Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service Transaction Unit

Shelf		Business Outbound		
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	3.1.2.3	Exhaustion of Remedies In Non-Transfer Pricing Situations		

Unit Name	Exhaustion of Remedies in Non-Transfer Pricing Situations

Document Control Number (DCN)	FTM/9413.01-02_03(2013)
Date of Last Update	08/28/2014

Table of Contents

(View this PowerPoint in "Presentation View" to click on the links below)

Issue and Transaction Overview

Exhaustion of Remedies In Non-Transfer Pricing Situations

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 non-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).

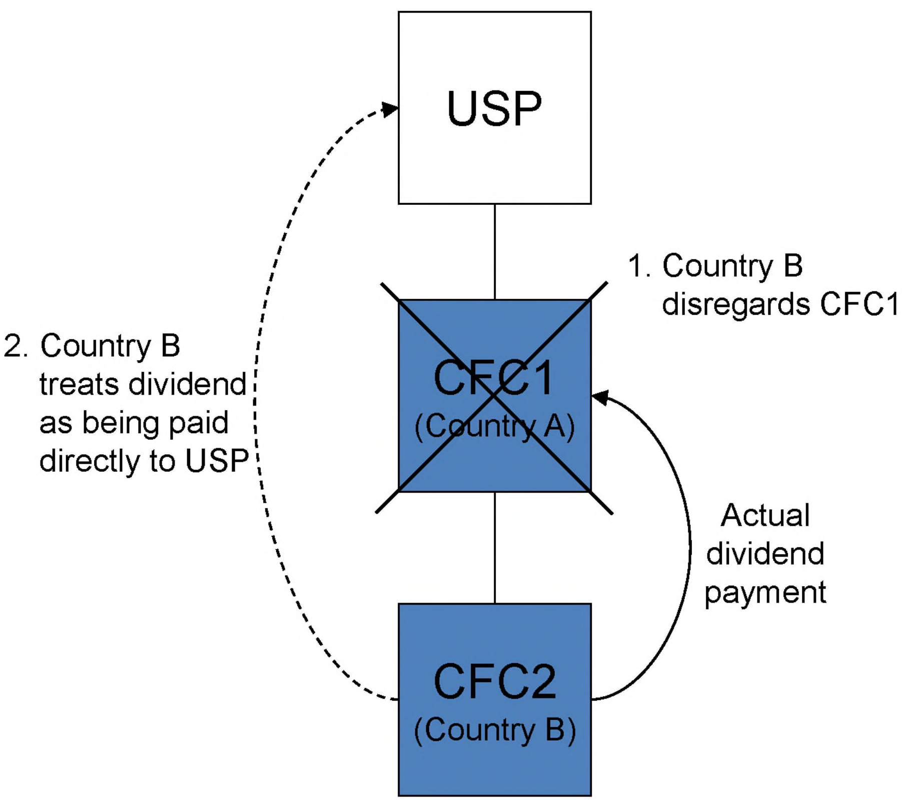
As a general rule, taxpayers cannot claim foreign tax credits for amounts paid to foreign taxing authorities where they have failed to exhaust all effective and practical remedies (including competent authority procedures where applicable). Treas. Reg. Section 1.901-2(e)(5)(i).

Non-transfer pricing 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 resort to competent authority (e.g., withholding tax rates reduced by treaty; inconsistent characterization of income, such as nontaxable sale gain vs. royalty subject to withholding tax; inconsistent expense allocation rules resulting in different amounts of taxable income attributable to a branch; economic activity that does not rise to the level of a permanent establishment (PE); or different source of income rules leading to conflicting or even multiple claims of primary taxing jurisdiction). Transfer pricing exhaustion of remedies issues are discussed in the IPS Unit: Exhaustion of Remedies and Transfer Pricing FTM/9413.01-02_02(2013).

Transaction and Fact Pattern

Exhaustion of Remedies In Non-Transfer Pricing Situations

Diagram of Transaction



Facts

Scenario #1 Different Withholding Tax Treatments. The fact pattern below illustrates how different treaty countries can impose different withholding rates based on their treatment of a payee entity as a sham, pass-through, or a regarded corporation.

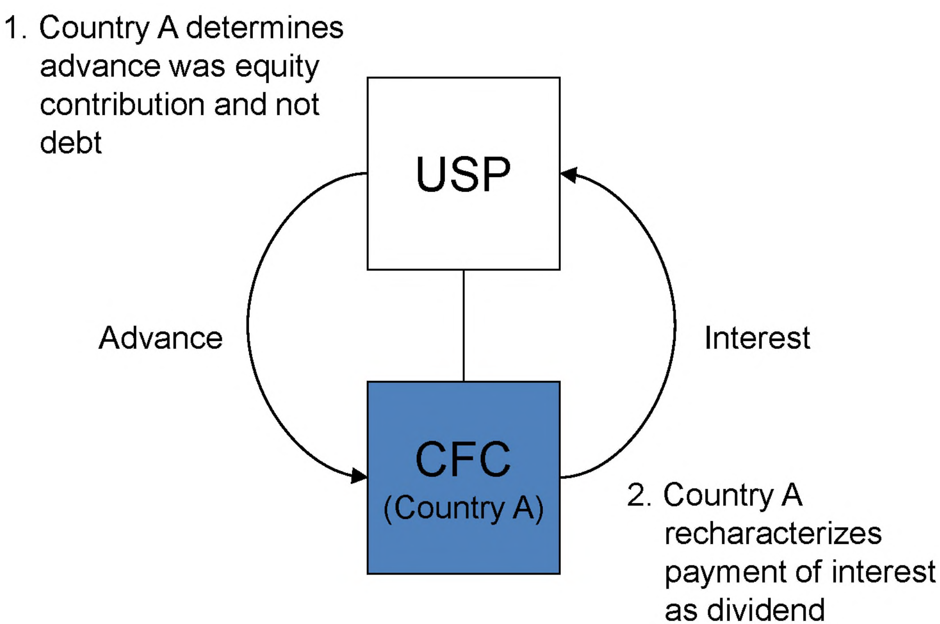
- USP is a corporation resident in the United States
- USP owns 100 percent of Controlled Foreign Corporation (CFC) 1, a corporation resident in Country A
- CFC1 owns 100 percent of CFC2, a corporation resident in Country B
- The tax treaty between Country A and Country B provides that Country B may impose an X-percent tax on payments of dividends from CFC2 to CFC1
- The tax treaty between the United States and Country B provides that Country B may impose an X+1-percent tax on payments of dividends from CFC2 to a U.S. corporation
- CFC2 pays a dividend to CFC1 and withholds at the X-percent rate specified in the Country A-Country B treaty
- On audit, Country B disregards CFC1 (thereby treating USP as the direct owner of CFC2), treats CFC2 as having paid the dividend to USP1, and assesses additional tax based on the X+1-percent rate specified in the U.S.-Country B treaty

Back to Table Of Contents

Transaction and Fact Pattern (cont'd)

Exhaustion of Remedies In Non-Transfer Pricing Situations

Diagram of Transaction



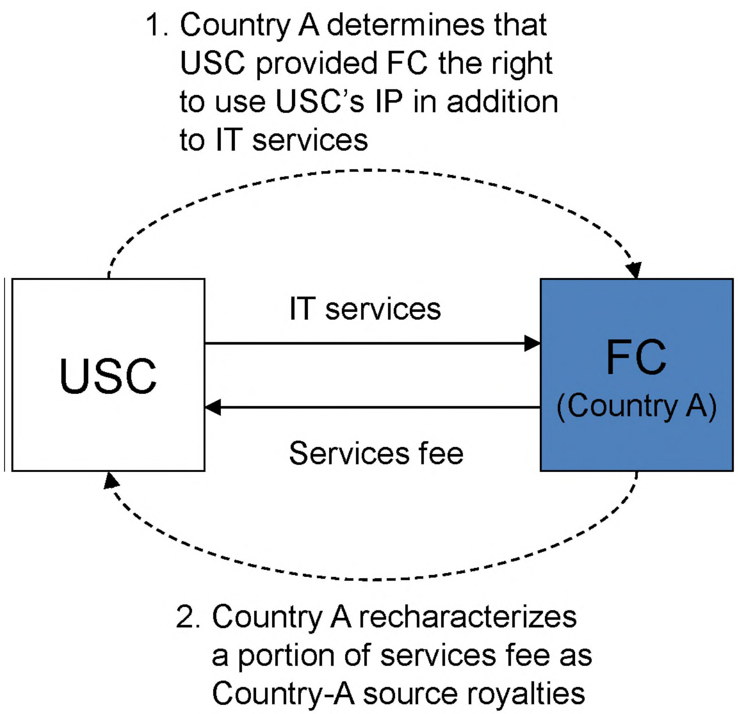
Facts

Scenario #2 Inconsistent Characterization of Debt and Equity By Different Jurisdictions

- USP is a corporation resident in the United States
- USP owns 100 percent of CFC, a Country A corporation
- The tax treaty between the United States and Country A provides that Country A may impose an X-percent tax on payments of interest from CFC to USP and an X+1 percent tax on payments of dividends from CFC to USP
- USP makes an advance of money to CFC, which USP and CFC treat as debt
- CFC makes interest payments to USP on the debt, deducts such payments in computing its Country A taxable income, and withholds at the X-percent rate specified in the U.S.-Country A treaty
- On audit, Country A determines that the advance from USP to CFC was an equity contribution and not debt and that the payments from CFC to USP were payments of dividends and not interest and disallows CFC’s interest expense deductions
- Country A assesses additional tax based on the X+1-percent dividend rate specified in the U.S.-Country A treaty and the disallowance of CFC’s interest expense deductions

Transaction and Fact Pattern (cont'd)

Exhaustion of Remedies In Non-Transfer Pricing Situations

Diagram of Transaction	Facts
	**Scenario #3 Inconsistent Country Characterization of U.S. provided Information Technology (IT) Services v. Royalties** ▪ USC is a corporation resident in the United States ▪ FC is a corporation resident in Country A ▪ The tax treaty between the United States and Country A provides that Country A (1) may tax the business profits of USC only to the extent attributable to a PE that USC has in Country A, and (2) may impose an X-percent tax on payments of royalties from FC to USC ▪ USC and FC enter into an agreement under which USC will provide IT services to FC in exchange for a fee ▪ USC provides its IT services to FC from USC's offices in the United States and does not have a PE in Country A ▪ FC pays for the services in accordance with the contract, and USC does not pay tax in Country A because the fees are not business profits attributable to a PE in Country A ▪ On audit, Country A determines that USC provided FC the right to use USC's intellectual property (IP) in addition to IT services, recharacterizes a portion of the services fees as royalties paid for FC's use of the IP in Country A, and assesses tax based on the X-percent royalties rate specified in the U.S.-Country A treaty

Summary of Potential Issues

Exhaustion of Remedies In Non-Transfer Pricing Situations	
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?

All Issues, Step 1: Initial Factual Development

Exhaustion of Remedies In Non-Transfer Pricing Situations

To examine foreign tax credits, examiners review Form 1118 and request the U.S. taxpayer's IRC §902 workpapers. During 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.

Fact Element	Resources	6103 Protected Resources
▪ Scenarios #1 through #3 illustrate how different treatment of a transaction under U.S. and foreign law can result. The scenarios are just a few common non-transfer pricing scenarios. In practice, there are many other situations that could result in different treatment of a transaction by U.S. and foreign law. ▪ 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 ▪ Form 5471 Information Return of U.S. Persons With Respect to Certain Foreign Corporations ▪ Taxpayer's FTC workpapers ▪ Foreign audit or foreign withholding tax documentation	

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

Exhaustion of Remedies In Non-Transfer Pricing Situations

To examine foreign tax credits, examiners review Form 1118 and request the U.S. taxpayer's IRC §902 workpapers. During 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.

Fact Element	Resources	6103 Protected Resources
▪ Is there different treatment of a transaction between the U.S. and a treaty country that results in the payment of more foreign tax (and thereby permit taxpayer to potentially claim more FTC) than required under foreign law? ▪ 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. ▪ Review U.S. initiated adjustments	▪ Applicable U.S. tax treaty ▪ IRC § 905(c) foreign tax redetermination workpapers ▪ IRS Pattern Letter 1853(P): advising taxpayer to extend foreign statutes ▪ Mutual Agreement Process (MAP) letter or MAP report	

Issue 1, Step 2: Review Potential Issues

Exhaustion of Remedies In Non-Transfer Pricing Situations

Issue 1

How does a taxpayer prove exhaustion of local law remedies?

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. 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.	▪ Treas. Reg. § 1.901-2(e)(5)(i)	
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	

Issue 1, Step 3: Legal Analysis

Exhaustion of Remedies In Non-Transfer Pricing Situations		
Issue 1		
How does a taxpayer prove exhaustion of local law remedies?		
Explanation of Approach	**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. 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.	▪ IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013) subchapter 3.1.2.1, Step 1	

Issue 2, Step 2: Review Potential Issues

Exhaustion of Remedies In Non-Transfer Pricing Situations

Issue 2

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

Explanation of Issue	Resources	6103 Protected Resources
Even if a taxpayer has shown that it has exhausted its administrative and judicial remedies under the foreign country's domestic law, if the foreign country has a tax treaty with the United States, the taxpayer also must show that— ▪ it exhausted its remedies under the treaty, for example by requesting Competent Authority assistance under the Mutual Agreement Procedure (MAP) article of the treaty, or ▪ the foreign adjustment did not result in a taxation for which MAP would properly be invoked, for example because the taxation was not contrary to the treaty. Mutual Agreement Procedures usually will be considered to be a reasonable remedy that the taxpayer will be expected to pursue unless the taxpayer can show that it would not have been an effective and practical remedy.	▪ Procter & Gamble Co. v. U.S., Not Reported in F.Supp.2d, 2010 WL 2925099 (S.D. Ohio, 2010) ▪ IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013)	

Issue 2, Step 3: Additional Factual Development

Exhaustion of Remedies In Non-Transfer Pricing Situations

Issue 2

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

Fact Element	Resources	6103 Protected Resources
▪ Determine whether the United States has a tax treaty with the country that made the adjustment resulting in the claim for additional FTCs ▪ Determine which articles of the applicable treaty might apply to the transaction ▪ Determine the basis on which the foreign country made its adjustment (that is, domestic law, a treaty, or a combination) ▪ Determine whether the taxpayer requested MAP relief in respect of the adjustment and the results, if any, of the taxpayer's request ▪ Obtain an explanation from the taxpayer regarding whether MAP relief was requested, when such relief was requested, from which country's Competent Authority relief was requested, and the status of the request	▪ ACCI Br. 7 Treaty Master List including TIEAs, MLATs and the Multilateral ▪ Competent Authority correspondence	

Issue 2, Step 4: Legal Analysis

Exhaustion of Remedies In Non-Transfer Pricing Situations

Issue 2

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

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. Consider whether the foreign-initiated adjustment that resulted in the increased foreign taxes resulted in taxation that would not be permitted under the treaty, and if so, whether taxpayer requested relief under the treaty. In the United States, non-transfer pricing issues with treaty countries are handled by the Treaty Assistance & Interpretation Team (TAIT) section of Competent Authority.	▪ Treaty Assistance & Interpretation Team	

Issue 2, Step 4: Legal Analysis (cont'd)

Exhaustion of Remedies In Non-Transfer Pricing Situations

Issue 2

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

Explanation of Approach	Resources	6103 Protected Resources
Note that not every adjustment made by a treaty partner will implicate the treaty or be suitable for MAP, even if the end result of the adjustment is that a treaty benefit is disallowed. For example, in the United States we would determine the substance of a transaction using domestic law principles before determining how the treaty would apply to the transaction.	▪ IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013)	

Issue 3, Step 2: Review Potential Issues

Exhaustion of Remedies In Non-Transfer Pricing Situations

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 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.	▪ FSA April 30, 1992 (1992 WL 1354818)	
The burden to prove an exhaustion of remedies without pursuing Competent Authority relief is on the taxpayer.	▪ Rev. Rul. 76-508	
Revenue Procedure 2006-54 sets forth a limited number of circumstances in which a taxpayer is not required to seek Competent Authority relief to provide an exhaustion of remedies. There also are circumstances where competent authority assistance may not be necessary, such as *de minimis* cases, cases where other administrative remedies or litigation are successful, or cases where the taxpayer has received an opinion of local counsel or otherwise has complied with foreign laws to minimize its taxes.	▪ Rev. Proc. 2006-54	

Issue 3, Step 3: Additional Factual Development

Exhaustion of Remedies In Non-Transfer Pricing Situations

Issue 3

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

Fact Element	Resources	6103 Protected Resources
▪ Determine why the taxpayer did not request Competent Authority relief (for example, did taxpayer fail to preserve its rights to Competent Authority relief by settling with the tax administration) ▪ Determine whether taxpayer obtained relief in some other manner ▪ Request from the taxpayer the Opinion letter from foreign local counsel **Consultation:** Consult with the Treaty Assistance & Interpretation Team (TAIT) section of Competent Authority	▪ Treaty Assistance & Interpretation Team	

Issue 3, Step 4: Develop Arguments

Exhaustion of Remedies In Non-Transfer Pricing Situations

Issue 3

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

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.	▪ Rev. Proc. 2006-54	

Training and Additional Resources

Chapter 3.1.2 Compulsory Payments/Exhaustion of Remedies		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
	IPS Unit: Exhaustion of Remedies FTM/9413.01-02_01(2013)	

Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled Foreign Corporation
FTC	Foreign Tax Credit
IE	International Examiner
IP	Intellectual Property
MAP	Mutual Agreement Procedure
PE	Permanent Establishment
TAIT	Treaty Assistance and Interpretation Team
USP	U.S. Parent corporation

Index of Related Issues

Issue	Associated UIL(s)	References
Outbound Income Shifting IPN	9411	
Foreign tax redeterminations §905(c)	9413.01-01	
Treaties IPN	9450	
MAP procedural issues	9450.12	