

Foreign Tax Credits

By James A. Riedy

Revisiting Application of the Contested Tax Doctrine and Relation Back Doctrine to Foreign Tax Credits

In Field Attorney Advice Memorandum 20105001F (the “FAA”),¹ the Houston office of the IRS Chief Counsel addressed the meaning of the phrase “accrual of foreign tax.” When in fact does a foreign income tax “accrue” for purposes of claiming a credit? Specifically, the FAA reviewed (1) the Code Sec. 901 relation back doctrine applicable to Code Sec. 901 credits when the tax liability is contested, and (2) the starting date for the extended 10-year period of limitations provided by Code Sec. 6511(d)(3) for refund claims attributable to payments of additional foreign taxes. The document is very heavily redacted, and the reader is often required to guess at what is meant.

1. Facts

Based on the analysis of the issues, one may assume that an accrual basis taxpayer contested a Code Sec. 901 foreign withholding tax. For purposes of discussion, assume that a payment potentially subject to a foreign withholding tax was made in 1997. The foreign government assessed a withholding tax in 2000. The tax was not paid and the taxpayer disputed the liability. In 2009, the dispute was resolved unfavorably, the foreign withholding tax was paid and the taxpayer filed a refund claim for the additional foreign tax paid.

Two issues appear (again, heavily redacted) to be addressed by the FAA. First, could the taxpayer claim a credit for the tax paid with respect to a 1997 liability on its 2000 return, the year of the assessment, or its 2009 return, the year in which the contested tax



James A. Riedy is a Partner in the law firm of McDermott Will & Emery LLP based in the Washington D.C. office.

was paid. Second, does the special ten year statute of limitations in Code Sec. 6511(d)(3) run from the time when the original return for 1997 was filed, from the time the 2000 return was filed, or from the time when the 2009 return is filed.

2. Accrual of Foreign Tax and the Contested Tax Doctrine

It is well settled that a taxpayer may claim a foreign tax credit for a foreign income tax that has “accrued” even if the tax is not paid as of the time the credit is claimed. For example, Code Sec. 901(b) provides that a domestic corporation shall be allowed a credit for taxes “paid or accrued.” Limitations on the ability to obtain a credit for accrued but unpaid taxes are included in Code Sec. 905(c), discussed below.

The contested tax doctrine is derived from *Dixie Pine Products Co.*² In that case, the Mississippi taxing authorities determined that a solvent used by the taxpayer in its business was “gasoline” within the meaning of a state law defining gasoline and, therefore, subject to a state tax imposed on gasoline. The taxpayer was issued an assessment. The taxpayer contested the liability for tax and at the same time, as an accrual basis taxpayer, deducted the amount of the tax assessed. The IRS disallowed the deduction for the accrued but contested tax.

The question considered by the Supreme Court was whether an accrual basis taxpayer could deduct a tax when the taxpayer simultaneously contested the liability. The court’s analysis started by setting forth the all events test. “It has long been held that in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer’s liability for items of indebtedness deducted though not paid.”³ The court went on to conclude that this requirement cannot be satisfied “where the liability is contingent and is contested by the taxpayer.”⁴ Finally, the court concluded that a deduction may be obtained “only for the taxable year in which its liability for the tax was finally adjudicated.”⁵

The “relation back doctrine” is derived from application of the contested tax doctrine to a creditable

foreign income tax. In *The Cuba Railroad Company*,⁶ a poorly decided case in which the court concluded that taxes paid to Cuba constituted a proper accrual for the purpose of the foreign tax credit for the year to which the taxes relate irrespective of the fact that such taxes were contested and paid in a later year. Thus, based on three lower court cases before *Dixie Pine* was decided, the court rejected the Supreme Court’s application of the contested tax doctrine in a case involving a credit for the accrual of a foreign income tax.

The IRS reconciled the holdings in *Dixie Pine* and *The Cuba Railroad Company* in Rev. Rul. 58-55.⁷ Specifically, the question addressed in that ruling was “whether a taxpayer may consider a foreign tax accrued for the purpose of the foreign tax credit if the liability therefore is disputed and can not be reasonably fixed.” The IRS reviewed the holding

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of both cases and then contrasted the holdings of those cases with the purpose for the foreign tax credit. The IRS reasoned that allowing a credit for an accrual of a foreign income tax is based on the fundamental purpose of the credit, *i.e.*, to avoid double taxation. If a credit

was not allowed for an accrued but unpaid foreign income tax, the year in which the income is reported would be separated from the year in which the tax is paid, thus increasing the risk of double taxation. However, the IRS also cautioned that claiming a credit for a foreign income tax must also align with the all events test articulated in *Dixie Pine* and reflected in Code Sec. 461.

The compromise reached by the IRS in Rev. Rul. 58-55 is the “relation back doctrine.”

Accordingly, in view of the statutory framework, the legislative history and the concept of the foreign tax credit, it is held that the ‘contested tax’ doctrine as expressed in the *Dixie Pine Products Company* case is not applicable to the accrual of a foreign tax for the purpose of the credit under section 901. A foreign tax for the purpose of such credit is accruable for the taxable year to which it relates even though the taxpayer contests the liability therefore and such tax is not paid until a later year. Such accrual, however, cannot be made until the contested liability is finally determined.

In other words, regardless of the year in which a foreign income tax is paid, a credit for the tax relates back to the year in which the taxpayer reported the income to which the tax relates. In addition, a foreign tax does not accrue until the dispute is resolved.

It is difficult to determine the extent to which, if any, the result in Rev. Rul. 58-55 was influenced by the facts that Code Sec. 904(d) allowing for a carryover of excess foreign tax credits had not been enacted and that all taxpayers were required to use the per country limitation. Consequently, applying *Dixie Pine* could result in a denial of any credit because the taxpayer had insufficient income from sources within the foreign country asserting the deficiency in the year in which the dispute was resolved. The relation back doctrine usually meant that this problem would not arise.

The relation back doctrine was illustrated and refined in Rev. Rul. 84-125.⁸ That ruling involved a domestic corporation (X) using the accrual method of accounting. In 1973, FC, a foreign country, asserted that X was liable for 100x dollars of additional FC income tax with respect to X's FC 1971 tax year. X contested the assessment. Although contesting the assessment and without admitting that any additional amount was due, X in 1973 paid FC 5x dollars of the asserted deficiency. In 1978, it was finally determined that X was liable for 20x dollars of additional FC income tax for 1971, and in 1978 X paid the remaining 15x dollars (the 20x dollars due less the 5x dollars thereof that was paid in 1973) in satisfaction of the 1978 determination. The question addressed was whether X could claim a credit of 5x dollars in 1973, relating back to 1971, even though the taxpayer was contesting the liability. The IRS ruled that X could claim a credit for a contested, but paid, foreign income tax. The IRS further ruled that the payment of 15x dollars in 1978 related back to the 1971 year of the taxpayer.

As indicated, Code Sec. 905(a) imposes restrictions on the ability to claim a credit for accrued but unpaid taxes and also incorporates the relation back doctrine. Code Sec. 905(c) repeats the rule in Code Sec. 901(b) that a domestic corporation may claim a foreign tax credit in the year in which the foreign tax is paid or accrued. However, an adjustment to the amount of foreign tax credits claimed for accrued taxes is required if (1) accrued taxes when paid differ from the amounts claimed as credits, or (2) accrued taxes are not paid before the date two years after the close of the tax year to which the taxes relate.⁹ If such taxes are subsequently paid, an adjustment is made

to the amount of foreign tax credit claimed. In the case of a direct credit claimed under Code Sec. 901, the adjustment is made to the year to which the tax relates under the relation back doctrine.¹⁰ In the case of taxes deemed paid under Code Sec. 902 or 960, an adjustment is made in the year the tax is paid.¹¹ The relation back doctrine was dropped for credits claimed under Code Secs. 902 and 960 following the introduction of Code Sec. 902 pools of earnings and foreign taxes by the Tax Reform Act of 1986. The adjustment is made to the pools of post-1986 foreign income tax and undistributed earnings pool.

3. 10-Year Rule Under Code Sec. 6511(d)(3)

A refund claim may generally be filed within three years from the time the return is filed. Code Sec. 6511(d)(3) provides an extended ten year period to claim a refund with respect to the payment of a foreign income tax. In particular, that statute provides that if the refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country, in lieu of the three-year period of limitations provided in Code Sec. 6511(a), "the period shall be 10 years from the date prescribed by law for filing the return for the year in which such taxes were actually paid or accrued."

4. Issues Addressed by the FAA

Because the actual facts of the FAA have been redacted, the example set forth above illustrates the issues. The foreign tax liability relating to 1997 arose out of an assessment made by the government in 2000. The assessment was contested and the tax was not paid. In 2009 the dispute was settled and the tax was paid. The taxpayer sought a foreign tax credit.

If the relevant year for claiming the credit under the relation back doctrine is 1997, then both the regular three year statute of limitations for claiming a refund and the special 10-year statute of limitations to claim a refund relating to foreign tax credits would be closed by 2009. The taxpayer appears to have argued that a credit should be allowed on either the 2000 or the 2009 return, reflecting the year of the assessment and the year of payment, but the IRS rejected both approaches and denied credit for the foreign tax. The FAA follows a strict application of the relation back doctrine. The approach to the application of Code Sec. 6511(d)(3) is the same, *i.e.*, mechanical applica-

tion of the relation back doctrine with no exceptions and the 10-year statute runs from 1997.

5. Conclusion

It is ironic that the IRS applied a revenue ruling that was intended to enhance the likelihood that a taxpayer could claim credit for foreign income taxes to say that this taxpayer could not do so because doing so caused the statute of limitations to have expired. It is also interesting to note that the reasoning for the relation back doctrine is similar to the splitter rule in new Code Sec. 909, *i.e.*, to match the foreign income tax with the base on which the tax was imposed. On the other hand, the relation back doctrine has been abandoned for credits claimed under Code Sec. 902 and Code Sec. 960.

It is ironic that the IRS applied a revenue ruling that was intended to enhance the likelihood that a taxpayer could claim credit for foreign income taxes to say that this taxpayer could not do so because doing so caused the statute of limitations to have expired.

The FAA does not discuss whether the taxpayer could have filed a protective refund claim before the amount of the foreign tax was determined. It may not be procedurally possible to have a refund claim pending for nearly 10 years. Query whether a refund claim could be filed today taking into account the two-year restriction in Code Sec. 905(c) for claiming a credit for an accrued but unpaid tax and the “reasonable basis” requirement in Code Sec. 6676 to avoid a penalty for an “erroneous claim for refund or credit.” Alternatively, if the taxpayer abandons its attempts to secure a refund of the foreign tax so that it can file a complete refund claim before the 10-year statute expires, query whether the IRS could assert that the taxpayer has not exhausted its administrative remedies. Each of these may be another “trap for the unwary.”

ENDNOTES

¹ FAA 20105001F (Dec. 17, 2010).

² *Dixie Pine Products Co.*, 44-1 USTC ¶9127, 320 US 516, 64 S Ct 364.

³ *Dixie Pine*, 320 US, at 519.

⁴ *Id.*

⁵ *Id.*

⁶ *The Cuba Railroad Company*, DC-NY, 54-2 USTC ¶9498, 124 F Supp 182.

⁷ Rev. Rul. 58-55, 1958-1 CB 266.

⁸ Rev. Rul. 84-125, 1984-1 CB 125.

⁹ Code Sec. 905(c)(1).

¹⁰ Code Sec. 905(c)(2)(B)(i)(II).

¹¹ Code Sec. 905(c)(2)(B)(i)(I).

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