

LB&I International Practice Service Transaction Unit

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Volume	3	FTC Management	UIL Code	9413
Part	3.1	Creditability	Level 2 UIL	9413.01
Chapter	3.1.2	Compulsory Payments/Exhaustion of Remedies	Level 3 UIL	9413.01-02
Sub-Chapter	3.1.2.2	Exhaustion of Remedies and Transfer Pricing		

Unit Name	Exhaustion of Remedies and Transfer Pricing

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Issue and Transaction Overview

Exhaustion of Remedies and Transfer Pricing

The United States taxes income on a worldwide basis. To prevent double taxation, under the Internal Revenue Code (IRC) U.S. taxpayers are allowed a credit for foreign income taxes paid. However, the ability to credit foreign income taxes paid is limited. Pursuant to Treasury Reg. § 1.901-2(e)(1) U.S. companies may not obtain credits for foreign taxes paid in which they are not legally compelled to pay. If the U.S. Treasury were to allow foreign tax credits (FTCs) without requiring U.S. taxpayers to effectively and practically reduce their foreign tax payments as legally imposed, taxpayers would have no incentive to challenge any foreign tax, whether or not properly imposed. As a result, foreign tax costs may potentially be improperly shifted to the United States.

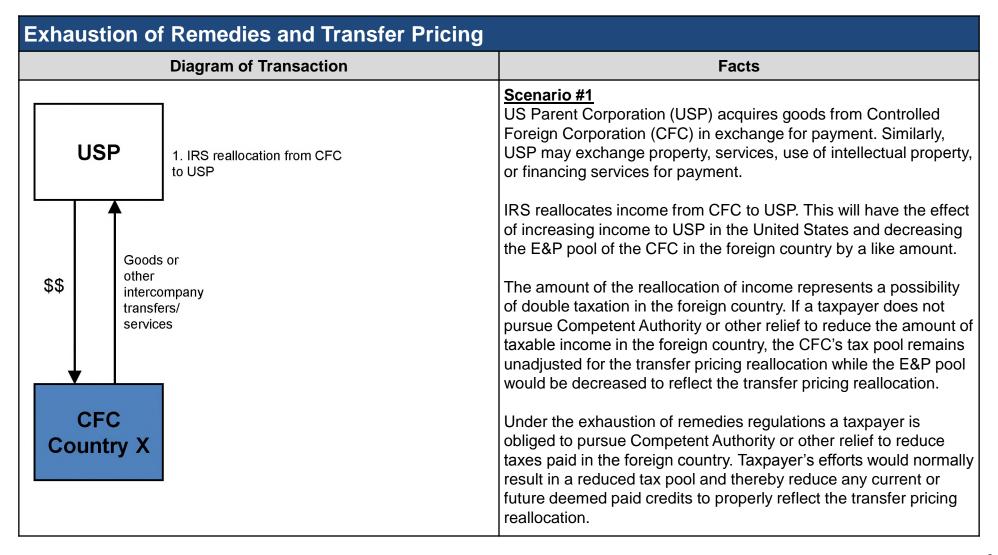
The purpose of this IPS unit is to assist the examiner in identifying "exhaustion of remedies" issues in transfer pricing contexts. For a more developed general overview and description of exhaustion of remedies concepts, please see the IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013).

As a general rule under Treas. Reg. Section 1.901-2(e)(5)(i), taxpayers cannot claim foreign tax credits for amounts paid to foreign taxing authorities where they have failed to exhaust all effective and practical remedies (including competent authority procedures where applicable).

The most typical situations presenting compulsory payment/exhaustion of remedies issues are transfer pricing adjustments made by the IRS or foreign authorities. Such transfer pricing adjustments may be for the sale or use of goods, services, intellectual property, or financing. In addition, compulsory payment and exhaustion of remedies issues arise where inconsistent tax treatment of a transaction or instrument by the U.S. and foreign authorities could be conformed to reduce or eliminate foreign tax through foreign administrative or judicial appeals or invoking competent authority. These issues are addressed in a separate IPS unit: Exhaustion of Remedies in Non Transfer Pricing Situations FTM/9413.01-02_03(2013).

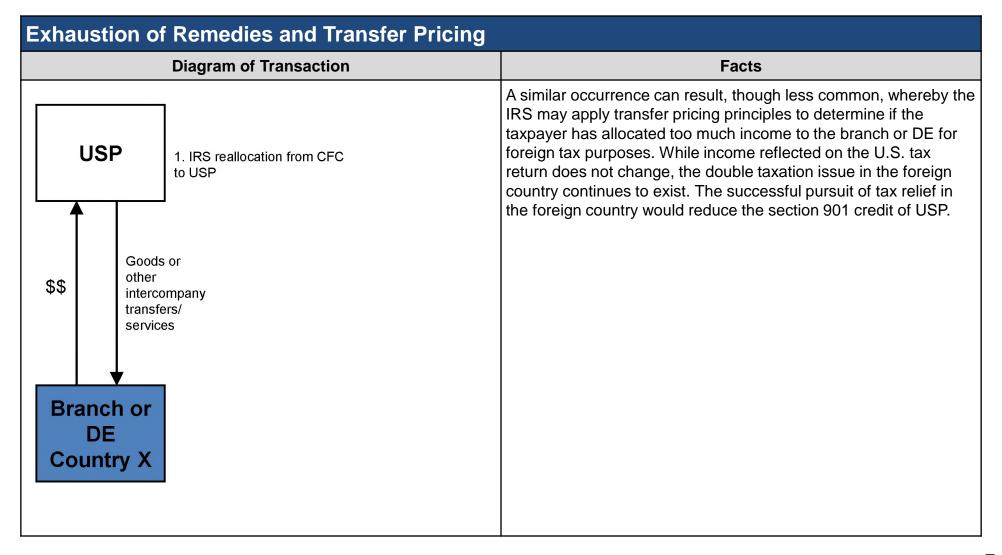
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Transaction and Fact Pattern



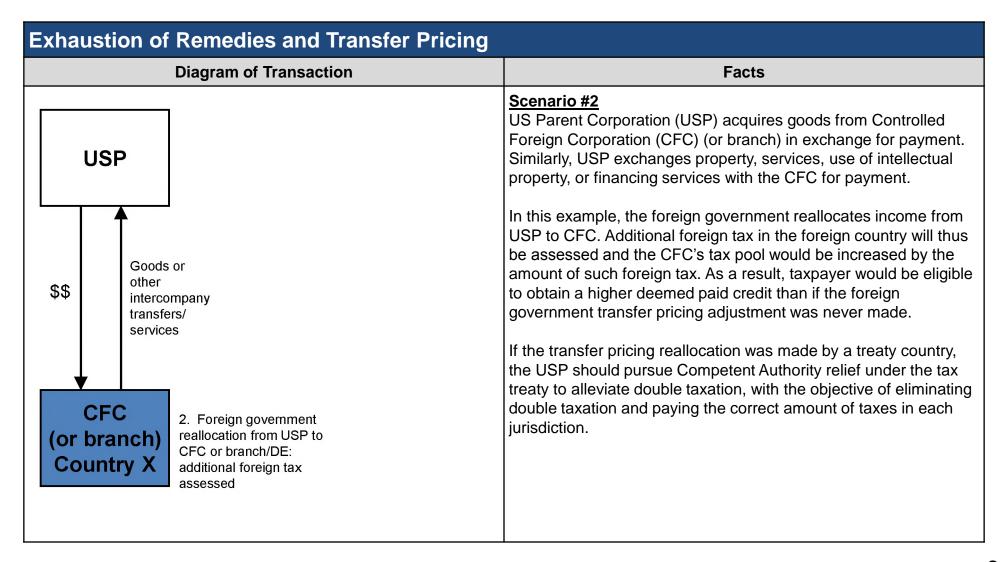
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Transaction and Fact Pattern (cont'd)



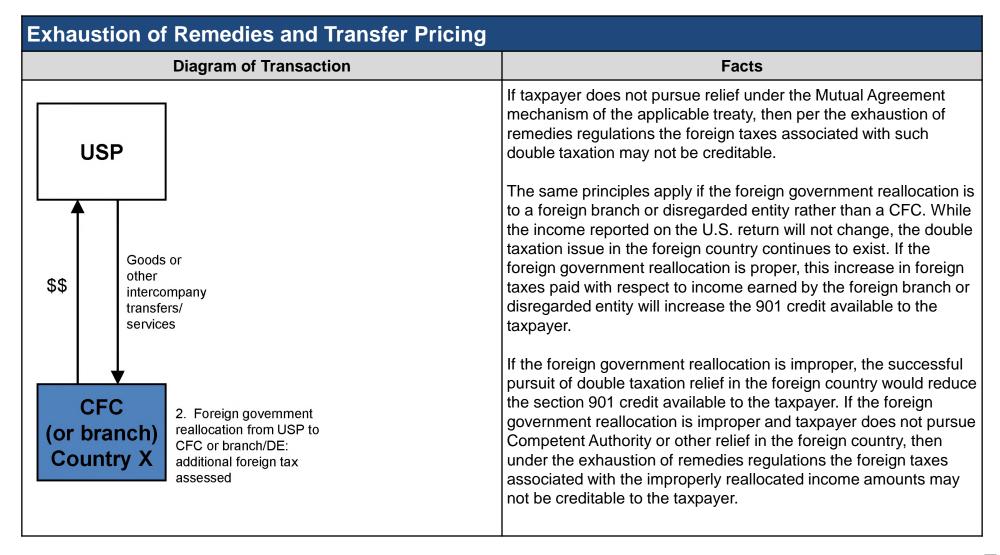
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Summary of Potential Issues

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Issue 1	How does a taxpayer prove exhaustion of local law remedies?		
Issue 2	How is the exhaustion of remedies analysis affected where a tax treaty applies?		
Issue 3	Can there be an exhaustion of remedies in a treaty country if taxpayer does not invoke Competent Authority?		

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All Issues, Step 1: Initial Factual Development

Exhaustion of Remedies and Transfer Pricing

The United States taxes income on a worldwide basis. To prevent double taxation, U.S. taxpayers are allowed a credit for foreign income taxes paid under IRC § 901. The regulations prevent U.S. companies from obtaining credits for foreign taxes they are not legally compelled to pay. The US taxpayer must exhaust all effective and practical remedies when a transfer pricing adjustment is made by either taxing authority.

Fact Element	Resources	6103 Protected Resources
 Was there a transfer pricing adjustment? In performing the initial risk analysis, keep in mind that an exhaustion of remedies challenge may not result in a current U.S. tax adjustment (though 904(c) carryovers could be affected) if the taxpayer is in an excess credit position or cannot currently use foreign tax credits due to overall net operating losses. Review Form 5471, Sch H book to tax adjustments and request an explanation of adjustments that may identify differing treatment between the U.S. and foreign tax authorities. Examine foreign books and records, foreign tax returns, and other sections of the 5471 (e.g. schedules C, E, G and I) along with Form 1118 to identify high effective rates of foreign tax that may not have been properly computed or could have been abated. 	 Treas. Reg. § 1.901-2(e)(5)(i) Form 1118 Foreign Tax Credit – Corporations Taxpayer's FTC Workpapers Form 5471 Information Return of U.S. Persons With Respect to Certain Foreign Corporations Mandatory Transfer Pricing Information Document Request (IDR): Transfer pricing study Foreign audit or foreign withholding tax documentation 	

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All Issues, Step 1: Initial Factual Development (cont'd)

Exhaustion of Remedies and Transfer Pricing

The United States taxes income on a worldwide basis. To prevent double taxation, U.S. taxpayers are allowed a credit for foreign income taxes paid under IRC § 901. The regulations prevent U.S. companies from obtaining credits for foreign taxes they are not legally compelled to pay. The US taxpayer must exhaust all effective and practical remedies when a transfer pricing adjustment is made by either taxing authority.

Fact Element	Resources	6103 Protected Resources
Was the transfer pricing adjustment imposed by a treaty country? A transfer pricing adjustment with a treaty country necessitates additional factual development and includes the Mutual Agreement Process (MAP) and Competent Authority procedures.	 Applicable U.S. tax treaty IRC § 905(c) foreign tax redetermination workpapers IRS Pattern Letter 1853(P): advising taxpayer to extend foreign statutes 	
Request from the taxpayer if there is the existence of foreign audits and if so, obtain the foreign audit reports or status of the foreign audit.	 Mutual Agreement Process (MAP) letter or MAP report 	
Review U.S. initiated adjustments	Rev. Proc. 99-32: statements filed with the return	

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Issue 1, Step 2: Review Potential Issues

Exhaustion of Remedies and Transfer Pricing

The United States taxes income on a worldwide basis. To prevent double taxation, U.S. taxpayers are allowed a credit for foreign income taxes paid under IRC § 901. The regulations prevent U.S. companies from obtaining credits for foreign taxes they are not legally compelled to pay. The US taxpayer must exhaust all effective and practical remedies when a transfer pricing adjustment is made by either taxing authority.

Explanation of Issue	Resources	6103 Protected Resources
Foreign taxes are not "paid" under the noncompulsory payment rules to the extent that payments to a foreign taxing authority exceed the amount reasonably owed under foreign law. One element of this requirement is that taxpayers must prove that they exhausted all effective and practical remedies to contest their liability for taxes.	■ Treas. Reg. § 1.901-2(e)(5)(i)	
The amount paid is a compulsory tax (and creditable, assuming other relevant requirements in the IRC and Treasury regulations are met) if (1) it is determined in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including treaties) to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax; and (2) the taxpayer exhausts all "effective and practical" remedies (including competent authority procedures provided under applicable tax treaties) to reduce, over time, its liability for tax.		
The process a taxpayer should undergo to exhaust its remedies is largely the same whether the issue is in a transfer pricing or non-transfer pricing context.	■ IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013) subchapter 3.1.2.1, Step 1	

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Issue 1, Step 3: Legal Analysis

Exhaustion of Remedies and Transfer Pricing

Issue 1

How does a taxpaver prove exhaustion of local law remedies?

How does a taxpayer prove exhaustion of local law remedies?				
Explanation of Approach	Resources	6103 Protected Resources		
The determination of whether an amount of tax paid is a noncompulsory amount and thus, is not eligible for U.S. foreign tax credit is a factual determination to be made on a case-by-case basis. An additional consideration in the transfer pricing context is whether Country X has a history of raising unsupportable transfer pricing adjustments and whether the courts of Country X have been available to contest such transfer pricing adjustments. CONSULTATION: APMA should be	IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013)			
consulted on the particular characteristics of Country X and its transfer pricing adjustments.				

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Issue 2, Step 2: Review Potential Issues

Exhaustion of Remedies and Transfer Pricing

Issue 2

How is the exhaustion of remedies analysis affected where a tax treaty applies?

How is the exhaustion of remedies analysis affected where a tax treaty applies?				
Explanation of Issue	Resources	6103 Protected Resources		
The process a taxpayer should undergo to exhaust its remedies in a treaty country is largely the same whether the issue is in a transfer pricing or non-transfer pricing context. Mutual Agreement Procedures (MAP) generally available and double taxation may be mitigated when transfer pricing situations (issues) arise. In the United States, transfer pricing issues with treaty countries are handled by APMA (Advanced Pricing and Mutual Agreement).	 Competent Authority discusses both transfer pricing and non-transfer pricing adjustments. In the U.S., Competent Authority personnel are located in the APMA section of LB&I. 			
TREATY IMPLICATION. For transfer pricing adjustments that involve a branch, there is an issue whether the Authorized OECD Approach would apply to determine the income of the branch under the relevant treaty. Also, it may not be clear whether a DE is eligible for treaty relief since, for U.S. tax purposes (IRC Section 7701(a)(10)) and related regulations, a DE is not a company and not a person for U.S. tax purposes. Some U.S. tax treaties would allow for MAP, but this will depend on the language of the relevant treaty.				

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Issue 2, Step 3: Legal Analysis

Exhaustion of Remedies and Transfer Pricing

Issue 2

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How is the exhaustion of remedies analysis affected where a tax treaty applies?			
Explanation of Approach	Resources	6103 Protected Resources	
The process a taxpayer should undergo to exhaust its remedies in a treaty country is largely the same whether the issue is in a transfer pricing or non-transfer pricing context. If the issue(s) involve transfer pricing government-to-government talks and the possibility of correlative relief are likely to occur. In the United States, transfer pricing issues with treaty countries are handled by APMA (Advanced Pricing and Mutual Agreement).	 Competent Authority handles both transfer pricing and non-transfer pricing adjustments Treas. Reg. § 1.901-2(e)(5)(ii), Example 2 – 4 		
Transfer pricing issues involving treaty partners will generally result in government-to-government talks and the possibility of correlative relief is likely to occur. In the United States, transfer pricing issues with treaty countries are handled by APMA.	■ IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013)		
The determination of whether an amount of tax paid is a noncompulsory amount and thus, is not eligible for U.S. foreign tax credit is a factual determination to be made on a case-by-case basis.			

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Issue 3, Step 2: Review Potential Issues

Exhaustion of Remedies and Transfer Pricing

Issue 3

Can there be an exhaustion of remedies in a treaty country if taxpayer does not invoke Competent Authority?

Explanation of Issue	Resources	6103 Protected Resources
If a taxpayer does not invoke Competent Authority, it is unlikely that the taxpayer would be considered to have exhausted its remedies and thus a foreign tax credit would be denied for that portion of foreign taxes paid.	■ IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013)	

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Issue 3, Step 3: Legal Analysis

Exhaustion of Remedies and Transfer Pricing

Issue 3

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Can there be an exhaustion of remedies in a treaty country if taxpayer does not invoke Competent Authority?			
Fact Element	Resources	6103 Protected Resources	
The process a taxpayer should undergo to exhaust its remedies is largely the same whether the issue is in a transfer pricing or non-transfer pricing context. If a taxpayer does not invoke Competent Authority, it is very unlikely that the taxpayer would be considered to have exhausted its remedies and thus a foreign tax credit would be denied for that portion of foreign taxes paid.	■ IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013)		
The determination of whether an amount of tax paid is a noncompulsory amount and thus, is not eligible for U.S. foreign tax credit is a factual determination to be made on a case-by-case basis.			
CONSULTATION: APMA should be consulted on the particular characteristics of Country X and its transfer pricing adjustments.			

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Training and Additional Resources

Chapter 3.1.2 Compulsory Payments/Exhaustion of Remedies			
Type of Resource	Description(s) and/or Instructions for Accessing	References	
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Glossary of Terms and Acronyms

Acronym	Definition		
APMA	Advanced Pricing and Mutual Agreement		
CFC	Controlled Foreign Corporation		
DE	Disregarded Entity		
ETR	Effective Tax Rate		
FDE	Foreign Disregarded Entity		
FTC	Foreign Tax Credit		
IDR	Information Document Request		
IE	International Examiner		
MAP	Mutual Agreement Process		
Rev. Proc.	Revenue Procedure		
USP	U.S. Parent corporation		

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Foreign tax redeterminations §905(c)	9413.01-01	
Treaties IPN	9450	
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