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The Creditability of Contemporaneously Paid Foreign Taxes

by Anthony Malik

Anthony Malik

Anthony "Tony" Malik (tony@pointsquaretax.com) is an enrolled agent and the principal consultant at, and owner of, Point Square Consulting, an international tax specialty firm in Atlanta.

In this article, Malik explains the different standards of creditability of foreign taxes imposed on varying types of foreign-source income and outlines the way practitioners should approach advising clients.

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Taxpayers earning foreign-source income can satisfy their foreign tax liabilities in several ways depending on the character of the income, the taxpayer's level of foreign activity, and local tax laws and practices, among other factors. A comprehensive understanding of a taxpayer's foreign activities and the mechanisms by which the taxpayer satisfies any foreign tax liability is critical for U.S. tax practitioners to ascertain the proper amount of foreign taxes paid for U.S. creditability purposes.[1] In practice, it is not uncommon for practitioners to view their clients' foreign tax payments in a static manner, particularly those on the cash basis method of accounting.

There is a tendency to simply translate into U.S. dollars the taxpayer's total amount of foreign taxes paid within the U.S. tax year via all mechanisms (for example, withholding, estimated tax payments, prepayments, and payments remitted along with the filing of their foreign tax returns) and then calculate the foreign tax credit. However, depending on a cash-basis taxpayer's facts and circumstances, there could be differences between the amount of foreign taxes paid in a U.S. tax year and the amount of foreign taxes paid that may be claimed by the taxpayer as a credit for that same tax year.

Divergence between the amount of foreign taxes paid and the amount of creditable foreign taxes paid can lead to timing differences. While this article is written from the perspective of an individual claimant,[2] the rules discussed apply almost equally to corporate claimants. To keep the topic manageable, the foreign taxes discussed should be construed as qualified (creditable) income taxes representing a U.S. taxpayer's legal and actual liability contemporaneously remitted to a foreign country not sanctioned by the U.S. secretary of state.

I will first examine the nonauthoritative guidance on this issue provided through IRS materials directed specifically toward the public for promoting and assisting tax compliance — however, I will not review any guidance contained within materials developed by the IRS for internal employee training and guidance (for example, audit technique guides, practice units, the Internal Revenue Manual, and so forth) that the IRS is obligated to electronically publish under disclosure laws applicable to federal agencies.[3] Once I exhaust what can reasonably and responsibly be discerned in this material, I will

[1] *See* section 901(a).

[2] Assuming the individual did not elect to claim the FTC on an accrual basis under section 905(a).

[3] Freedom of Information Act, 5 U.S.C. section 552.

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turn to the specificity of guidance contained within the law.

I. Review of the Relevant IRS Materials

Materials provided by the IRS are an appropriate starting point because compliance-oriented tax practitioners are most likely to — in many cases, for good reason — turn first to instructions in tax forms and various handbooks to resolve queries germane to clients' reporting requirements. While the materials' purpose is to lead return preparers step-by-step to accurately report the information required by law, in many instances they fail to provide appreciable guidance. Claiming a credit for paid foreign taxes under section 901(a) is one such instance.

A. Form Instructions

The instructions to Form 1116 are surprisingly scant in this area. They state that "generally, you can take a foreign tax credit in the tax year you paid . . . the foreign taxes."[4] They further state that "Generally, you must enter in Part II[5] the amount of foreign taxes . . . that relate to the category of income checked above Part I.[6] Taxes are related to the income if the income is included in the foreign tax base on which the tax is imposed."[7]

Remarkably, the instructions state nothing beyond this on the determination of either the amount of foreign taxes paid for creditability purposes or the U.S. tax year within which paid foreign taxes become creditable. This is problematic because relying on the form instructions alone misleads practitioners in both regards. Experienced practitioners should recognize that the insufficiency of these instructions conceals something consequential and that the search for answers must continue.

[4] Instructions to Form 1116, at 19 (Dec. 28, 2022).

[5] Referring to Form 1116, Part II, "Foreign Taxes Paid or Accrued," at 1 (2022).

[6] Referring to Form 1116, Part I, "Taxable Income or Loss From Sources Outside the United States," at 1 (2022).

[7] Instructions, *supra* note 4.

B. Publication 514

Publication 514, "Foreign Tax Credit for Individuals," partially addresses these issues. It specifies that:

> If you use the cash method of accounting, you can claim the credit only in the year in which you pay the tax. You are using the cash method of accounting if you report income in the year you actually or constructively receive it, and deduct expenses in the year you pay them.[8] You can claim the credit for a qualified foreign tax in the tax year in which you pay it. . . . "Tax year" refers to the tax year for which your U.S. return is filed, not the tax year for which your foreign return is filed.[9]

This verbiage implicitly conveys important guidance; taken together, it is at least rudimentarily instructive for determining the U.S. tax year within which paid foreign taxes become creditable. It provides that taxpayers are not to apportion the paid amount of their foreign taxes between two separate U.S. tax years if the foreign fiscal year does not coincide with the Gregorian-calendar-based U.S. tax year.

To illustrate, the U.K. fiscal year runs from April 6 to April 5 of the following year. For the U.K. fiscal year ending April 5, 2023, if a U.S. taxpayer accurately determines and pays the full amount of U.K. tax on April 6, 2023, the taxpayer won't apportion the payment between the two U.S. tax years across which the U.K. fiscal year falls (April 6, 2022, to December 31, 2022; and January 1, 2023, to April 5, 2023). Rather, for potential U.S. creditability, the taxpayer would claim the entire amount of the paid U.K. taxes for the 2023 U.S. tax year.

Publication 514 is also instructive (again, not explicitly) because paid foreign taxes do not relate back to the U.S. tax year in which the liability arose. This is the case whether or not the foreign fiscal year coincides with the U.S. tax year. For simplicity, consider a U.S.-coincident foreign fiscal year. If a U.S. taxpayer pays 2022 foreign tax on January 1, 2023, the foreign income on which

[8] Publication 514, at 5 (Jan. 31, 2023).

[9] *Id.*

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the tax is imposed is taken completely into account during the 2022 U.S. tax year, while the correct reading of Publication 514 has the foreign taxes taken into account in 2023.[10] Temporary timing mismatches like this between cash-basis taxpayers' foreign-source income and the remittance of taxes are common.

The chief problem with the Publication 514 guidance is that it too zealously pegs the year of credit to the year of payment. Further compounding the problem is the verbiage of Form 1116, Part II,[11] which asks for the date of payment of the foreign taxes. In the context of guidance in the Form 1116 and Publication 514 instructions, practitioners can easily be misled into reporting the amount of foreign taxes paid during the U.S. tax year for which the form is being prepared. It is not obvious that the correct date of payment to be listed on Form 1116 for a given year can pertain to a past (though not a future) U.S. tax year. A review of the IRS materials, no matter how thorough, does not make it clear that in some cases foreign taxes paid in a current U.S. tax year may not become creditable until a future U.S. tax year. Although the narrative coherence of the IRS materials is reassuring, the apparent payment transaction-timing connection effectively precludes practitioners from questioning whether there are instances in which the two are separable.

Legal guidance in this area shows that the treatment prescribed by the IRS materials is mostly applicable to taxpayers with relatively limited foreign activities. The determination hinges largely on the specific facts and circumstances of the taxpayer and, to a lesser extent, on the practitioner's discretion.

II. Overview of the Relevant Law

Despite the useful guidance Publication 514 provides, it fails to explain how the rules apply in relatively common cross-border scenarios. In this section I turn to substantive guidance to gain a more complete understanding.

A. Foreign Taxes on Portfolio Income

The law makes it clear that the chance of immediate creditability of contemporaneously remitted foreign taxes is inversely proportional to the taxpayer's level of foreign activity. To wit, a credit is allowed for a reasonable approximation (or less than a reasonable approximation) of a taxpayer's final foreign tax liability, and this rule applies most aptly to taxpayers with minimal foreign activities. If the amount withheld is reasonably seen as the amount of a taxpayer's final foreign tax liability, then the taxpayer can claim a credit for the amount of foreign taxes withheld during the U.S. tax year. This would apply, for example, to a gross basis withholding tax applied against a U.S. taxpayer's isolated stream of foreign-source portfolio income[12] if the taxpayer is lacking a trade or business in the foreign country.

Rev. Rul. 57-516, 1957-2 C.B. 435, provides that:

> The credit provided in section 901 of the Code is not based on tax withheld by a foreign country or possession of the United States during the tax year, because tax withheld is merely an advance collection of what may or may not be an actual tax liability.

After this elucidation, Rev. Rul. 57-516 proceeds to allow a credit for foreign taxes withheld by a foreign corporation paying dividends to a U.S. taxpayer. The language of the ruling suggests that the dividends are the only foreign-source income of the U.S. taxpayer.

It should be noted that the straightforward guidance offered by Rev. Rul. 57-516 inheres in the foreign-source portfolio income of taxpayers with minimal foreign activity. Though this guidance may create assurance that the law is not completely arbitrary or mysterious, one cannot overlook that the treatment articulated in Rev. Rul. 57-516 would not necessarily be applicable to all taxpayers earning foreign-source portfolio income. For example, reliance on Rev. Rul. 57-516 would probably not be appropriate for a taxpayer

[10] Though outside of the scope of this article, it should be tangentially noted that this treatment is consistent with the tax accounting rules. *See* reg. sections 1.446-1(c)(1)(i) and 1.461-1(a)(1).

[11] Form 1116, Part II, *supra* note 5.

[12] Portfolio income generally includes gross income, other than that derived in the ordinary course of a trade or business. *See generally* reg. section 1.469-2T(c)(3).

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with an active trade or business in a foreign country who is also earning foreign-source portfolio income subject to withholding taxes at source. This kind of taxpayer would, depending on the set of facts, likely be required to determine the final foreign tax liability after the close of the foreign fiscal year and before claiming an FTC. In these cases, the withheld foreign taxes are akin to estimated tax payments that are uncreditable until the taxpayer's final foreign tax liability is settled.[13]

B. Foreign Taxes on Trade or Business Income

At the other end of the spectrum, foreign taxes paid during the U.S. tax year via either withholding, estimated payments, or prepayments do not qualify for an FTC during the same U.S. tax year if the taxpayer is engaged in a trade or business in the source country. The apparent rationale for this treatment is that business profits are taxed on a net instead of a gross basis determined under foreign legal principles.

Rev. Rul. 71-517, 1971-2 C.B. 268, addressed the question of creditability when a U.S. partnership was engaged in a business in Peru. Under Peruvian law at the time, entities incorporated or registered outside of Peru that were engaging in mining operations in Peru were required to prepay an amount representing a percentage of the net value of the mining products exported. These prepayments would later be applied against the entities' ultimate Peruvian income tax liability once it was determined. It was held that the advance payments were not taxes at the time of payment because they were more akin to deposits against a future tax liability. However, the ruling specified that any portion of these prepayments, once applied against the properly determined and assessable amounts of Peruvian income taxes, qualified as payments of creditable foreign income taxes.

Rev. Rul. 70-425, 1970-2 C.B. 151, had previously reached a similar conclusion in denying an immediate credit for foreign taxes withheld on income attributable to business profits. The ruling considered a taxpayer that earned both business and nonbusiness income from Italian sources. Regarding the taxpayer's nonbusiness income, the ruling didn't address whether a reasonable approximation of the withheld Italian taxes would be immediately creditable; instead, it simply provided that the ultimate liability against which the withheld taxes would be applied would be creditable. As for the Italian taxes withheld on the taxpayer's business income, the ruling was clear that they would not be separately allowable as a credit until the taxpayer's final Italian tax liability was settled.[14] The settlement is therefore the event that transforms uncreditable advance deposits against future foreign tax liabilities into actual payments of creditable foreign tax liabilities. The reasonability of the approximated final foreign tax liability is immaterial for income derived in the course of a trade or a business.

Rev. Rul. 74-373, 1974-2 C.B. 203, also considered the issue of prepayment of foreign taxes on business profits. However, this ruling did so in the context of multiyear payments. In the case at issue, a U.S. corporation that was transacting business in Peru was required to remit compulsory prepayments to the Peruvian government that would later be credited in equal parts against the U.S. corporation's final Peruvian income and complementary tax liabilities for the next eight years. The ruling held that:

> the payments [were] not taxes at the time of their payment since they [were] merely deposits against future liability for tax. However, the payments when actually applied as a credit[15] against a Peruvian tax that does qualify as an income tax within the meaning of section 901 of the Code, qualify as creditable income taxes for purposes of section 901.[16]

[13] For a more targeted discussion on the tax treatment in such scenarios, see Rev. Rul. 70-425, discussed *infra*.

[14] *See also* Rev. Rul. 68-147, 1968-1 C.B. 338; and Rev. Rul. 68-318, 1968-1 C.B. 342.

[15] For Peruvian — not U.S. — tax purposes.

[16] In this vein, see also *New York & Honduras Rosario Mining Co. v. Commissioner*, 168 F.2d 745 (2d Cir. 1948), in which a New York corporation prepaid income taxes to cover a 20-year period. The court decided that the sum advanced stood as a credit to the taxpayer and that the court was concerned with the debits charged against the credit in those years. The debits, the court held, were payments of income tax to a foreign country.

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This guidance relates back to the preceding discussion on foreign-source portfolio income. Though multiyear prepayments on nonbusiness income are even more unlikely, they are not impossible, and based on the treatment prescribed by Rev. Rul. 74-373, they are a deposit against a future creditable income tax liability.

C. Foreign Taxes Paid on Employment Income

U.S. taxpayers living and employed abroad are in a grayer area of the law than their counterparts earning arm's-length foreign-source investment income from the source country or deriving profits through a fixed place of business.

Rev. Rul. 59-101, 1959-1 C.B. 189, addressed the creditability of foreign taxes remitted via both withholding and estimated payments by wage earners in Puerto Rico. The taxpayers discussed in the ruling had a relatively simple set of facts. The ruling held that both the withheld and the estimated foreign taxes were creditable during the U.S. tax year of payment to the extent that the amounts represented the taxpayers' legal and actual tax liability.[17]

There is also at least one generic legal advice memorandum (GLAM)[18] that is, although not precedential,[19] highly instructive because it pertains to foreign wage withholding tax when the taxpayer's foreign fiscal year is at odds with the U.S. tax year. The GLAM concludes that a cash-basis taxpayer can claim credits in the U.S. tax year within which the withholding occurs to the extent that the amount withheld does not exceed a reasonable approximation of the final amount owed at the end of the taxpayer's foreign fiscal year.

This is instructive because it clarifies that it doesn't matter that the foreign taxes paid during the U.S. tax year pertain to a foreign fiscal year with a different ending date. Rather, foreign wage withholding taxes "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."[20] The GLAM's analysis strongly suggests creditability for foreign taxes overwithheld during the portion of the foreign fiscal year that coincides with the latter part of the first U.S. tax year, followed by a corrective adjustment to underwithhold foreign taxes during the portion of the foreign fiscal year that coincides with the first part of the second U.S. tax year.

While any semblance of unambiguous guidance is welcome, matters of taxation are rarely devoid of confounding elements. Consider that the exercise of employment, at least in the inbound context, constitutes a trade or business.[21] However, as evident from the guidance discussed, the exercise of employment is, at least in the FTC context, alienated from the constitution of a trade or business. Furthermore, the available guidance addresses taxpayers with very simple factual scenarios. In practice, it is not uncommon for taxpayers — particularly sophisticated ones — to earn multiple types of foreign-source income items in countries with complex tax regimes.[22]

This inevitably poses difficulties for even the most astute practitioners in judging the reasonableness of their clients' approximated final foreign tax liabilities. Though the calculation of a taxpayer's estimated final foreign tax liability by an experienced local practitioner would likely constitute a reasonable approximation for purposes of U.S. creditability, it would not guarantee that the final foreign tax liability wouldn't vary from the approximation. This can cause, for U.S. purposes, a foreign tax redetermination[23] event, which obligates

[17] See also Rev. Rul. 56-124, 1956-1 C.B. 97, which considers the issue of the deductibility of withheld and estimated payment amounts of Maryland state income tax against the eventual tax liability resulting from a cash-basis individual's salary. The ruling references sections 164(a) and 461(a) in allowing the deduction in the year of payment.

[18] GLAM 2008-05 (May 9, 2008).

[19] Section 6110(k)(3) denies written determinations precedential status, but it is not entirely clear whether the nomenclature "precedent" connotes only "binding authority" or "persuasive authority" as well. Indeed, courts have considered written determinations in formulating their judgments. *See American Express Co. v. United States*, 262 F.3d 1376 (Fed. Cir. 2001); and *Western Co. of North America v. United States*, 323 F.3d 1024 (Fed. Cir. 2003).

[20] GLAM 2008-05, *supra* note 18.

[21] Section 864(b); reg. section 1.864-2(a).

[22] As a convenient example, consider our very own U.S. tax regime that makes available various tax-advantageous preferences to various classes of taxpayers, imposes multiple types of income-based taxes, and applies varying graduated tax rates to different types of income.

[23] Reg. section 1.905-3(a).

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taxpayers to amend their U.S. tax returns.[24] To avoid the potential unnecessary administrative burdens and compliance costs of filing multiple tax returns for the same U.S. tax year, the prudent course of action is to advise the taxpayer to finalize (and file) any foreign tax returns before finalizing original U.S. tax returns.

III. Final Thoughts

Determining the accurate amount of contemporaneously paid foreign taxes for purposes of U.S. creditability is more nuanced than what many compliance-oriented practitioners may suspect. The difficulty inherent in the determination stems from the unique way in which the law distinguishes the transaction from its temporal dimension. While IRS materials suggest parity between the two, the law severs them, revealing how the nonauthoritative guidance serves unwittingly as a curtain against the dynamism of the law.

While it may be tempting to conclude that the extent of the relevant information provided in the IRS materials ought to be sufficient, this temptation can impel the tax professional to forgo something consequential. Our walk through the authoritative sources of tax guidance reveals that practitioners must remain vigilant knowing that even something as seemingly simple as determining a foreign tax payment amount can be highly fact-dependent and require keen professional judgment. ■

[24] Reg. section 1.905-4.

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