S. tax principles that had set the foreign tax to accrue generally upon the culmination of the foreign fiscal year. The ruling pertained to a U.S. taxpayer, reporting foreign source income under the completed contract method, which was allowed to claim a credit for all foreign tax attributable to the portion of the income included in its gross income for U.S. tax purposes that stemmed from contract completion during the taxpayer's U.S. annual accounting period. This ruling apparently creates a taxpayer-friendly exception for taxpayers reporting foreign source income under the completed contract method of accounting.

There is also at least one very interesting Private Letter Ruling ("PLR") which is, although not precedential,[36] worth mentioning because it reveals the IRS's position regarding the relevant law.[37] PLR 8401071, considering a taxpayer with considerably different facts and circumstances, also based the accrual of foreign tax on the implications of foreign tax procedure. The taxpayer, to whom the ruling applied, had earned income in a foreign country during the years 1977 and 1978 which qualified for an exemption from tax therein pursuant to the relevant provisions of an existing income tax treaty ("old treaty") with

[28] See *Van Norman Co. v. Welch*, 141 F.2d 99 (1st Cir. 1944) wherein the Court held that a retroactively imposed tax accrues in the year the tax is enacted, not in the prior year in which the income subject to such retroactively imposed tax is earned. See also *United States v. Anderson*, 269 U.S. 422 (1926).

[29] IRC § 905(c)(2)(A).

[30] IRC § 905(c)(2)(B).

[31] Ibid.

[32] IRC § 986(a)(1)(A); Treas. Reg. § 1.986(a)-1(a)(1).

[33] IRC § 905(c)(2)(B)(ii); Treas. Reg. § 1.986(a)-1(a)(2)(i).

[34] *United States v. Cruz*, 698 F2d 1148 (11th Cir.), cert. denied, 464 U.S. 960 (1983).

[35] Rev. Rul. 288, 1953-2 C.B. 27.

[36] IRC § 6110 (k)(3); Treas. Reg. § 301.6110-7(b).

[37] In spite of their non-precedential status, the fact remains that many Courts have, in both pre- and post-IRC § 6110 cases, lent weight to, and cited, PLRs in support of their interpretation of substantive provisions of the IRC, e.g., see *Hanover Bank v. Commissioner*, 369 U.S. 672 (1962); *International Business Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965); and *Rowan Companies v. United States*, 452 U.S. 247 (1981).

the U.S. However, in 1975 the foreign country had signed a new income tax treaty ("new treaty") with the U.S. according to the relevant provisions of which the foreign country would have been permitted to tax the local source earnings of the taxpayer. The new treaty would not enter into force until April 25, 1980. It was, however, retroactive to April 6, 1975.

In light of the new treaty's retroactivity, the foreign country's tax authority asserted a tax against taxpayer prior to the new treaty entering into force. The taxpayer subsequently paid, and also disputed, a portion of the total amount of the asserted foreign tax. The ruling, rather contrary to the expected outcome, held that both the paid and the disputed portions of the total amount of the foreign tax would accrue on the date the new treaty was ratified to grant taxing rights to the foreign country.

Final Thoughts

The purpose of this paper is obviously not to disparage instructions to tax forms published by the IRS or the tax professionals who utilize them in their practice. Rather, the goal is to encourage compliance-oriented tax professionals to develop a sense to better recognize the point at which they reach the limits of the instructive usefulness of the relevant IRS material. While it may be tempting to conclude that the extent of the relevant information provided in the IRS material ought to be sufficient in determining a tax return position, as we saw, such temptation can impel the tax professional to forgo something consequential in its implication. In our case of trying to ascertain the timing of the accrual of creditable foreign tax, on the level of our immediate interpretive interaction with the pertinent IRS material, it eventually presents us with telltale signs that one must go beyond its limits into authoritative sources of tax guidance.

The unconditional justification for the inadequacies of the IRS's Instructions to Form 1116 and Publication 514 lies in their necessity. Their inadequacy is the result of the kind of legal guidance they attempt to distill in plain language about the complex interrelationships between different and distinct fact patterns and the laws applicable thereon. As our walk through the authoritative sources of tax guidance relevant to our query reveals, even something seemingly as simple as determining when an accrual accounting event takes place can be highly fact-dependent, governed by a complex set of crisscrossing laws, and subject to keen professional judgment – the coverage by IRS materials of the length and breadth of which is an unrealistic expectation. ●