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# New Foreign Tax Credit Regulations: In Need of a Redetermination

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## I. INTRODUCTION

For those who were light on holiday reading, the IRS and Treasury published in December proposed and final regulations dealing with various aspects of the foreign tax credit. Included in those regulations were new rules to address foreign tax redeterminations (FTRs).

Guidance on FTRs was clearly needed: The most recent set of operative rules were temporary regulations that expired in 2010. Further, taxpayers were unsure how to deal with FTRs of indirect foreign tax credits in light of the repeal of §902[1] and changes made to §960 by the Tax Cuts and Jobs Act (TCJA).[2]

Still, for a 12-year wait, the new FTR regulations leave a lot to be desired. The problem is not so much with the final regulations. The final regulations have a fairly limited scope and do not depart much from the 2007 proposed regulations they finalize. The new proposed regulations are where the most problematic aspects lurk, and those will need to be mitigated before the proposed regulations are finalized.

This article discusses the impact the new FTR regulations will have on taxpayers and the issues that will arise if the proposed regulations are finalized as drafted.

### A. Section 905(c) and the Foreign Tax Credit Generally

To prevent double taxation, a person who is subject to U.S. income tax on a net income basis is generally permitted a credit against its U.S. federal income tax for foreign taxes imposed on the person's foreign-source income. A variety of restrictions and limitations apply to the foreign tax credit, an understatement comparable to saying "Odysseus had some trouble getting home from Troy."

One such restriction is imposed by §905(c). Section 905(c)(1) provides that a taxpayer must notify the IRS if any of the following occur:

- Accrued taxes when paid differ from the amounts claimed as credits by the taxpayer;
- Accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate; or
- Any tax paid is refunded in whole or in part.

Upon notification, the IRS "shall redetermine the amount of tax for the year or years affected."[3]

Section 905(c)(2) provides a special rule for accrued taxes not paid within two years, particularly the exchange rate to be used when they are actually paid.

The rules of §905(c) exist to ensure that foreign tax credits are claimed only for taxes actually paid. For a

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[1] Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations thereunder.

[2] Pub. L. No. 115-97 (Dec. 22, 2017).

[3] §905(c)(1).

variety of reasons, a taxpayer may need to file a U.S. tax return before a final determination of foreign tax liability is known. This could be because the taxpayer has elected the accrual basis for foreign tax credit purposes, and the foreign taxes claimed as a credit are not actually paid before the U.S. return is due. Or, the taxpayer or a foreign tax authority may determine that the amount of foreign taxes originally paid by the taxpayer is incorrect and that the taxpayer owes more or less than originally paid. In any case, for the taxpayer to claim, as a foreign tax credit, no more or less than the foreign taxes actually paid, §905(c) requires the amount of foreign taxes the taxpayer originally claimed as a credit to be redetermined and the taxpayer's U.S. taxes recomputed to reflect the redetermined amount of foreign taxes paid.

Section 905(c) creates a framework but leaves the mechanics and details to the IRS. Section 905(c)(3) simply states that the amount of tax (if any) due on any redetermination shall be paid by the taxpayer on notice and demand and the amount of tax overpaid (if any) shall be credited or refunded to the taxpayer in accordance with §6511 and the other provisions of subchapter B of chapter 66 of the Internal Revenue Code. Because the taxpayer's obligation to pay additional federal income tax is subject to the notice and demand of the IRS without any reference to time limits but the taxpayer's right to receive a refund or pay less federal income tax is subject to §6511, the statute sets up the possibility of an asymmetrical rule. Section 905(c) does not mandate such one-sided results, however. Rather, the statute, by leaving it to the IRS's "notice and demand," gives the IRS discretion in designing the taxpayer's payment obligations.

## B. New Regulations

On December 17, 2019, the IRS published in the Federal Register final Treasury regulations (the "2019 final regulations")[4] addressing a variety of foreign tax credit issues. New Reg. §1.905-3, which addresses adjustments to U.S. tax liability necessary as a result of an FTR, applies to FTRs occurring in 2019 for taxpayers with calendar year taxable years and to FTRs occurring in taxable years ending on or after December 16, 2019, for taxpayers with non-calendar year fiscal years.

Also on December 17, 2019, the IRS published in the Federal Register proposed foreign tax credit regulations (the "2019 proposed regulations").[5] For FTRs, the 2019 proposed regulations are much more detailed and, for many taxpayers, more onerous. The IRS and Treasury to their credit recognized this — indeed, they state in the preamble that they are issuing the regulations in proposed form to give taxpayers a chance to comment on them. Like the 2019 final regulations, the new rules under §905(c) and §6689 (which imposes a penalty on failures to notify the IRS of an FTR) in the 2019 proposed regulations generally would apply to FTRs occurring in taxable years ending on or after December 16, 2019.

## C. FTRs Generally

Sometimes a taxpayer expects a change in foreign tax liability and perhaps even knows the amount of the expected FTR. For example, a taxpayer may be subject to a withholding tax but expects the withholding tax to be refunded once the taxpayer shows that it is eligible for the exemption or lower withholding rate provided by a treaty. Or, the taxpayer may have paid a tax under protest or to stop interest and penalties, now expecting to be refunded. Such a payment may be a noncompulsory payment and therefore not creditable under Reg. §1.901-1(e)(5) as a result. But, if the foreign tax was properly creditable when paid or accrued, the taxpayer expects to have an FTR once the amount is refunded.

More often, though, the taxpayer does not know whether an FTR will occur. A taxpayer may be under audit and not have a good idea of how the items at issue in the audit will be resolved. Or, the taxpayer may in the course of preparing its tax return discover an error in an earlier return that affects the amount of foreign tax owed in that earlier year. In these "unexpected" FTR circumstances, even if the taxpayer knows that the amount of foreign taxes taken into account on an earlier return is incorrect, the taxpayer may not know the correct amount (i.e., how much of an FTR the taxpayer should expect or possibly even which direction the FTR will run) until a much later point in time. Thus, FTRs are often difficult to deal with under the best of circumstances, and the new regulations — especially the 2019 proposed regulations — make that task nearly impossible.

# II. IMPACT OF THE 2019 FINAL REGULATIONS

Regarding FTRs, the 2019 final regulations finalize only Reg. §1.905-3, and their effect is limited to "direct" credits claimed under §901.[6] As under the 2007 temporary and proposed regulations, Reg. §1.905-3(b)(1)(i) generally requires a redetermination of U.S.

[4] T.D. 9882, 84 Fed. Reg. 69,022 (Dec. 17, 2019).

[5] REG-105495-1, 84 Fed. Reg. 69,124 (Dec. 17, 2019).

[6] The 2019 final regulations also provide clarity regarding the currency translation of an FTR. Those are welcome, but they are not the subject of this article.



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tax liability in the taxable year in which the tax was claimed as a credit; however, it also now requires a redetermination in ''any year to which unused foreign taxes from such year were carried under section 904(c).''

To illustrate this redetermination requirement, assume that a taxpayer has an FTR that relates to the 2017 year. The taxpayer had a loss in 2017 and did not claim any foreign tax credit in 2017. Rather, the taxpayer carried its 2017 foreign taxes back to 2016 and forward to 2018. As under the 2007 proposed and temporary regulations, the 2019 final regulations require the taxpayer to amend its 2017 return to account for the FTR. In addition, the 2019 final regulations require the returns for the relevant carryover years (i.e., 2016 and 2018) to be amended as well to account for the carryover of the redetermined 2017 foreign taxes.

The 2019 final regulations generally adopt the definition of ''foreign tax redetermination'' used in the expired 2007 temporary regulations, with some clarifying changes. The clarifications to the definition of FTR in Reg. §1.905-3(a) have the effect of broadening it, however. For example, the 2019 final regulations, like the 2007 proposed and temporary regulations, state that accrued taxes that are not actually paid within the two-year window of §905(c)(1)(B) are treated as an FTR. The 2019 final regulations go farther, however, providing that any amount of accrued tax that is not paid on or before the date that is 24 months after the close of the taxable year to which they relate is treated as refunded on that date. Because the 2019 final regulations apply to FTRs occurring in taxable years ending on or after December 16, 2019, this rule will apply (for calendar year taxpayers) to accrued 2017 taxes that were not paid at the end of 2019. So, if the amount of foreign taxes a taxpayer accrued on its 2017 return exceeds the amount of foreign tax the taxpayer paid through the end of 2019, then an FTR for the §901 taxes has occurred at the end of 2019 and is subject to new Reg. §1.905-3(a). The taxpayer must file an amended 2017 tax return to take into account the FTR and amended returns for the years to which accrued but unpaid taxes were carried back or forward.

## III. IMPACT OF THE 2019 PROPOSED REGULATIONS

The 2019 proposed regulations expand the definition of FTR and the actions that a taxpayer must take in response to an FTR.

### A. Definition of FTR

The 2019 proposed regulations would substantially broaden the definition of FTR in Reg. §1.905-3(a) to include not just changes in the foreign tax credit but anything that affects U.S. tax liability. This includes:

- the amount of distributions the taxpayer is considered to receive from a foreign corporation;
- the taxpayer's inclusions under Subpart F, GILTI (Global Intangible Low-Taxed Income), and the PFIC (Passive Foreign Investment Company) Qualified Electing Fund rules;
- whether and how the §954(b)(4) high-tax exception applies; and
- increases in tax liability under §1291.[7]

Compared to the language in the 2019 final regulations, this broadening of what constitutes an FTR would significantly increase the number (and complexity) of amended returns that taxpayers must file.

For direct credits under §901, the proposed broader definition applies to FTRs occurring in 2019 for taxpayers with calendar year fiscal years (for those taxpayers on a non-calendar year fiscal year, to FTRs occurring in taxable years ending on or after December 16, 2019). FTRs that involve a foreign corporation (e.g., §960 credits and the non-foreign-tax-credit-related changes), the broader definition generally applies to FTRs of foreign corporations occurring in taxable years that end with or within a taxable year of a U.S. shareholder ending on or after December 16, 2019, and that relate to taxable years of foreign corporations beginning after December 31, 2017. However, as discussed below, the broader definition of FTR winds up applying to pre-2018 years through Prop. Reg. §1.905-5.

### B. Taking Into Account an FTR

Compared to the 2007 proposed and temporary regulations, the 2019 proposed regulations make several significant changes in how taxpayers take into account an FTR. One is unavoidable: TCJA's repeal of §902 vitiated the approach taken in the 2007 proposed and temporary regulations regarding adjusting the pools of post-1986 undistributed earnings and post-1986 tax. Instead, as the preamble notes,[8] for post-2017 years a foreign corporation's FTR means that its U.S. shareholders have to redetermine their U.S. tax liability in that year as well. The remaining changes

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[7] *See* Prop. Reg. §1.905-3(a).

[8] ''With the repeal of the pooling regime and related amendments to section 905(c) in the [TCJA], the statute now requires U.S. tax redeterminations to reflect all foreign tax redeterminations, including those that result in adjustments to foreign taxes deemed paid. Accordingly, proposed §1.905-3(b)(2)(i) provides that a U.S. tax redetermination is required in all cases to account for the effect of a foreign corporation's foreign tax redetermination.'' REG-105495-1, 84 Fed. Reg. 69,135.



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in the 2019 proposed regulations reflect the decision to define FTR in such a way that it includes any change in U.S. tax liability, and not just changes in the foreign tax credit. Accordingly, a redetermination of U.S. tax liability is required not only if an FTR changes the amount of foreign taxes deemed paid (and the related §78 dividend), but also if the FTR changes the amount of a U.S. shareholder's Subpart F or GILTI inclusion in the year to which the FTR relates. As the examples below show, this broader definition of FTR can have wide-ranging effects.

The 2019 proposed regulations require a redetermination of U.S. tax liability even when an FTR has an indirect effect on U.S. tax liability. A redetermination of U.S. tax liability of a U.S. shareholder[9] is required if an FTR affects the Subpart F income, tested income, and E&P of a controlled foreign corporation in the year to which the FTR relates because such an FTR affects the amount of the shareholder's Subpart F or GILTI inclusion in such year. Alternatively, an FTR may affect whether the shareholder is eligible for the high-tax exception under §954(b)(4) in the year to which the redetermined foreign tax relates.

These rules in the 2019 proposed regulations would apply to FTRs occurring in 2019 for calendar year taxpayers. If that effective date holds, the regulations finalizing the 2019 proposed regulations will apply retroactively.

## C. Special Rules for FTRs That Relate to Years Affected by Repeal of §902

Prop. Reg. §1.905-5 would apply to FTRs of foreign corporations that relate to pre-2018 (i.e., pre-TCJA) taxable years.[10] This ''transition rule'' — as the preamble styles Prop. Reg. §1.905-3(b)(2)(iv) and §1.905-5 — provides that post-2017 redeterminations of pre-2018 foreign income taxes must be accounted for by adjusting the foreign corporation's taxable income, E&P, post-1986 undistributed earnings, and post-1986 foreign income taxes (or pre-1987 accumulated profits and pre-1987 foreign income taxes, as applicable) in the pre-2018 year to which the redetermined foreign taxes relate. The 2019 proposed regulations require a redetermination of U.S. tax liability to account for the effect of the FTRs on foreign taxes deemed paid by domestic corporate shareholders of the foreign corporation in the relation-back year and any subsequent pre-2018 year in which the domestic corporate shareholder computed a deemed-paid credit under §902 or §960 with respect to the foreign corporation, as well as any year to which unused foreign taxes from any such year were carried. Further, affected U.S. shareholders of the foreign corporation must determine their applicable U.S. tax liability to account for the effect of the FTR on the E&P and taxable income of the foreign corporation and the taxable income of the U.S. shareholder. Recognizing the complexity of this approach, the preamble requests comments ''on whether an alternative adjustment to account for post-2017 foreign tax redeterminations with respect to pre-2018 taxable years of foreign corporations, such as an adjustment to the foreign corporation's taxable income and earnings and profits, post-1986 undistributed earnings, and post-1986 foreign income taxes as of the foreign corporation's last taxable year beginning before January 1, 2018, may provide for a simplified and reasonably accurate alternative.''

## D. Notifying the IRS of an FTR

Prop. Reg. §1.905-4 sets forth the new general notification rules.[11] The notification rules in the 2019 proposed regulations are broadly consistent with the notification rules in the 2007 proposed and temporary regulations. They require the taxpayer to file an amended return with a Form 1116 or 1118 (as applicable), with a required explanatory statement.[12] There are special rules to deal with multiple redeterminations in the same taxable year[13] and special rules to address taxpayers under audit,[14] and the 2019 proposed regulations includes tweaks and revisions to those previously published in the 2007 proposed and temporary regulations. These revisions include new detailed rules for owners of pass-through entities[15] and a placeholder for the IRS to permit alternative notification procedures.[16]

Generally, if an FTR increases U.S. tax liability, the taxpayer must file a separate notification by the due date (with extensions) of the original return for the

[9] *See* §951(b).

[10] Prop. Reg. §1.905-3(b)(2)(iv) makes clear that the rules of Prop. Reg. §1.905-5, rather than the general rules of Prop. Reg. §1.905-3, apply to FTRs of a foreign corporation that relate to a taxable year of the foreign corporation beginning before January 1, 2018.

[11] For notifications of FTRs covered by Prop. Reg. §1.905-5, taxpayers generally follow the rules of Prop. Reg. §1.905-4, as modified by Prop. Reg. §1.905-5(b)(2) (notification relating to post-1986 undistributed earnings and post-1986 income taxes) and §1.905-5(b)(3) (notification relating to pre-1987 accumulated profits and pre-1987 foreign income taxes). Prop. Reg. §1.905-5(b)(1).

[12] Prop. Reg. §1.905-4(b)(1)(i).

[13] Prop. Reg. §1.905-4(b)(1)(iv).

[14] Prop. Reg. §1.905-4(b)(4).

[15] Prop. Reg. §1.905-4(b)(2).

[16] Prop. Reg. §1.905-4(b)(3).



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taxpayer's taxable year in which the FTR occurs.[17] On the other hand, if an FTR decreases U.S. tax liability, the taxpayer generally must file its claim for refund within the relevant period set forth in §6511.[18] No amended return is required for a particular taxable year if the FTR does not change U.S. tax liability for that taxable year.[19] Instead, the taxpayer adjusts the amount of unused foreign taxes carried over from that year. Even though no amended return may be required for a year, the taxpayer must attach a statement containing the information described in Reg. §1.904-2(f) to the taxpayer's timely filed (with extensions) original return for the taxpayer's taxable year in which the FTR occurs.[20]

The 2019 proposed regulations also include a new Prop. Reg. §301.6689-1 to deal with penalties for failure to make the required notifications.

Until the 2019 proposed regulations are finalized, though, it raises the question as to what notification procedures a taxpayer is supposed to follow. This is particularly confounding in instances where the 2019 final regulations provide no guidance, such as for FTRs that affect pre-2018 taxable years and for which indirect foreign tax credits were claimed. The fact that the 2019 proposed regulations replace the 2007 proposed and temporary regulations raises real questions as to what taxpayers are supposed to do between now and finalization of the 2019 proposed regulations. The preamble to the proposed regulations does not state that taxpayers can rely on them, and they replace the proposed regulations that accompanied the expired temporary regulations. This seems to be an issue of temporary uncertainty, assuming that the regulations finalizing the 2019 proposed regulations allow taxpayers to apply the recently finalized regulations retroactively.

## IV. EXAMPLES

The effects, both intended and unintended, of the 2019 final regulations and the 2019 proposed regulations are probably best illustrated through examples. For the sake of simplicity, assume that:

- TP is a domestic corporation that owns 100% of FC, a corporation formed in Country Z.
- Both TP and FC have calendar year taxable years for U.S. and foreign tax purposes.
- TP claims foreign tax credits on an accrual basis.
- FC's functional currency is the "u," and one u equals one U.S. dollar at all times.
- TP claims both direct credits under §901 and indirect credits under §960 for foreign taxes paid to Country Z.

These facts and assumptions understate much of the complexity of the 2019 final regulations and (especially) the 2019 proposed regulations, given that the facts assume away the need to apply currency conversion, multiple redeterminations, and other special rules. However, my goal is to illustrate the basic thrust of the new rules, which can be obscured if the examples get too complicated.

### A. Country Z Audit Adjustment in 2020 for 2015 Taxable Year

#### 1. Direct Credit

Assume that TP directly received the Country Z audit adjustment, and so the FTR affects TP's §901 credit.

Consider first a reduction in Country Z tax. Assume that the FTR is a decrease in Country Z taxes and that TP claimed some or all of those decreased Country Z taxes as a credit on its 2015 Form 1120. The decrease in Country Z tax is an FTR requiring a redetermination of TP's 2015 U.S. tax liability because TP now has a smaller 2015 foreign tax credit. This result would be the case under the 2019 final regulations or under the 2019 proposed regulations. Because no statute of limitations applies, TP would file an amended 2015 Form 1120, with the applicable Form 1118, showing the revised foreign tax credit, and pay any additional U.S. tax owed. If TP does not owe any additional U.S. tax in 2015 because TP carried its 2015 foreign taxes forward to 2016 and 2017 (or back to 2014), then TP would also need to file amended 2016 and 2017 Forms 1120 (or 2014 Form 1120) with the relevant Forms 1118 to the extent the disallowed foreign taxes were used in those years.

Alternatively, assume that the FTR is an increase in Country Z taxes. The increase in Country Z tax is an FTR requiring a redetermination of TP's 2015 U.S. tax liability because TP is eligible for a larger 2015 foreign tax credit. That is the case under the 2019 final regulations or the 2019 proposed regulations. Because the 10-year period of §6511(d)(3) should apply, TP would file an amended 2015 Form 1120, with the applicable Form 1118, showing the revised foreign tax credit. If TP could not credit all of its 2015 Country Z income taxes in 2015 and carries some of them forward to 2016 and 2017 (or back to 2014), then TP would also need to file amended 2016 and 2017 Forms 1120 (or 2014 Form 1120) with the relevant Forms 1118 to the extent that the FTR increases the foreign tax credit claimed in those years.

[17] Prop. Reg. §1.905-4(b)(1)(ii).
[18] Prop. Reg. §1.905-4(b)(1)(iii).
[19] Prop. Reg. §1.905-4(b)(1)(v).
[20] Prop. Reg. §1.905-4(b)(1)(v).



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In sum, in this direct credit scenario, there is no real difference between the 2019 final regulations and the 2019 proposed regulations, other than the 2019 proposed regulations' inclusion of guidance regarding timing and procedure for the filing of the amended returns.

**2. Indirect FTRs**

Now, let's assume that FC has the FTR with respect to its 2015 Country Z taxes. Assume further that in 2015, FC had 100 u of income, all of which is Subpart F income, and made a $200 distribution to TP, treating $100 as a dividend and $100 as PTEP, all before taking into account foreign tax credits under §902 and §960.

The final regulations do not provide direct guidance in this case. They explicitly exclude taxes deemed paid under §960 from the operative rules of Reg. §1.905-3(b)(1)(i). Given the repeal of §902, the absence of a reference to §902 in Reg. §1.905-3(b)(1)(i) strongly implies that they do not apply to §902 credits either, and all of the examples in Reg. §1.905-3(b)(1)(ii) address direct credits.

By implication, though, TP's required action in this case should be limited to adjusting the amount of its indirect foreign tax credit. The definition of FTR in the 2019 final regulations limits FTRs to those that affect the taxpayer's foreign tax credit. So, under the definition of FTR in the final regulations, the need to account for an FTR in this case should be limited to changes in the amount of foreign tax credit under §902 and §960, and not the amount of Subpart F inclusions, amounts owed under the PFIC rules, etc.

The 2019 proposed regulations, on the other hand, provide a direct answer. Prop. Reg. §1.905-5, as its title helpfully points out,[21] is directly on point. Because the FTR relates to a taxable year beginning before January 1, 2018, FC's taxable income and E&P, post-1986 undistributed earnings, and post-1986 foreign taxes must be adjusted for the 2015 taxable year. The consequences of implementing these adjustments can be wide-ranging, as the following scenarios show.

First, assume that the FTR is a refund of 2015 Country Z tax. The refund of Country Z tax increases FC's Subpart F income, E&P, and post-1985 undistributed earnings in 2015 by the functional currency amount of the foreign tax refund. From TP's standpoint, the Country Z tax refund increases TP's Subpart F inclusion (assuming that the high-tax exception of §954(b)(4) does not apply following the FTR) but would reduce any credit claimed under §960. Because the foreign tax refund may also reduce TP's §902 credit, TP's §78 dividend may also decrease as well although the amount of U.S. tax on the dividend paid by FC, net of §902 credit, may increase. To the extent that the 2015 Country Z taxes had been carried forward or back to another year, or the FTR affects the calculation of inclusions or distributions in another year, TP's tax liability in those years would need to be recalculated as well.

If the FTR is an increase in 2015 Country Z tax, then FC's Subpart F income, E&P, and post-1985 undistributed earnings would be decreased in 2015 by the functional currency amount of the increase in Country Z tax. From TP's standpoint, the increase in Country Z tax decreases TP's Subpart F inclusion (either incrementally or because TP is now eligible for the high-tax exception of §954(b)(4)) but would increase any credit claimed under §960. Because the higher Country Z taxes may also increase TP's §902 credit, TP's §78 dividend may also increase although the amount of U.S. tax on the dividend, net of §902 credit, may decrease. To the extent that the 2015 taxes are now carried forward or back to another year, or the FTR affects the calculation of inclusions or distributions in another year, TP's tax liability in those years would need to be recalculated as well.

## B. Country Z Audit Adjustment in 2020 for 2018 Taxable Year

**1. Direct Credit**

Assume that TP directly received the Country Z audit adjustment, and so the FTR affects TP's §901 credit. From a direct credit standpoint, the 2019 final and 2019 proposed regulations do not distinguish between FTRs that occur in pre-2018 years and post-2017 years. Granted, there are different foreign tax credit baskets to take into account when one moves from pre-TCJA to post-TCJA taxable years, but the mechanics of taking into account the FTR would be the same as those described above.

Once again, consider first a reduction in Country Z tax. If the FTR is a decrease in Country Z taxes and TP claimed some or all of those decreased Country Z taxes as a credit on its 2018 Form 1120, then the decrease in Country Z tax is an FTR requiring a redetermination of TP's 2018 U.S. tax liability because TP has a smaller 2018 foreign tax credit. This result is the case under the 2019 final regulations or under the 2019 proposed regulations. Because no statute of limitations applies, TP would file an amended 2018 Form 1120, with the applicable Form 1118, showing the revised foreign tax credit, and pay any additional U.S. tax owed. Under the 2019 proposed regulations, that amended 2018 Form 1120, with Form 1118, must be filed by the due date (with extensions) of TP's

[21] "Foreign tax redeterminations of foreign corporations that relate to taxable years of the foreign corporation beginning before January 1, 2018." REG-105495-1, 84 Fed. Reg. 69,176.



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2020 Form 1120. If TP does not owe any additional U.S. tax in 2018 because TP carried its 2018 foreign taxes forward to 2019, then TP would also need to file, along with its amended 2018 Form 1120, an amended 2019 Form 1120 with the relevant Form 1118 to the extent the disallowed foreign taxes were used in 2019.

If the FTR is an increase in Country Z taxes, then the increase in Country Z tax is an FTR requiring a redetermination of 2018 U.S. tax liability because TP is eligible for a larger 2018 foreign tax credit. That is the case under the 2019 final regulations or the 2019 proposed regulations. TP must file its amended 2018 Form 1120 and relevant Form 1118 within the 10-year period of §6511(d)(3). If TP does not credit all of its 2018 Country Z income taxes in 2018 and carries some of them forward to 2019, then TP would also need to file, along with its amended 2018 Form 1120, an amended 2019 Form 1120 with the relevant Form 1118 to the extent that the FTR increases the foreign tax credit claimed in 2019.[22]

**2. Indirect FTRs**

Under the final 2019 regulations, if TP claimed a §960 credit, TP's accounting for FTRs would be the same under pre-2018 and post-2017 years. The main difference is that GILTI applies in post-2017 years, making the calculation of the revised foreign tax credit more complicated.

The 2019 proposed regulations would apply in a way that can boggle the mind, however. This means that it is impossible to show a simple but realistic example of their effect. The following examples will err on the side of simplicity, but the examples in Prop. Reg. §1.905-3(b)(2)(v) provide good, detailed examples of how TP would implement the new, broader definition of FTR.

First, assume that the FTR is a refund of 2018 Country Z tax paid by FC. The refund of Country Z tax increases FC's Subpart F income, tested income, and E&P in 2018 by the functional currency amount of the foreign tax refund.[23] The refund should increase TP's Subpart F inclusion and/or GILTI inclusion and decrease TP's §78 dividend if TP claimed a credit under §960.[24] Alternatively, the lower foreign taxes may cause TP no longer to qualify for the high-tax exception of §954(b)(4). To the extent that the 2018 taxes had been carried forward or back to another year, TP's Subpart F inclusions, §960 credits, §78 dividends, amount of distributions, and other components of tax liability in those years would need to be recalculated as well. Because the net result is an increase in federal income tax liability, the 2019 proposed regulations would require TP to file the amended 2018 Form 1120 and relevant Form 1118 (and other years' returns, if applicable) by the due date for TP's 2020 Form 1120.

If the FTR is an increase in 2018 Country Z tax, then FC's Subpart F income, tested income, and E&P would be decreased in 2018. TP's Subpart F inclusion and/or GILTI inclusion should be reduced and §78 dividend increased if TP claims a credit under §960. Alternatively, the higher foreign taxes may cause TP to qualify for the high-tax exception of §954(b)(4).[25] To the extent that the 2018 taxes are carried forward or back to another year, TP's Subpart F inclusions, §960 credits, §78 dividends, amount of distributions, and other components of tax liability in those years would need to be recalculated as well. Any adjustments that are, on net, taxpayer favorable may require TP to file its amended returns within the period required by §6511.

In the best-case scenario, all of the amended returns to reflect all of the redeterminations of U.S. tax liability would be a lot of work for what may be a small change in net U.S. tax liability. In the worst-case scenario, the asymmetrical rules for FTRs can mean that what should be a small increase or decrease in U.S. tax becomes a large increase in U.S. tax. Consider the example above but assume that the FTR for the 2018 taxable year occurs in 2022. In the case of a refund of foreign taxes, the IRS takes the position that no time limit applies to a redetermination that increases U.S. tax liability, and so TP must pay tax on the additional GILTI and Subpart F. In the case of an additional payment of foreign tax by FC that reduces TP's GILTI or Subpart F inclusion, the standard three-year statute of limitation of §6511 will have already run. So, unless TP has done something to keep its potential refund claim alive, it cannot file for a refund of any overpayment of U.S. tax in 2018 due to its overstatement of GILTI and Subpart F income.

Absent some tolling or netting rule, the result can be indefensibly harsh. Consider a simple timing difference, with identical overpayments and underpayments of foreign tax. Assume that the Country Z tax authority determines in 2023 that FC should have reported 100 u in income in 2018 that it instead reported in 2019 and shifts the timing of FC's taxation accordingly. Let's assume that this FTR means that TP's gross Subpart F income or tested income increased $25 in 2019 (to reflect the lower Country Z tax paid) but decreased $25 in 2018 (to reflect the higher Coun-

[22] Prop. Reg. §1.905-4(b)(5)(i) provides a much more thorough example illustrating these rules.

[23] See the ''analysis'' portions of Prop. Reg. §1.905-3(b)(2)(v) *Exs*. 1, 3, 4.

[24] *Id*.

[25] *See* Prop. Reg. §1.905-3(b)(2)(v) *Ex*. 2.



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try Z tax paid). This FTR means that TP must increase its U.S. tax liability in 2019 (to account for the reduced Country Z taxation in 2019) but is time-barred from claiming an identical refund from its U.S. taxes in 2018. Even the most conscientious taxpayer will blanch at complying with a rule that unfair.

Putting aside the question whether the 2019 proposed regulations are fair or unfair, the final question is what taxpayers do until the proposed regulations are finalized. Technically, they are not reliance regulations, but they are the only guidance taxpayers have, given that they replace the 2007 temporary and proposed regulations.

## V. CONCLUSIONS

The 2019 proposed regulations' broader definition of FTR and new rules for taking into account an FTR exacerbate the pre-existing problem that §905(c) requires an FTR that favors the government (i.e., a refund of foreign tax) to be implemented by a taxpayer, notwithstanding the otherwise applicable statute of limitations. In contrast, an FTR that favors the taxpayer (i.e., an increase in foreign tax paid) must be implemented within the time period of §6511. Given that some of the changes in U.S. tax liability required to be taken into account as a result of an FTR are not foreign tax credit-related, that generally means that a taxpayer cannot take advantage of an increase in foreign taxes that affects U.S. tax liability outside the foreign tax credit area (e.g., to claim the high-tax exception or a smaller Subpart F or GILTI inclusion) unless the claim is filed within the regular three-year period of §6511. The preamble to the 2019 proposed regulations suggests that this is intentional: Without the rules in the 2019 proposed regulations, "taxpayers would have an incentive to overpay their CFC's foreign tax in the origin year, claim the high-tax exception to avoid subpart F or GILTI inclusions, wait for the 3 year statute of limitations to pass, and then claim a foreign tax refund with the foreign authorities."

This misguided view that FTRs are a problem for the government but not for taxpayers permeates the 2019 proposed regulations. The preamble to the 2019 proposed regulations makes no bones about that, clearly coming across as more concerned about taxpayers taking advantage of an FTR than it is with the burden taxpayers face in dealing with FTRs. I know taxpayers and tax practitioners complain about burdens imposed by tax rules, and we complain more loudly when the burden is due to enforcing a taxpayer-unfavorable provision than we do when the burden is due to substantiating eligibility for a taxpayer-favorable provision. And, to a certain extent, a burden on taxpayers is unavoidable in this area, given the statutory rules. Still, the new FTR regulations are sufficiently unbalanced that they raise a serious compliance risk. FTRs generally rely on self-policing by taxpayers and, as some of the examples above show, reasonable taxpayers will wonder why they are expected to assist in this heads-the-government-wins-tails-the-taxpayer-loses regime.

In addition, affected taxpayers would be right to wonder about the value of the financial and compliance burden imposed on them by the 2019 proposed regulations. It is hard to see how the IRS can effectively administer these rules, especially for taxpayers that operate in multiple jurisdictions and who suffer complicated audits that last for years. Unless the IRS is going to devote substantial resources to reviewing all of the amended returns required by the 2019 proposed regulations, the 2019 proposed regulations will force taxpayers to comply with new complex and onerous rules and file multiple returns that will rarely be reviewed in more than a superficial way. That seems like a high price for taxpayers to pay just so the regulations can track a literal reading of §905(c).

The broad definition of FTR in the 2019 proposed regulations, along with the different time limits for addressing overpayments and underpayments of federal income tax, will also force taxpayers to file protective refund claims or take other steps to preserve their rights in future FTRs. It is unclear how a plethora of amended returns (in part due to the rule that unpaid but accrued taxes are treated as refunded at the end of the two-year period) and protective amended returns and refund claims is in the interest of tax administration. If the IRS and Treasury want to retain this approach, they must provide taxpayers with guidance as to how taxpayers file protective refund claims so that taxpayers will not be whipsawed by the new rules. Failure to do so will only hurt tax compliance. It is unreasonable to expect taxpayers to comply with a costly and burdensome approach for FTRs that "works" only half the time, and that half of the time is when it hurts them.



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