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Special Reports

Deconstructing Section 905(c): An Examination of The Redetermination Rules After TRA 1997

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Does anybody pay attention to section 905(c)? Although redetermination[1] of U.S. tax liability when there are changes in foreign taxes claimed as credits has been required since the foreign tax credit was introduced in 1918, section 905(c) and its predecessors have attracted little commentary. Even amendments to the redetermination rules in the Taxpayer Relief Act of 1997 (TRA) do not appear to have sparked much attention. This may be changing, though, in the wake of two recent pronouncements by the Internal Revenue Service and as taxpayers attempt to interpret and apply the new rules.[2]

TRA made two significant changes to the rules. First, it amended the regime for translating foreign taxes to U.S. dollar amounts, accepting in certain circumstances the exchange rate used for accrual of taxes instead of the rate at the time those taxes are paid. That change should reduce significantly the number of required redeterminations. Second, it added nonpayment of accrued taxes within two years as a triggering event for a redetermination. In addition, TRA explicitly authorized the use of pool adjustments in the case of deemed foreign tax credits in lieu of redeterminations.[3] The new two-year rule and its interaction with pool adjustments leave, or create, several unanswered questions, particularly with respect to the section 902 indirect foreign tax credit. No guidance has been issued with respect to the amendments to date, nor does any appear to be imminent. Taxpayers are thus left to extrapolate from the scant legislative history and limited guidance provided in temporary regulations issued in 1988 for answers to questions such as whether pool adjustments are the only option for indirect credit redeterminations and how to handle adjustments for taxes paid after the two-year window introduced by TRA.

This article is divided into three parts. First, it provides a broad overview of the foreign tax credit. It then discusses the development of the redetermination rules. Finally, it addresses the applica-

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[1]As discussed *infra*, the term "redetermination" as used in the section 905(c) regulations has two meanings: a change in foreign tax liability that may affect a U.S. taxpayer's U.S. tax liability and actual redetermination of U.S. tax liability. As used herein "redetermination" generally will refer to a redetermination of U.S. tax liability, except where the context makes a different meaning plain.

[2]PLR 200127011 (3 Apr. 2001); FSA 200035019 (31 May 2000). *See* Caren S. Shein and Kristine K. Schlaman, "Section 905(c) — The Neglected Piece of the Foreign Tax Credit Puzzle," *Tax Management International Journal,* 11 Jan. 2002, at 3.

[3]Such authorization had been implied by the Tax Reform Act of 1986, and pool adjustments have been prescribed under the temporary regulations issued under that enactment.

tion of the redetermination rules after the TRA changes, identifying and discussing questions that either remain unanswered or that were created by the TRA amendments.

I. The Foreign Tax Credit

Taxation by the United States of the worldwide income of residents combined with taxation by foreign countries of income earned within their borders gives rise to the possibility that U.S. persons with foreign operations could be subject to double taxation on income earned from those operations. Recognizing that U.S. companies doing business abroad could be at a disadvantage with respect to both U.S. companies doing business solely within the United States and foreign companies operating solely within their borders, Congress in 1918 introduced the foreign tax credit. The basic mechanics of the credit have not changed since then: A taxpayer that chooses the benefits of the credit receives, in lieu of a deduction for foreign income taxes paid, a dollar-for-dollar credit against U.S. income taxes. The implication is that foreign taxes are not just an expense but a special kind of expense on a par with U.S. taxes in many respects.[4] Through the years, however, this seemingly simple concept has given rise to a myriad of rules designed to prevent abuses — real and perceived — in the determination of allowable credits.

A. Creditable Taxes

A U.S. citizen or domestic corporation that elects the benefits of the foreign tax credit is credited, subject to limitations established in section 904 and other sections, with the amount of "any income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or to any possession of the United States" and, in the case of a corporation owning at least 10 percent of a foreign corporation, taxes deemed paid under sections 902 and 960.[5] Under section 905(a) a taxpayer may choose to claim the foreign tax credit in the year the foreign taxes accrue, irrespective of the taxpayer's general method of accounting. Thus, even a cash-basis taxpayer that normally reports income and expenses only on payment may elect to claim a credit for foreign taxes in the year the taxes accrue, prior to payment of the taxes. If an election is made, it applies for all subsequent years.[6]

As with any liability, foreign taxes accrue when the "all events test" is satisfied, that is, when all events have occurred that determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy.[7] The all events test is not met for an item any earlier than economic performance occurs with respect to that item.[8] In the case of taxes, economic performance generally occurs when the tax is paid to the governmental authority that imposed the tax.[9] However, in the case of taxes eligible for the foreign tax credit, economic performance occurs "when the requirements of the all events test . . . other than economic performance are met, whether or not the taxpayer elects to credit such taxes under section 901(a)."[10] That is, the foreign tax credit may be claimed, subject to the section 904 and other limitations, when the liability for the foreign tax is fixed and can be determined with reasonable accuracy, and the foreign tax accrues at that time even if the taxpayer chooses not to claim the credit.[11]

Shortly after it introduced the foreign tax credit Congress recognized that the mechanics of the credit effectively subsidized high foreign taxes.

Even though a taxpayer who elects to claim the credit in the year taxes accrue may eventually pay, in foreign currency, the exact amount of taxes that accrued, the U.S. dollar amount of taxes paid may very well be different from the dollar amount of accrued taxes by reason of currency fluctuations between the time of accrual and the time of payment. Therefore, as a condition for permitting a credit for accrued taxes, section 905(c) requires notification to the Secretary whenever taxes ultimately paid differ from those accrued and used in claiming the credit. The Secretary then makes appropriate adjustments to (redetermines) the taxpayer's U.S. tax for the year or years affected.

B. Section 904 Limitations

Shortly after it introduced the foreign tax credit Congress recognized that the mechanics of the credit effectively subsidized high

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[4] *See Compaq Computer Corp. v. Commissioner*, 2002-1 U.S.T.C. para. 50144 (5th Cir.); *IES Industries Inc. v. United States*, 2001-1 U.S.T.C. para. 50470 (8th Cir.).

[5] Section 901(a) and (b).

[6] Section 905(a).

[7] Section 461(h)(4).

[8] Section 461(h)(1).

[9] Treas. reg. section 1.461-4(g)(6)(i).

[10] Treas. reg. section 1.461-4(g)(6)(iii)(B).

[11] In TAM 9727002 (14 Mar. 1997) the taxpayer argued that its foreign subsidiary's pool of taxes should not be reduced on receipt of a dividend from its foreign affiliate because the taxpayer had not elected the benefit of the foreign tax credit. The Service held that the pool had to be reduced despite the taxpayer's decision not to claim the credit.

foreign taxes. That could occur because all foreign taxes paid on foreign income were creditable against U.S. income taxes. If the foreign income tax rate was higher than the U.S. rate, the dollar-for-dollar credit for foreign taxes imposed on foreign income could wipe out part of the U.S. tax "properly attributable to income derived from sources within the United States."[12] In response, in 1921 Congress introduced a limitation on the foreign tax credit. Currently found in section 904(a), the limitation provides that the total credit for a tax year cannot "exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States . . . bears to the entire taxable income for the same taxable year." Any excess credit, that is, credit disallowed under the limitation, may be carried back two years and forward five.[13]

Over time the "overall" limitation was found inadequate because, by permitting cross-crediting of taxes, or averaging, it allowed "taxpayers to credit high foreign taxes paid on one stream of income against the residual U.S. tax otherwise due on other, lightly taxed foreign income."[14] That is, low-taxed foreign earnings that otherwise would attract U.S. tax equal to the difference between the U.S. tax rate and the foreign tax rate could, through the use of excess foreign tax credits attributable to foreign earnings taxed at a rate higher than the U.S. rate, escape U.S. taxation. That phenomenon was viewed as creating an incentive for U.S. taxpayers with excess foreign tax credits to make investments in foreign jurisdictions with tax rates lower than the U.S. rate. The possibility of such favoring of foreign investment led over the years to a variety of limitation provisions, culminating in 1986 in section 904(d), which requires that the limitation be applied separately to nine different categories of income, popularly referred to as "baskets": passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, DISC dividends, foreign trade income, FSC distributions, and all other income (general income).

Under section 904(d) foreign income and taxes are allocated to those nine separate categories. A separate limitation is then computed for each one, and any foreign taxes in excess of the limitation for a particular basket are not currently creditable.[15]

Under section 960 subpart F inclusions are treated as dividends for purposes of determining foreign taxes that a U.S. corporation is deemed to have paid.

C. Deemed Paid Credit

In addition to receiving a credit for foreign taxes that it pays directly, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation may receive a credit for foreign taxes imposed on the foreign corporation.[16] That is accomplished by treating the U.S. corporation as if it had paid a portion of the foreign corporation's income taxes whenever it receives a dividend from the foreign corporation.[17] Provided certain ownership requirements are met the indirect credit may extend through six tiers of foreign corporations.[18] Further, under section 960 subpart F inclusions are

[12] S. Rep. No. 67-275, at 17 (1921).

[13] Section 904(c).

[14] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 862 (1987).

[15] The number of potential baskets for any given taxpayer is much higher than nine because, as originally enacted in 1986, the noncontrolled section 902 dividend basket was applied separately to each such corporation. The TRA amended section 904(d), providing, for tax years beginning after 31 December 2002, for a single basket for dividends from noncontrolled section 902 corporations out of earnings and profits accumulated in tax years beginning before 1 January 2003.

[16] Sections 901(a) and 902(a). The ownership must be through a single entity; ownership by affiliated corporations cannot be aggregated to meet the 10 percent threshold. *First Chicago NBD Corporation v. Commissioner*, 135 F.3d 457 (7th Cir. 1998), *aff'g* 96 T.C. 421 (1991).

[17] A gross-up for the amount of the credit ensures that the domestic corporation does not receive, in addition to the credit, a deduction. The gross-up, provided for in section 78, eliminates the need to apply the rule of *American Chicle Co. v. United States*, 316 U.S. 450 (1942), which limits the credit to the portion of foreign taxes attributable to accumulated earnings after deduction for the foreign taxes. *See* S. Rep. No. 87-1881, at 69 (1962), 1962-3 C.B. 927.

[18] Section 902(b). A foreign corporation that is a member of a qualified group and that receives a dividend from another member of which it owns at least 10 percent of the voting stock is deemed to have paid a proportion of the other member's foreign income taxes as determined under the section 902(a) rules. A qualified group means a foreign corporation of which at least 10 percent of the voting stock is owned by a domestic corporation plus any other foreign corporation if the domestic corporation indirectly owns at least 5 percent of the voting stock of such other foreign corporation through a chain of foreign corporations connected by stock ownership of at least 10 percent of voting stock, and further provided such other foreign corporation is not below the sixth tier in the chain (considering the foreign corporation directly owned by the domestic corporation as the first tier). A qualified group does not, however, include any foreign corporation below the third tier unless such corporation is a controlled foreign corporation within the meaning of section 957 and the domestic corporation is a U.S. shareholder as defined in section 951(b) with respect to the controlled foreign corporation.

treated as dividends for purposes of determining foreign taxes that a U.S. corporation is deemed to have paid.

Before 1986, a dividend paid by a foreign corporation was traced to specific year-by-year earnings of the distributing corporation on a last-in, first-out basis. Under that system a dividend paid out of earnings of a specific year was deemed to carry up the portion of the foreign corporation's taxes in that year corresponding to the ratio of the dividend to the distributing corporation's after-tax earnings for the year. The Tax Reform Act of 1986 changed that system to one involving perpetual pools of earnings and taxes for years after 1986.

Under the post-1986 system, a foreign corporation has pools of post-1986 undistributed earnings and post-1986 foreign income taxes corresponding to each of the section 904(d) limitation baskets.[19] On payment of a dividend by a foreign corporation to a 10 percent U.S. corporate shareholder, the shareholder is deemed to have paid a portion of the foreign taxes paid by the foreign corporation. For dividends paid out of post-1986 earnings the portion of foreign taxes that the domestic corporation is deemed to have paid is the same proportion of the foreign corporation's post-1986 foreign income taxes as the amount of the dividend bears to the foreign corporation's total post-1986 undistributed earnings.[20] For example, if a foreign corporation has post-1986 undistributed earnings of 100x, all of which fall in a single basket, and post-1986 foreign income taxes of 30x in the same basket, and it pays a dividend to its domestic parent of 50x, the domestic parent will be deemed to have paid 15x in foreign taxes. Following payment of the dividend, the foreign corporation's pool of post-1986 undistributed earnings will be reduced to 50x, and its pool of post-1986 taxes will be reduced to 15x. By reason of section 78, the dividend received by the U.S. corporation will be grossed up to include the deemed paid foreign taxes. That is, the U.S. corporation will be treated as receiving income of 65x (50 percent of the income of the foreign corporation before it paid foreign taxes).

"Post-1986 foreign income taxes" are defined as "the foreign income taxes with respect to the taxable year of the foreign corporation in the year of the foreign corporation in which the dividend is distributed" plus "the foreign income taxes with respect to prior taxable years beginning after 31 December 1986, to the extent such foreign taxes were not attributable to dividends distributed by the foreign corporation in prior taxable years."[21] Since the definition uses the term "taxes with respect to" rather than "taxes paid," a foreign corporation's post-1986 tax pool includes taxes accrued as well as paid. Just as a U.S. corporation may receive a direct credit for foreign taxes that it has accrued but not yet paid, it may receive an indirect credit for foreign taxes accrued but not yet paid by its foreign affiliate.

II. Foreign Tax Credit Redeterminations

A. The Evolution of Section 905(c)

The Revenue Act of 1918, which introduced the foreign tax credit, included the requirement that:

> If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the Commissioner, who shall redetermine the amount of the taxes due under this title and under Title III for the year or years affected, and the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner, as a condition precedent to the allowance of this credit may require the corporation to give a bond with sureties satisfactory to and to be approved by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due upon any such redetermination; and the bond herein prescribed shall contain any further conditions as the Commissioner may require.[22]

This language remained effectively unchanged until amendment of section 905(c) in TRA.[23]

The redetermination provision in the 1918 act is somewhat curious, since the statute appears to have allowed credit only for taxes "paid during the taxable year."[24] Thus, although there may

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[19]If applicable, the look-through rules of section 904(d)(3) are used to make assignments of income earned from related corporations to the appropriate baskets.

[20]Section 902(a). The computation is made on a basket-by-basket basis.

[21]Section 902(c)(2).

[22]Revenue Act of 1918, section 238(a). The Revenue Act of 1918 contained separate foreign tax credit sections for corporations and individuals in section 238 and section 222. Section 222(b) contained a redetermination provision identical to the one in section 238.

[23]In the Revenue Act of 1928 the separate foreign tax credit provisions for individuals and corporations were combined into a single provision, section 131, with the redetermination provision becoming section 131(c). In 1949 section 131(c) was amended to clarify that in the case of a refund of foreign taxes any redetermination of U.S. tax would be only for the net amount of the refund (to account for the practice in some countries of taxing a refund in the year it was made), and to eliminate interest with respect to any U.S. tax deficiency on account of the redetermination except to the extent that the foreign country paid interest on the refund. Pub. L. No. 378, 81st Cong.; H.R. Rep. No. 81-920, at 2-3 (1949). Section 131(c) became section 905(c) of the Internal Revenue Code of 1954.

[24]Revenue Act of 1918, sections 222(a) and 238(a).

have been a need to provide for redeterminations when foreign taxes were refunded, there should not have been a need to address differences in accrued and paid amounts. Perhaps the term "paid" as used in the 1918 act incorporated "accrued" for accrual-basis taxpayers. In any case, the Revenue Act of 1924 amended sections 222(a)(1) and 238(a), clarifying that the foreign tax credit was available for "taxes paid or accrued during the same taxable year to any foreign country."[25] The reason for allowing a credit for accrued foreign taxes was that, like the United States, most countries allowed payment of income taxes in the year following the year for which the taxes were imposed. Restricting the credit to foreign taxes actually paid meant that the credit would often be taken against U.S. tax for the year following the one in which the income that gave rise to the foreign tax was earned.[26] Whether to take the credit for foreign taxes as paid or accrued was solely at the option of the taxpayer.

Foreign taxes generally are assessed and paid in foreign currency. To determine for U.S. tax purposes whether accrued foreign taxes when paid differ from amounts claimed as credits, the value of the amount accrued in U.S. currency is compared with the value of the amount paid in U.S. currency.[27] Before the Tax Reform Act of 1986 there were no statutory rules governing the translation of taxes accrued or paid from foreign currency into U.S. currency, but the position of the Service was that, in the case of the direct credit, taxes paid were translated using the exchange rate in effect on the date of payment, and accrued taxes were translated using the exchange rate in effect on the last day of the tax year in which the taxes were accrued.[28] A change in exchange rates between accrual and payment dates would require notification and a potential redetermination under section 905(c). If foreign taxes were refunded, the refund was translated using the exchange rate in effect at the time of the refund.[29]

In the case of the indirect credit, the *Bon Ami* decision of the Board of Tax Appeals required that both the amount of the dividend and deemed paid foreign taxes be translated using the exchange rate in effect on the date of distribution.[30] Under that approach the historic ratio between foreign tax and foreign income was preserved, and the use of the exchange rate on the date of distribution to translate deemed paid foreign taxes "effectively negated the requirement that a foreign tax be retranslated if accrued and paid on a different date."[31] That is, a change in exchange rates between the date when a foreign subsidiary accrued foreign tax and when the tax was paid would not produce a section 905(c) redetermination.

> The legislative history indicates that adjustments to dollar-based pools of taxes were anticipated, in lieu of redeterminations.

The Tax Reform Act of 1986 introduced sections 985 through 989, providing a comprehensive set of rules governing foreign currency transactions. In the case of the deemed paid credit, Congress concluded that the *Bon Ami* approach resulted in different treatment for operations through subsidiaries from those carried on through branches, and that the purposes of the foreign tax credit would be better served by fixing the dollar cost for all foreign taxes as of the date when those taxes were paid. It therefore enacted section 986(a), which provided that (1) foreign taxes would be translated using the exchange rate in effect as of the time the taxes were paid, and (2) any adjustments to the amount of foreign taxes would be translated using the exchange rate in effect at the time the adjustment was made (paid), except that refunds would be translated using the exchange rate in effect at the time the refunded tax was paid — in other words, the refund would roll back the tax that had been paid previously. For purposes of section 905(c) the comparison between accrued and foreign taxes would be made, both for direct and indirect taxes, by comparing the U.S. dollar value of the accrued foreign tax to the U.S. dollar value of the tax paid. Recognizing that the rule could lead to administrative problems, section 989(c)(4) provided for alternative adjustments in the application of

[25] Section 222(a)(1) eliminated the word "same."

[26] S. Committee Print, 68th Cong., 1st Sess., at 22 (1924) (Statement of the Changes Made in the Revenue Act of 1921 and the Reasons Therefore).

[27] *First National City Bank v. United States*, 557 F.2d 1379 (Ct. Cl. 1977); *Comprehensive Designers International Ltd. v. Commissioner*, 66 T.C. 348 (1976); Rev. Rul. 73-506, 1973-2 C.B. 268.

[28] Rev. Rul. 73-491, 1973-2 C.B. 267. As used herein, the term "exchange rate in effect" means the spot rate on the date referred to.

[29] *American Telephone & Telegraph v. United States*, 430 F. Supp. 172 (S.D.N.Y. 1977), *aff'd* 567 F.2d 554 (2d Cir. 1978; Rev. Rul. 58-237, 1958-1 C.B. 534.

[30] *See Bon Ami v. Commissioner*, 39 B.T.A. 825 (1939).

[31] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1085 (1987).

section 905(c). The legislative history indicates that adjustments to dollar-based pools of taxes were anticipated, in lieu of redeterminations.[32]

B. The 1988 Temporary Regulations

In 1988 the Service promulgated temporary regulations to provide guidance on the new method for accounting for foreign tax redeterminations through adjustments to multi-year pools of foreign taxes and earnings and profits, as permitted by section 989(c)(4).[33] In addition, the regulations were intended to provide guidance both on events that trigger section 905(c) and on the notice requirements relating to that section.

1. The Definition of 'Redetermination'

Section 905(c) provides that following certain events a taxpayer should "notify the Secretary, who shall redetermine the amount of the tax for the year or years affected." The temporary regulations, however, use the term "redetermination" to mean both an event that triggers the requirement to notify the Secretary and the ensuing adjustment to U.S. tax liability. The triggering event is referred to as a foreign tax redetermination, and means any change in foreign tax liability that may affect a taxpayer's foreign tax credit. Foreign tax redeterminations include:

- a refund of foreign taxes;
- a difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid attributable to differences in the units of foreign currency paid and the units of foreign currency accrued; or
- a difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid attributable to fluctuations in the value of the foreign currency relative to the dollar value between the date of accrual and the date of payment.[34]

Following a foreign tax redetermination there is a redetermination of U.S. tax liability, that is, U.S. taxes are recomputed based on changes in available foreign tax credits as a result of the foreign tax redetermination.

2. Direct Credit

In the case of a foreign tax paid by the taxpayer claiming the credit (direct credit) the taxpayer's U.S. tax liability for the tax year in which the credit was claimed must be redetermined when a foreign tax redetermination occurs.[35] However, since currency fluctuations are likely to cause at least some difference between the U.S. dollar amount of foreign taxes accrued and foreign taxes eventually paid even with no change in the amount of foreign taxes due in terms of foreign currency, the temporary regulations provide a *de minimis* exception that allows an appropriate adjustment in the tax year in which the foreign tax redetermination occurs rather than the tax year in which the credit was claimed. That exception applies when the foreign tax redetermination is caused solely by currency fluctuations and the amount of the redetermination is less than the lesser of US $10,000 and 2 percent of the original accrual.

The triggering event is referred to as a foreign tax redetermination, and means any change in foreign tax liability that may affect a taxpayer's foreign tax credit.

3. Indirect Credit

A foreign corporation's pools of undistributed earnings are maintained in the foreign corporation's functional currency.[36] On payment of a dividend to a U.S. shareholder the distributed earnings are translated into dollars using the exchange rate in effect at the time of the distribution. The pool of foreign income taxes, however, is maintained in dollars. Prior to the TRA, accrued foreign taxes were translated, as in the direct tax case, using the exchange rate for the last day of the tax year; paid foreign taxes were translated using the exchange rate in effect at the time of payment. Thus, section 905(c) required notification whenever the exchange rate for deemed paid taxes differed between the time of accrual and the time of payment. That meant that U.S. tax liability would be redetermined whenever a U.S. corporation was deemed to have paid accrued foreign taxes that differed in dollars when paid, that is, virtually always when the foreign corporation paid a dividend that "carried out" a portion of accrued foreign taxes.

However, under the authority of section 989(c)(4), rather than requiring a redetermination of U.S. tax liability on any foreign tax redetermination of deemed paid taxes, the temporary regulations provide for adjustments to the foreign corporation's pools of foreign taxes and earnings and

[32] *Id.*, at 1109.

[33] T.D. 8210, 1988-2 C.B. 248.

[34] Treas. reg. section 1.905-3T(c).

[35] Treas. reg. section 1.905-3T(d)(1).

[36] Section 986(b).

profits. The regulations, though, continue to require a full redetermination of U.S. tax liability in four situations:

- if the foreign tax liability is in a hyperinflationary currency;
- if adjustment to pools would have the effect of reducing below zero the foreign corporation's pool of foreign taxes in any separate category;
- at the Service's option, if the accrued foreign tax, measured in foreign currency, exceeds the paid foreign tax by more than 2 percent; and
- if a U.S. shareholder of a controlled foreign corporation receives a distribution out of previously taxed earnings and profits and a foreign country has imposed tax on the income of the controlled foreign corporation, which tax is reduced on the distribution of the corporation's earnings and profits.[37]

In determining whether the pool adjustment would create a deficit in any of the pools of foreign taxes, examination is made as of the close of the tax year in which the foreign tax redetermination occurs.

Example: The wholly owned foreign subsidiary (FS) of P, a domestic corporation, has 200u of general limitation earnings and profits in year 1 with respect to which it pays 100u of foreign taxes when the exchange rate is $1:1u. In year 1, FS pays a 100u dividend to P. P is deemed to have paid $50 of foreign taxes, FS's foreign tax pool is decreased to $50, and FS's earnings pool is decreased to 100u. In year 2, FS receives a refund of the full 100u in foreign taxes paid in year 1 and earns 90u of general limitation earnings and profits, with respect to which it pays 45u of foreign taxes when the exchange rate is $1:1u. P's U.S. tax liability will be redetermined because if the adjustment was made to FS's pool of general limitation foreign taxes the pool would have a deficit of $5 ($50 remaining after year 1 distribution less $100 refund in year 2 plus $45 paid in year 2).[38]

If a redetermination of U.S. tax liability is not required, appropriate upward and downward adjustments are made, as of the time of the foreign tax redetermination, to the pools of foreign taxes and earnings and profits of the foreign corporation.[39] In the case of a refund of foreign taxes, the foreign corporation reduces its pool of foreign taxes in the appropriate separate limitation category by the dollar amount of the foreign tax refund translated using the exchange rate for the date the taxes were initially paid. The foreign corporation increases its pool of earnings in the appropriate separate limitation category by the foreign currency amount of the refund.[40] Additional assessments of foreign taxes increase the pool of foreign taxes in the appropriate separate limitation category by the dollar amount of the additional foreign taxes paid or accrued. The foreign corporation decreases its earnings in the appropriate separate limitation category by the foreign currency amount of the additional foreign tax paid or accrued.[41] A foreign tax redetermination caused solely by an exchange rate fluctuation results in an adjustment to the pool of foreign taxes in the appropriate separate limitation category or categories, but no change in the earnings pool or pools.

> The refund was to be translated using the exchange rate in effect when the taxes were initially paid, but it might be difficult to determine that rate if payments had been made in installments.

All pool adjustments under the temporary regulations are forward looking — that is, they affect foreign tax credit computations for distributions only as of the year of the foreign corporation in which the earnings and tax pools are adjusted. Originally, temp. reg. section 1.905-3T(d)(2)(ii)(A) required an adjustment on the U.S. taxpayer's return to account for the effect of a foreign tax redetermination if the redetermination occurred more than 90 days before the due date of the U.S. return and before the return was filed. That provision, however, was suspended indefinitely by Notice 90-26.[42]

C. 1991 Proposed Changes

Not long after the Tax Reform Act of 1986 changed the rules for translation of foreign taxes, Congress became concerned with the substantial recordkeeping, verification, and examination burdens associated with deferral and the foreign tax credit, including the indirect credit.[43] With each foreign tax payment translated at the exchange rate for the date of payment, a taxpayer making frequent foreign tax payments in a single tax year would have to maintain documentation for each such payment. If a refund was received, the refund was to be translated using the

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[37] Treas. reg. sections 1.905-3T(d)(4) and (f).

[38] Treas. reg. section 1.905-3T(d)(4)(iv).

[39] Treas. reg. section 1.905-3T(d)(2)(ii)(B).

[40] Treas. reg. section 1.905-3T(d)(3)(ii).

[41] Treas. reg. section 1.905-3T(d)(3)(iii).

[42] 1990-1 C.B. 336.

[43] Technical Explanation of H.R. 4287, Ways and Means Committee Print 102-35, at 205 (24 Feb. 1992).

exchange rate in effect when the taxes were initially paid, but it might be difficult to determine that rate if payments had been made in installments. To relieve those burdens revised translation and redetermination rules were proposed. Those proposals were based on the beliefs that taxpayers should be permitted to use average translation rates for the period in which tax payments are made, taxpayers using the accrual method should not have to retranslate taxes if they are paid within a reasonably short time after accrual, and taxes not paid within a reasonably short time after accrual should not be treated as paid in the year of accrual. Specifically, it was proposed that taxpayers who take accrued foreign taxes into account for purposes of determining the foreign tax credit be permitted to translate such taxes at the average exchange rate for the tax year to which the taxes relate. If tax in excess of the accrued tax is eventually paid, the excess amount would be translated using the exchange rate at the time of payment.

The rules would not apply to taxpayers who did not use the accrual method for determining creditable taxes, for taxes paid in a year before the year to which they relate or, to the extent provided in the regulations, to tax payments denominated in an inflationary currency. In addition, the rules would not apply to any foreign income tax paid more than two years after the close of the tax year to which the tax relates. Notification and redetermination would be required for any accrued tax not paid within the two-year period, as well as for any refunded tax and any accrued tax that, when paid, differed in the amount of foreign currency from the amount claimed.

The proposed legislation was not passed, but it resurfaced and was enacted, essentially unchanged, as part of the TRA.

D. The TRA Changes

Section 986(a)(1), as amended by TRA, provides:

> TRANSLATION OF ACCRUED TAXES. —
>
> (A) IN GENERAL. — For purposes of determining the amount of the foreign tax credit, in the case of a taxpayer who takes foreign income taxes into account when accrued, the amount of any foreign income taxes (and any adjustment thereto) shall be translated into dollars by using the average exchange rate for the taxable year to which such taxes relate.
>
> (B) EXCEPTION FOR CERTAIN TAXES. — Subparagraph (A) shall not apply to any foreign income taxes —
>
> (i) paid after the date 2 years after the close of the taxable year to which such taxes relate, or
>
> (ii) paid before the beginning of the taxable year to which such taxes relate.
>
> (C) EXCEPTION FOR INFLATIONARY CURRENCIES. — Subparagraph (A) shall not apply to any foreign income taxes the liability for which is denominated in any inflationary currency (as determined under regulations).
>
> (D) CROSS REFERENCE. — For adjustments where tax is not paid within 2 years, see section 905(c).

Foreign taxes not covered by section 986(a)(1) are covered by section 986(a)(2), which provides:

> TRANSLATION OF TAXES TO WHICH PARAGRAPH (1) DOES NOT APPLY. — For purposes of determining the amount of the foreign tax credit, in the case of any foreign income taxes to which subparagraph (A) of paragraph (1) does not apply —
>
> (A) such taxes shall be translated into dollars using the exchange rates as of the time such taxes were paid to the foreign country or possession of the United States, and
>
> (B) any adjustment to the amount of such taxes shall be translated into dollars using —
>
> (i) except as provided in clause (ii), the exchange rate as of the time when such adjustment is paid to the foreign country or possession, or
>
> (ii) in the case of any refund or credit of foreign income taxes, using the exchange rate as of the time of the original payment of such foreign income taxes.

Finally, section 986(a)(3) provides that "to the extent prescribed in regulations, the average exchange rate for the period (specified in such regulations) during which the taxes or adjustment is paid may be used instead of the exchange rate as of the time of such payment."

Section 905(c), as amended, now provides:

> (1) IN GENERAL. — If —
>
> (A) accrued taxes when paid differ from the amounts claimed as credits by the taxpayer,
>
> (B) accrued taxes are not paid before the date 2 years after the close of the taxable year to which such taxes relate, or
>
> (C) any tax paid is refunded in whole or in part,
>
> the taxpayer shall notify the Secretary, who shall redetermine the amount of the tax for the year or years affected. The Secretary may prescribe adjustments to the pools of post-1986 foreign income

taxes and the pools of post-1986 undistributed earnings under sections 902 and 960 in lieu of the redetermination under the preceding sentence.

(2) SPECIAL RULE FOR TAXES NOT PAID WITHIN 2 YEARS. —

(A) IN GENERAL. — Except as provided in subparagraph (B), in making the redetermination under paragraph (1), no credit shall be allowed for accrued taxes not paid before the date referred to in subparagraph (B) of paragraph (1).

(B) TAXES SUBSEQUENTLY PAID. — Any such taxes if subsequently paid —

(i) shall be taken into account—

(I) in the case of taxes deemed paid under section 902 or section 960, for the taxable year in which paid (and no redetermination shall be made under this section by reason of such payment), and

(II) in any other case, for the taxable year to which such taxes relate, and

(ii) shall be translated as provided in section 986(a)(2)(A).

(3) ADJUSTMENTS. — The amount of tax (if any) due on any redetermination under paragraph (1) shall be paid by the taxpayer on notice and demand by the Secretary, and the amount of tax overpaid (if any) shall be credited or refunded to the taxpayer in accordance with subchapter B of chapter 66 (section 6511 et seq.).

(4) BOND REQUIREMENTS. — In the case of any tax accrued but not paid, the Secretary, as a condition precedent to the allowance of the credit provided in this subpart, may require the taxpayer to give a bond, with sureties satisfactory to and approved by the Secretary, in such sum as the Secretary may require, conditioned on the payment by the taxpayer of any amount of tax found due on any such redetermination. Any such bond shall contain such further conditions as the Secretary may require.

(5) OTHER SPECIAL RULES.—In any redetermination under paragraph (1) by the Secretary of the amount of tax due from the taxpayer for the year or years affected by a refund, the amount of the taxes refunded for which credit has been allowed under this section shall be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund; but no credit under this subpart, or deduction under section 164, shall be allowed for any taxable year with respect to any such tax imposed on the refund. No interest shall be assessed or collected on any amount of tax due on any redetermination by the Secretary, resulting from a refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

> Before the TRA, accrued but unpaid foreign taxes were translated into dollars using the exchange rate in effect for the last day of the taxpayer's tax year.

The TRA changes to section 986(a) apply to taxes paid or accrued in tax years beginning after 31 December 1997, and the changes to section 905(c) apply to taxes relating to tax years beginning after 31 December 1997.[44]

III. Applying Section 905(c) After the TRA Changes

A. Direct Credit

As discussed above, the TRA changed the translation rules for foreign taxes to effectively eliminate redeterminations when the sole reason for the difference in amounts accrued and paid is due to exchange rate fluctuations and the taxes are paid within two years from the close of the year to which they relate. Before the TRA, accrued but unpaid foreign taxes were translated into dollars using the exchange rate in effect for the last day of the taxpayer's tax year.[45] Foreign taxes when paid were translated at the exchange rate in effect on the date of payment.[46] That meant that, subject to the *de minimis* rule, redetermination was required any time the exchange rate on the date taxes were paid differed from the exchange rate on the last day of the year in which the taxes accrued.

The TRA changed those rules so that accrued foreign taxes and

[44]Pub. L. No. 105-34, section 1102(c).

[45]Treas. reg. section 1.905-3T(b)(1).

[46]Section 986(a)(1)(A) (prior to TRA).

adjustments thereto are translated using the average exchange rate for the tax year to which the taxes relate, provided the taxes are paid within two years after the close of the tax year in which they accrued and the taxes are not paid before the beginning of the tax year to which they relate and are not denominated in an inflationary currency.[47] That means that if a foreign currency is not inflationary and the units of foreign tax accrued are paid within two years there will be no redetermination even though the actual dollar amount of foreign taxes at the date of payment (as represented by those units of foreign currency) differs from the dollar amount accrued.[48]

Any foreign taxes paid more than two years after the close of the tax year to which the taxes relate will be translated using the exchange rate in effect on the date of payment, and any adjustment to such taxes will be translated at the exchange rate in effect on the date the adjustment is paid, except that a refund or credit of foreign taxes will be translated using the exchange rate in effect at the time of the original payment.[49] For example:

> Assume in year 1 a taxpayer accrues 1,000 units of country X tax that relate to year 1, the country X currency is not inflationary, the tax is unpaid at the end of year 1, and the average exchange rate in year 1 is $1 per unit of country X currency. The taxpayer will accrue $1,000 of foreign tax and claim a foreign tax credit for that amount assuming all necessary requirements are met. Now assume that at the end of year 3 the taxpayer pays 800 units of the country X tax when the exchange rate is $0.85 per unit of country X currency, and that the remaining 200 units of country X tax are paid in year 4 when the exchange rate is $0.80. After the end of year 3 the taxpayer must notify the Secretary, who will redetermine U.S. tax liability for year 1 using foreign tax accrued in year 1 of $800 (800 units paid within two years using the average exchange rate for the year in which the taxes were accrued). When the remaining 200 units of foreign tax relating to year 1 are paid in year 4, the taxpayer must again notify the Secretary (because accrued taxes when paid differ from the amounts claimed as credits).[50] Year 1 foreign taxes will be $960 (800 units at $1 and 200 units at $0.80) and U.S. tax liability will be redetermined based on that amount.[51]

Although the redetermination rules as applied to the direct credit are fairly straightforward, the provisions relating to the indirect credit are problematic.

B. Indirect Credit

Section 905(c), as amended by the TRA, provides that the Secretary may prescribe adjustments to the post-1986 pools of foreign taxes and undistributed earnings under sections 902 and 960 in lieu of the required redetermination when (1) accrued foreign taxes when paid differ from the amount claimed as credits, (2) accrued foreign taxes are not paid within two years after the close of the tax year to which they relate, or (3) a foreign tax is refunded in whole or in part. When foreign taxes are not paid within two years after the close of the tax year to which they relate, no credit is allowed for the accrued taxes.[52] In the case of foreign taxes deemed paid under sections 902 and 960, accrued foreign taxes paid more than two years after the close of the year to which they relate are taken into account in the year paid, and there is no redetermination when payment occurs.

Although the redetermination rules as applied to the direct credit, both before and after the TRA amendments, are fairly straightforward and raise few, if any, questions, the provisions relating to the indirect credit are

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[47] Section 986(a)(1). "Inflationary currency" is to be determined under regulations, but the term may have the same meaning as "hyperinflationary currency," that is, reflecting 100 percent inflation for the 36-month period preceding the first day of the current calendar year. Treas. reg. section 1.985-1(b)(2)(ii)(D).

[48] Under the temporary regulations a more than *de minimis* change in the dollar value of accrued and paid foreign taxes caused solely by currency fluctuation remains a foreign tax redetermination. However, the TRA Conference Report indicates that no redetermination of foreign tax is required if the units of foreign tax accrued are paid within two years. H.R. 105-220, at 615 (1997). Thus, even though the change technically would be a foreign tax redetermination (assuming no change in the definition when new guidance is issued), the foreign tax redetermination would not cause a redetermination of U.S. tax liability since, under the new translation rules, the dollar amount of foreign taxes paid would be the same as the dollar amount of taxes accrued.

[49] Section 986(a)(2).

[50] Section 905(c)(1)(A).

[51] Sections 905(c)(2)(B)(i)(II) and (ii).

[52] As discussed below, if pool adjustments are used in lieu of redeterminations for deemed-paid credits, it appears that, notwithstanding the statute, credits may be allowed for accrued foreign taxes not paid within the two-year period.

problematic. The following paragraphs identify and discuss some of the principal questions raised by those provisions.

1. When Does a Foreign Tax Redetermination Occur?

Section 905(c) notification and redetermination requirements are triggered if (1) accrued foreign taxes when paid differ from amounts claimed as credits, (2) accrued foreign taxes are not paid within the two-year period, or (3) a foreign tax, having been paid, is refunded. The temporary regulations use the term "foreign tax redetermination" to refer to a triggering event. A foreign tax redetermination includes: (1) a refund of foreign taxes; (2) a difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid attributable to differences in units of foreign currency paid and units of foreign currency accrued; and (3) a difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid attributable to fluctuations in the value of foreign currency relative to the dollar value between the date of accrual and the date of payment. With respect to differences in the amount of taxes accrued and paid (items (2) and (3) above), the definition in the temporary regulations does not refer to "the amounts claimed as credits" that is found in the statute. That raises the question whether the term "foreign tax redetermination" as used in the temporary regulations is intended to include changes between the initial accrual of a tax and the amount ultimately paid even if the initial accrual was not claimed as a credit prior to payment. Field Service Advice (FSA) 200035019[53] may shed some light on the question.

In the FSA, U.S. Parent (USP) filed a consolidated return with USSub1 and USSub2. USSub1 owned 100 percent of the stock of USSub2, which owned 100 percent of the stock of FS, a Country X corporation. FS settled a year 4 controversy by paying additional foreign income tax in year 9. The controversy pertained to FS's treatment of gain realized on the sale in year 4 of stock of a Country X corporation. FS treated the gain as nontaxable in Country X, while USSub2 treated the gain as subpart F income. Country X challenged FS's position on audit, and in year 9 the parties settled, with FS paying tax on the gain. USP filed an amended return for year 4, requesting a refund on account of additional deemed-paid foreign tax credits for the Country X tax paid by FS in year 9. Year 4 was a tax year beginning before 1 January 1998, and year 9 was a tax year beginning after 31 December 1997.

> The temporary regulations use the term 'foreign tax redetermination' to refer to a triggering event.

The taxpayer took the position that there was no foreign tax redetermination because the amount of foreign tax paid was identical to the foreign tax accrued and claimed as a credit on the amended return. In support of its position the taxpayer cited Revenue Rulings 84-125, 70-290, and 58-55,[54] which hold that, although a contested tax does not accrue until the contest is settled, on settlement the tax accrues, for foreign tax credit purposes, in the year to which the tax relates.

Recognizing that the amount of tax ultimately paid was identical to the amount ultimately accrued, the National Office nevertheless argued that that did not matter for purposes of the section 905(c) test. Instead it maintained that the taxpayer must compare the amount originally accrued and claimed as a credit with the revised amounts accrued and paid as a result of the settlement. Since the amount used to calculate USP's deemed-paid credit on its year 4 return as originally filed differed from the amount accrued and paid by FS, there was a foreign tax redetermination. None of the exceptions to pool adjustments applied, and prospective adjustment to FS's earnings and taxes pools was required as of year 9.

In the FSA, USSub2 had claimed a credit in year 4 using the amount of deemed-paid tax originally accrued by FS in that year. Although not stated clearly in the FSA, presumably USSub2's subpart F inclusion from FS in year 4 brought up credits from FS's tax pool, including all taxes accrued in year 4 as of the time of the inclusion. Therefore, FS's accrual and payment of additional year 4 tax in year 9 triggered section 905(c) because "the accrued taxes when paid differ[ed] from the amounts claimed as credits."

Suppose, however, that USSub2 had not had a year 4 subpart F inclusion from FS and had not yet claimed a credit with respect to FS's year 4 taxes at the time of the settlement. In those circumstances it appears that there should not be a foreign tax redetermination solely on account of the additional accrual, because the accrued taxes (the combination of the original year 4 taxes and the additional taxes attributable to the settle-

[53] 31 May 2000.

[54] 1984-2 C.B. 125, 1970-1 C.B. 160, and 1958-1 C.B. 266.

ment relating to year 4) when paid would not differ, in foreign currency, from the amounts claimed as credits. For example, assume FS originally accrued 100u of country X tax in year 4, which it paid in year 5, had no subpart F income, did not make any distributions in years 4 and 5, settled a year 4 contest in year 6 by accruing and paying additional country X tax, and made a distribution in year 6. Under those facts it appears that section 905(c) should not apply, that is, the difference between the original and final accrual should not be a foreign tax redetermination.[55]

On those facts it really does not matter whether the additional accrual is a foreign tax redetermination, since in any case FS would add the additional accrual to its taxes pool (either in year 4 or year 6) and bring up the appropriate portion of the pool with the year 6 distribution. However, it would make a difference if there had been a distribution in year 5. If a foreign tax redetermination requires that a credit has been claimed and the deemed credit on account of the year 5 distribution is not claimed until USP files its year 5 return in year 6,[56] the additional year 4 accrual on account of the year 6 settlement could be claimed for year 5. That is, since the additional accrual would not be a foreign tax redetermination the taxpayer would not be restricted to a forward-looking pool adjustment. If, instead, the accrual as a result of the settlement is a foreign tax redetermination even though no credit had been claimed with respect to the year 4 tax, forward-looking pool adjustments would be required and the additional accrual could not be claimed as a credit in year 5.

2. After TRA Are Pool Adjustments Permitted if Taxes Are Not Paid Within Two Years?

Section 905(c)(2)(A) provides that no credit shall be allowed for accrued foreign taxes not paid within two years after the close of the year to which the taxes relate. Moreover, the Joint Committee on Taxation explanation of the TRA states that section 905(c) was intended to require redeterminations whenever accrued foreign taxes are not paid within the two-year period. "By drawing a bright line between those foreign tax payment delays that do and do not require redetermination, the Congress believed that a reasonable degree of certainty and clarity will be added to the law in this area."[57] The statutory language and the legislative history seem to indicate that if foreign taxes are not paid within the two-year period U.S. tax liability must be redetermined, regardless of whether the taxes represent direct or indirect credits.

Section 905(c)(2)(A) provides that no credit shall be allowed for accrued foreign taxes not paid within two years after the close of the year to which the taxes relate.

On the other hand, section 905(c)(1)(C) provides that the Secretary may adjust pools in lieu of redetermination, and section 905(c)(2)(B)(i)(I) provides that no redetermination is to be made when taxes deemed paid under section 902 or section 960 and not paid within two years of accrual are subsequently paid. Those provisions suggest pool adjustments when an accrued tax claimed as an indirect credit is not paid within the two-year period.

The resolution of the apparent inconsistency in statutory language could lead to very different results. For example, assume FS accrues foreign tax of 100x in year 1, its corresponding earnings pool after deducting accrued tax is -20x, and FS makes a distribution to USP at the end of year 1. The distribution would not carry out any foreign taxes, and USP would not be able to claim an indirect credit. Now assume FS pays only 40x of the tax within the two-year period. With a pool adjustment, the taxes pool would be decreased by 60x, the earnings pool would be increased by 60x, and a credit would be available in year 4.[58] Under section 904(c) the credit could be carried back to year 2. If, instead, there was a redetermination, foreign taxes for year 1 would be decreased by 60x and earnings increased by that amount. The distribution in year 1 would bring up a credit in that year.

Alternatively, assume the same facts except that FS has a positive earnings pool in year 1, pays a dividend at least equal to the

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[55]*See* Treas. reg. section 1.905-3T(d)(2)(iv), ex. 3. In addition to shedding some light on the meaning of "foreign tax redetermination," the FSA makes clear the Service's position that pool adjustments are mandatory unless one of the exceptions in the regulations applies.

[56]*See* discussion *infra*.

[57]Joint Committee on Taxation, General Explanation of the Taxpayer Relief Act of 1997, at 297 (1997).

[58]This assumes the pool adjustment is made after the end of the two-year period, that is, at the beginning of year 4. If instead the pool adjustment is made as of the end of year 3, a credit could be claimed for year 3. That is, if the pool adjustment is made as of the end of year 3 resulting in a positive year 3 earnings pool, a distribution in that year would bring up credits, but if the adjustment is made only after the end of year 3, the year 3 earnings pool would remain negative and a year 3 distribution would not bring up any credits.

earnings pool, and USP claims a credit of 100x. Also assume that sufficient additional taxes are accrued in years 2 and 3 so that the taxes pool remains positive after being reduced by the 60x of taxes not paid within the two-year period. There would be no redetermination under the temporary regulations and USP would have received a credit for foreign taxes not paid within the two-year period, even though section 905(c)(2)(A) provides that there shall be no credit for such taxes. That result appears inconsistent with the statute and congressional intent; on the other hand, the requirement that no credit be allowed for foreign taxes not paid within the two-year period would require retroactive pool adjustments, which are not contemplated by the temporary regulations. It is to be hoped that new regulations, when issued, will address and resolve those anomalies. On the face of the statute the better answer would appear to involve retroactive pool adjustments, that is, require a redetermination of U.S. tax liability whenever foreign taxes are not paid within the two-year period.

3. How Does the Two-Year Rule Apply to Indirect Credits?

If in fact no credit is allowed for accrued deemed-paid foreign taxes not paid within the two-year period, as section 905(c)(2)(A) appears to dictate, there are questions regarding the method for eliminating the credit. For example, assume FS has earnings after foreign taxes of 200u and foreign taxes of 100u in year 1, all in a single basket, and that the exchange rate for year 1 is $1:1u. In year 2, with the exchange rate still $1:1u, FS has no earnings and pays no foreign taxes, and at the end of the year pays a dividend of 100u to USP. The dividend will carry out a credit of $50, and USP will have income of $150 (100u dividend translated at $1:1u, grossed up under section 78 for the $50 credit).

Now assume the 100u in foreign taxes accrued by FS in year 1 have not been paid as of the end of year 3. If section 905(c)(2)(A) applies to deny a credit in year 2, either retroactive adjustments could be made to FS's year 1 pools, with a redetermination of USP's year 1 U.S. tax liability using revised pools, or the year 1 credit claimed by USP could be suspended until the foreign tax is paid. In the latter event, would there be an adjustment to the grossed-up dividend as well, yielding the same result as a redetermination, or would the foreign tax continue to be deemed paid in year 2 for income purposes but denied solely for credit purposes? It certainly would be a strange result if the credit was suspended until the year the foreign tax is paid, as section 905(c)(2)(B)(i)(I) appears to require, but an equivalent amount was included in income in the prior year under section 78. However, there is nothing to prevent that result; under section 902 USP would be deemed to have paid $50 in foreign tax and under section 78 the deemed tax would be treated as a dividend received by USP.

> The temporary regulations do not contemplate a situation in which there are no pools to adjust at the time of a foreign tax redetermination.

If the credit is suspended, would it be allowed when the foreign tax is paid, or would it be allowed only on a distribution following payment? Moreover, if the elimination of the credit does not remove the amount of the deemed-paid foreign tax from income in the year when the credit was first claimed, section 78 would have to be inoperable when the credit is brought up to ensure that the deemed-paid tax is not included in income twice: once on the original distribution and again when allowed as a credit. That could be accomplished either by allowing a credit for the foreign tax when it is paid without payment of a dividend or by treating an amount equal to the foreign tax as previously taxed income when it is carried out through payment of a dividend.

Given the complications if the credit is suspended, the better answer appears to be a retroactive pool adjustment and redetermination of U.S. tax liability.

4. Could Treasury Promulgate Regulations Permitting Retroactive Pool Adjustments When Taxes Are Paid Outside the Two-Year Period?

Section 905(c)(2)(B)(i)(I) provides that for deemed-paid taxes no redetermination shall be made by reason of a payment of accrued foreign taxes that does not occur within the two-year period, and that such taxes shall be taken into account for the tax year in which they are paid. That seems to preclude retroactive shareholder-level redeterminations for taxes deemed paid under section 902 or section 960. However, if regulations are promulgated providing for pool adjustments in lieu of redeterminations for indirect credits, as permitted by section 905(c)(1), section 905(c)(2) would seem to be a nullity with respect to indirect credits. That is, since there would be no redetermination under section 905(c)(1), section 905(c)(2)(B), which provides the rule for when a credit may be allowed for taxes paid after expiration of the two-year period, would not apply. On that reading, with the admonition on when subsequently paid foreign taxes may be taken into account inoperable, regulations could permit retroactive pool adjustments and shareholder-level redeterminations when the taxes are actually paid.

5. How Are Adjustments Handled When Pools No Longer Exist?

In PLR 200127011[59] the Service considered how to deal with payments of additional foreign tax by a controlled foreign corporation after the CFC had been liquidated for U.S. tax purposes. In the ruling Corp B, a Country X entity treated as a corporation for U.S. tax purposes, was liquidated before completion of Country X audits for years 2 through 5. It was expected that, on completion of the audits, additional Country X taxes would be assessed against Corp B for years 2, 3, 4, and 5. Years 2 through 4 began before 1 January 1998, and year 5 began after 31 December 1997. Thus, there would be a foreign tax redetermination at a time when Corp B, and its pools, no longer existed for U.S. tax purposes.

The temporary regulations do not contemplate a situation in which there are no pools to adjust at the time of a foreign tax redetermination. The National Office held that a redetermination of U.S. tax liability would be required. That would be accomplished by adjusting the pools for the tax years to which the additional taxes relate, and redetermining U.S. tax liability for those years using the adjusted pools.

There is no obvious alternative to that approach. Suppose, however, that instead of liquidating Corp B had ceased to be a CFC and no longer had any 10 percent U.S. shareholders. Under current regulations Corp B would continue to maintain its post-1986 pools, so it would be possible to make the pool adjustments on payment of additional tax.[60] However, there would not be any way to harvest those additional taxes as credits unless a subsequent ownership change was to produce a 10 percent U.S. shareholder.

The ruling provides two reasons for not taking account of the foreign tax redetermination of pre-1998 foreign taxes through a pooling adjustment. First, following liquidation of the foreign corporation there are no pools to adjust at the time of the redetermination. Second, the effect of the redetermination cannot be reflected in calculating the amount of deemed-paid credits with respect to subsequent distributions and inclusions since no subsequent distributions/inclusions can occur.

Does 'subsequent' mean the year in which the foreign tax redetermination occurs and later years, or does it mean any year after the year to which the taxes relate?

The second reason could apply to a change to foreign ownership, requiring redetermination of U.S. tax liability for the year to which the foreign taxes relate.

For post-1997 years the ruling states that, because no pools will exist in the year the additional tax is paid, section 905(c)(2)(B)(i)(I) cannot apply, that is, the taxes cannot be taken into account in the year paid. Therefore, section 905(c)(2)(B)(i)(II) applies, and the taxes are taken into account in the year to which they relate. That rationale could apply to an ownership change. Thus, it appears that a foreign tax redetermination after an ownership change that causes a foreign corporation to no longer have a 10 percent U.S. shareholder should be treated as another exception to forward-looking pool adjustments.

6. When Are Pool Adjustments Effective?

Treasury reg. section 1.905-3T(d)(2)(B) provides that pool adjustments are made at the time of the foreign tax redetermination to "reflect the effect of the foreign tax redetermination in calculating foreign taxes deemed paid with respect to distributions and inclusions . . . that are includible in taxable years subsequent to the taxable year [to which the taxes relate]." Does "subsequent" mean the year in which the foreign tax redetermination occurs and later years, or does it mean any year after the year to which the taxes relate? If there has not been a distribution or inclusion between the year to which the taxes relate and the year in which the foreign tax redetermination occurs, there is no issue. That is, the pools will be adjusted in the year of the foreign tax redetermination, and distributions/inclusions in that year or subsequent years will carry out the credit. If, instead, there has been an intervening distribution or inclusion, the meaning of "subsequent" is relevant.

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[59] 3 April 2001.

[60] Treasury reg. section 1.902-1(a)(13) provides that the post-1986 pools reflect only tax years beginning on or after the first day of the first tax year of the foreign corporation in which the ownership requirements of section 902(c)(3)(B) are met, including subsequent tax years in which the ownership requirements are not met. Regulations have been proposed that would suspend pooling for years in which the ownership requirement is not met. *See* prop. reg. section 1.902-1(a)(13). If those regulations become final, pools would not exist at the time the additional foreign taxes are paid, and the rationale of the ruling should apply.

Assume, for example, that FS earns subpart F income in years 1, 2, and 3, and that in year 3 additional foreign tax is assessed with respect to year 1. Assume further that the assessment in year 3 occurs before both FS and USP file their year 2 returns. Treasury reg. section 1.905-3T(d)(2)(B) can be read to permit adjustments to FS's year 2 pools, since such adjustments would be reflected in calculating foreign taxes deemed paid with respect to a year 2 inclusion, that is, a tax year subsequent to year 1, the year to which the foreign tax redetermination relates. Such a result would be odd, particularly since a year 3 foreign tax redetermination with respect to a year 2 tax cannot be reflected in year 2, even if the foreign tax redetermination occurs more than 90 days before filing the year 2 return.[61] Thus, it appears that the term "subsequent" means the year of the foreign tax redetermination and subsequent years.

C. Collateral Issues

In addition to the issues discussed above, there are several other issues related to the application of section 905(c). For example:

1. When Does a Tax Accrue for Foreign Tax Credit Purposes?

As discussed above, foreign taxes accrue when liability for the foreign tax is fixed and can be determined with reasonable accuracy. Under general accrual principles a contested tax is not fixed, and does not accrue, until the contest is settled.[62] However, in Revenue Ruling 58-55[63] the Service concluded that the rule does not apply to the accrual of foreign tax for purposes of the foreign tax credit, holding that "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 [*sic*] and such tax is not paid until a later year."[64]

As support for its holding the Service cited *The Cuba Railroad Company v. United States*,[65] a case that predated *Dixie Pines*, holding that taxes paid to Cuba were a proper accrual for foreign tax credit purposes for the year to which they related, even though they were contested and paid in a later year. The Service also discussed the purpose of the foreign tax credit and its legislative history and statutory framework, concluding that the special nature of the credit requires relation back. There is no apparent reason for restricting the rationale of Revenue Ruling 58-55 to contested taxes. That is, it appears that any additional foreign tax liability that is fixed in

One of the triggering events for section 905(c) is that accrued foreign taxes when paid differ from amounts claimed as credits.

a year subsequent to the year to which it relates accrues for foreign tax credit purposes in the year to which it relates, regardless of the reason for the additional liability.

A related question is how to treat a foreign tax for accrual purposes under the two-year rule when the foreign tax liability is fixed and the amount of the tax is known, but payment of the tax is to be deferred beyond the two-year period. For example, under a certain Italian tax on gains from the transfer of a business, the tax may be paid in up to five equal annual installments, beginning in the year after the year in which the transfer takes place. Thus, 60 percent of the tax can be deferred beyond the two-year period.

For the direct credit, if the entire amount is accrued immediately, the amount not paid within the two-year period will be a foreign tax redetermination, and U.S. tax liability will be redetermined. Subsequent payments will be taken into account for the tax year to which the taxes relate, but will be translated using the exchange rate at the time of payment. If the taxes that will not be paid within the two-year period are not accrued, section 905(c) would not apply, and the taxes when paid would represent credits in the year paid.

For the indirect credit the effect could be more significant, since accruing the entire tax initially could decrease the corresponding earnings pool to the point where it turns negative. That could preclude a distribution from carrying out indirect credits. Note that under the rationale of Revenue Ruling 58-55, it appears that the entire tax would accrue in the initial year, even though the taxpayer knows that it will not be paying a portion of the tax until after the two-year period expires.

2. When Is a Credit Claimed?

One of the triggering events for section 905(c) is that accrued foreign taxes when paid differ from amounts claimed as credits. A credit is not "claimed" until a return is filed, which generally does not occur until a year subse-

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[61]*See* Notice 90-26, suspending Treas. reg. section 1.905-3T(d)(2)(ii)(A) and so much of (C) as relates to (A).

[62]*Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516 (1944).

[63]1958-1 C.B. 266.

[64]*See also* Rev. Rul. 84-125, 1984-2 C.B. 125; Rev. Rul. 70-290, 1970-1 C.B. 125.

[65]124 F. Supp. 182 (S.D.N.Y. 1955), *aff'd* 254 F.2d 280 (2nd Cir. 1958), *cert. denied* 358 U.S. 840 (1958).

quent to the year to which the credit relates. Thus, it would appear that section 905(c) should never be triggered by the initial return for a tax year; only events subsequent to that initial filing should constitute a triggering event.

The temporary regulations as originally issued appeared to reflect that logic, providing that if a foreign tax redetermination affecting the indirect credit occurred more than 90 days before the due date for the taxpayer's U.S. return and before the return was actually filed the credit claimed was to be adjusted on that return to account for the foreign tax redetermination. However, Notice 90-26 suspended that rule, possibly implying that a credit effectively is claimed as of the end of the year to which the credit relates. It is possible that Notice 90-26 was focused on the pre-TRA translation rules under which the accrued tax was translated using the exchange rate in effect on the last day of the tax year to which the tax related, but the tax when paid was translated using the exchange rate on the date of payment. If so, the TRA translation rules should alleviate that concern.

There does not appear to be any reason for invoking section 905(c) because of differences in the amount of foreign taxes accrued and paid if differences can be reflected when the credit with respect to the foreign tax is first claimed on a return. New guidance, when issued, should reflect such a rule.

3. How Do the Statute of Limitation Rules Work Under Section 905(c)?

Section 6511(d)(3) provides a 10-year statute for filing a claim for refund or credit on account of payment of additional foreign tax. That means, for example, that if as the result of the completion of a controversy additional foreign tax is assessed in year 11 with respect to year 1, the taxpayer would be precluded from claiming a refund of U.S. tax based on a redetermination of its year 1 tax liability. On the other hand, section 6501(c)(5) provides that section 905(c) is an exception to the general three-year period of limitation for assessing tax. Section 905(c) provides that if accrued foreign taxes when paid differ from amounts claimed as credits "the taxpayer shall notify the Secretary, who shall redetermine the amount of the tax for the year or years affected." Since section 905(c) does not incorporate any period of limitations, it appears that additional tax may be assessed at any time following a redetermination. Thus, section 905(c) seems to create an inequity; no redetermination on account of the payment of additional foreign tax more than 10 years after the year to which the tax relates, but unlimited redetermination on account of a reduction in foreign tax.

Since section 905(c) does not incorporate any period of limitations, it appears that additional tax may be assessed at any time following a redetermination.

4. Are the Section 988 Rules Implicated by the Accrual of Foreign Taxes?

Under section 988(a)(1)(A) foreign currency gain or loss attributable to a section 988 transaction is computed separately and treated as ordinary income or loss. The term "section 988 transaction" includes "accruing (or otherwise taking into account) . . . any item of expense or gross income or receipts which is to be paid or received after the date on which so accrued or taken into account."[66] "A payable relating to foreign taxes (whether or not claimed as a credit under section 901) is within the meaning of [a section 988 transaction]."[67] However, "a payable of a domestic person relating to accrued foreign taxes of its qualified business unit (QBU branch) is not within the meaning of [a section 988 transaction] if the QBU branch's functional currency is the U.S. dollar and the foreign taxes are claimed as a credit under section 901."[68] In all other cases it appears that accrual of foreign taxes is covered by section 988. Exchange gain or loss will be computed by multiplying the exchange rate on the date the taxes are accrued by the units of nonfunctional currency paid and subtracting from that amount the amount determined by multiplying the units paid by the exchange rate on the date of payment.[69] Thus, although after the TRA redetermination will be avoided by paying, within the two-year period, the foreign currency amount of the accrued tax, it will still be necessary to maintain exchange rate information for accrual and payment dates, and some of the benefit of the two-year provision will be negated by the foreign currency transaction rules.

5. What Are the Notification Requirements?

Treasury reg. section 1.905-4T(b)(2) provides that if a foreign tax redetermination that reduces the amount of foreign taxes paid or deemed paid necessitates a redetermination of U.S. tax

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[66]Section 988(c)(1)(B)(ii).

[67]Treas. reg. section 1.988-1(a)(2)(ii).

[68]*Id.*

[69]Treas. reg. section 1.988-2(c)(3).

liability the taxpayer must file notification with respect to the foreign tax redetermination within 180 days after the redetermination occurs. Section 6689 provides for a penalty of 5 percent per month, up to a maximum of 25 percent, if "the taxpayer fails to notify the Secretary (on or before the date prescribed by regulations for giving such notice) of foreign tax redetermination." Thus, it appears that a taxpayer will be subject to penalty if notice of a foreign tax redetermination is not provided in timely fashion. However, Treasury reg. section 1.905-4T(d) provides that a taxpayer shall have 180 days following publication of an announcement notifying taxpayers of the availability of forms to comply with the notice requirements of the regulation. To date no such announcement has been made. It therefore appears that penalties cannot currently be imposed for a failure to provide notification. In addition, since there does not appear to be any limitation on assessments following a redetermination, failure to notify would also not have any adverse limitation effects. With no benefit from notifying and no penalty for not notifying, one has to wonder whether taxpayers pay much attention to the notification requirements.

6. If a Taxpayer Is Entitled to an Additional Credit as a Result of a Redetermination and Is Thus Entitled to a Refund, Is the Taxpayer Also Entitled to Interest?

If a foreign tax redetermination results in a redetermination of U.S. tax liability, interest with respect to any resulting deficiency or overpayment will be computed under sections 6601 and 6611.[70] Under normal rules interest is assessed on a deficiency from the last date prescribed for the payment of the tax until the date the tax is paid, and interest on an overpayment is paid from the date of the overpayment through a date preceding the date of the refund check by not more than 30 days. However, the regulations provide a special rule for underpayments caused by a refund of foreign tax: no interest is assessed for the period before receipt of the refund except to the extent interest was paid by the foreign country with respect to the refund.[71]

The interest rules do not extend to pool adjustments. That is because if there is a pool adjustment in lieu of a redetermination there will be no underpayment or overpayment of U.S. tax liability on account of the adjustment. "Consequently, no interest will be paid by or to a United States corporation as a result of adjustment to its pools of foreign taxes and earnings and profits under paragraph (d)(2) of section 1.905-3T."[72]

IV. Conclusion

The TRA amendments should significantly reduce the number of foreign tax redeterminations. However, they leave a number of unanswered questions. This article has touched on some of those questions, but there are undoubtedly more that will arise as taxpayers and the Service attempt to interpret and apply the amendments. It has been more than 13 years since the temporary regulations were issued. Given the changes made by TRA and the many difficult issues inhering in the redetermination rules, it is long past time to update and finalize those regulations. ✦

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[70]Treas. reg. section 1.905-4T(c)(1).

[71]*Id.*

[72]Treas. reg. section 1.905-4T(c)(2).