



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Process Unit

Unit Name	Foreign Currency Translation	
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Knowledge Base	International
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Book	Foreign Tax Credit
Chapter	Calculation of Amount of Allowable FTC

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Process Overview

Foreign Currency Translation

Because the United States (U.S.) taxes U.S. persons on their world-wide income, foreign source income may be subject to tax in both the U.S. and in the source country, resulting in double taxation. The Foreign Tax Credit (FTC) regime attempts to mitigate double taxation by providing a credit against the U.S. tax on foreign source income. Foreign taxes generally are denominated in the currency of the foreign country. Since all U.S. federal income tax determinations, including FTC, must be made in U.S. dollars, foreign income taxes that are eligible for the FTC must be translated or converted into U.S. dollars according to IRC 986(a). Because the rate of exchange between the U.S. dollar and a foreign currency fluctuates continuously, when and how a taxpayer converts a foreign currency into U.S. dollars is important.

A taxpayer can claim FTC for a qualified foreign tax either in the tax year the tax is paid or when it is accrued, depending on an election the taxpayer makes on Form 1116 (Part II) in the first year FTC is claimed. See IRC 905(a). The rules of “how” and “when” a taxpayer translates foreign taxes into dollars depends on whether the taxpayer elects the “paid” or “accrued” method. Below is a summary of the general rules.

Paid Method	Accrued Method
Foreign Currency should be translated into dollars using the exchange rate as of the date of payment. This applies to taxes withheld as well as estimated tax paid.	Foreign currency is translated into U.S. dollars based on the average exchange rate for the tax year to which the taxes relate. However, if any of the exceptions listed below exists, the taxpayer must use the exchange rate as of the date of payment of the foreign taxes.
	Exceptions: <ol style="list-style-type: none"><li data-bbox="1048 1133 1798 1200">1. The foreign taxes are paid more than 24 months after the close of the tax year to which they relate.<li data-bbox="1048 1208 1798 1275">2. The foreign taxes are paid before the taxable year begins.<li data-bbox="1048 1282 1831 1349">3. The foreign taxes are denominated in an inflationary currency.

Process Overview (cont'd)

Foreign Currency Translation

Even if a taxpayer takes foreign taxes into account based on the accrued method, the taxpayer can elect to translate foreign taxes into U.S. dollars by using the exchange rate on the date of payment. See Treas. Reg. 1.986(a)-1(a)(2)(iv). However, this election can only be made if the liability for such foreign taxes is denominated in a nonfunctional currency. A nonfunctional currency is a currency other than that which is defined as a functional currency under IRC 985(b).

Depending on the tax year in question, the following statutory provisions apply:

- For taxable years beginning after December 31, 1997, and before November 7, 2007, currency translation rules under IRC 986(a), as amended by the Taxpayer Relief Act of 1997 and the American Jobs Creation Act of 2004, apply.
- For taxable years beginning on or after November 7, 2007 and ending before December 16, 2019, Treas. Reg. 1.905-3T(b) applies. Although this temporary regulation expired under its own terms on November 5, 2010, the rules remained outstanding in proposed form (Treas. Reg. 1.905-3T(f)), and taxpayers may rely on those proposed regulations as the position of the Service. For taxable years ending on or after December 16, 2019, Treas. Reg. 1.986(a)-1(a) applies.

Step 1: Tax Year(s) Under Examination

Foreign Currency Translation

Step 1

Identify the tax year(s) under examination in order to apply the relevant law.

Considerations	Resources
<ul style="list-style-type: none"> ▪ For taxable years beginning after December 31, 1997, and before November 7, 2007, currency translation rules under IRC 986(a), as amended by the Taxpayer Relief Act of 1997 and the American Jobs Creation Act of 2004, apply. ▪ For taxable years beginning on or after November 7, 2007, and ending before December 16, 2019, Treas. Reg. 1.905-3T(b) applies. Although the 2007 temporary regulations expired on November 5, 2010, the rules remained outstanding in proposed form, and taxpayers may rely on those proposed regulations as the position of the Service. ▪ For taxable years ending on or after December 16, 2019, Treas. Reg. 1.986(a)-1(a) applies. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.905-3T(a)(1) ▪ IRC 986(a) ▪ Treas. Reg. 1.905-3T(b) ▪ Treas. Reg. 1.905-3T(f) ▪ Prop. Treas. Reg. 1.905-3 ▪ CCA 201145015 ▪ Treas. Reg. 1.986(a)-1(a) ▪ Treas. Reg. 1.905-3

Step 2: Paid or Accrued Method

Foreign Currency Translation

Step 2

Verify whether the taxpayer elected the paid or accrued method.

Considerations	Resources
<ul style="list-style-type: none"> ▪ Rules of currency translation differ depending on the method the taxpayer elected on Form 1116, Part II. ▪ Taxpayers that take foreign income taxes into account when paid should generally use the rate of exchange in effect on the date they paid the foreign tax. This applies to both income taxes withheld and any estimated tax paid in foreign currency. ▪ If a taxpayer takes foreign income taxes into account when accrued, the amount of any foreign income taxes must generally be translated into the U.S. dollar by using the average exchange rate for the taxable year to which such taxes relate. The following are the exceptions to this rule: <ul style="list-style-type: none"> – Foreign income taxes paid more than 24 months after the close of the taxable year to which they relate. – Foreign income taxes paid before the beginning of the taxable year to which they relate. – Foreign income taxes the liability for which is denominated in any inflationary currency. If any of the above exceptions exists, the taxpayer must use the exchange rate as of the date the foreign taxes were paid. 	<ul style="list-style-type: none"> ▪ Form 1116 - <i>Foreign Tax Credit (Individual, Estate, or Trust)</i> ▪ IRC 986(a)(2) ▪ Treas. Reg. 1.986(a)-1(b) ▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i> ▪ IRC 986(a)(1)(A) – (B) ▪ Treas. Reg. 1.986(a)-1(a) ▪ IRC 986(a)(1)(C) ▪ Treas. Reg. 1.986(a)-1(a)(2) ▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i>

Step 2: Paid or Accrued Method (cont'd)

Foreign Currency Translation

[Step 2](#)

Considerations	Resources
<p>Example 1: Taxpayer A uses the accrued method to account for foreign taxes. In tax year 2016, Taxpayer A accrued 500 units of foreign currency Y on Form 1116. The average exchange rate for tax year 2016 is 1 unit of foreign currency Y to 2 U.S. dollars. Thus, for FTC purposes, total foreign taxes accrued is translated into 1,000 U.S. dollars. Assume Taxpayer A does not pay the accrued taxes within 24 months after the close of tax year 2016, but pays the tax on February 2, 2019, which is more than 24 months after 12/31/2016. If on February 2, 2019 the exchange rate is 1 unit of foreign currency Y to 1.5 U.S. dollars, Taxpayer A must amend the 2016 tax return to correct the accrued foreign taxes to 750 U.S. dollars.</p> <p>Example 2: Taxpayer B uses the accrued method to account for foreign taxes. He lives and works in foreign country X where taxpayers are required to report their income taxes on a fiscal year basis (May 1 to April 30) instead of calendar year. Taxpayer B claims credit on his Form 1040 for calendar year 2016 for 200 units of tax paid to foreign country X that accrued on April 30, 2016. Because Taxpayer B uses the accrued method, he should translate foreign currency X to the U.S. dollar by using the average exchange rate for calendar year 2016, his U.S. taxable year. If the average exchange rate for 2016 is 1 unit of foreign currency X to 3 U.S. dollars, taxpayer B will accrue 600 U.S. dollars of creditable tax on Form 1116.</p>	

Step 2: Paid or Accrued Method (cont'd)

Foreign Currency Translation

Step 2

Considerations	Resources
<ul style="list-style-type: none"> ▪ If the taxpayer is otherwise required to translate foreign currency using the average exchange rate (accrued method), an election can be made to use the exchange rate in effect on the date the foreign income taxes are paid, provided the liability for such taxes is denominated in nonfunctional currency. Other considerations related to this election are: <ul style="list-style-type: none"> – A taxpayer may make the election for all nonfunctional currency foreign income taxes or only those nonfunctional foreign income taxes that are attributable to qualified business units (QBUs) with U.S. dollar functional currency. – If any of the accrued taxes are unpaid as of the close of the taxable year when the taxes accrue, the taxpayer must translate them into U.S. dollars using the exchange rate on the last day of the U.S. tax year to which those taxes relate. When the taxes are subsequently paid, the taxpayer's foreign tax credit and U.S. tax in the year the taxes accrued and any subsequent affected year must generally be adjusted to translate the foreign tax using the rate on the date the taxes are paid. – The election is available for tax years beginning after 2004. It is made by attaching a statement to the taxpayer's timely filed return (including extensions) for the first taxable year to which the election applies. The statement must identify whether the election is made for all foreign income taxes or only for those taxes attributable to QBUs with U.S. dollar functional currencies. Once made, the election shall apply for the taxable year for which made and all subsequent tax years unless revoked with the consent of the IRS. 	<ul style="list-style-type: none"> ▪ IRC 986(a)(1)(D) ▪ Treas. Reg. 1.905-3 ▪ Treas. Reg. 1.986(a)-1(a)(2)(iv) ▪ Treas. Reg. 1.988-1(c) ▪ Treas. Reg. 1.985-1(b) ▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i>

Step 3: Conversion Rates

Foreign Currency Translation

Step 3

Verify the taxpayer is using the correct foreign currency exchange rate and the rate is applied consistently.

Considerations	Resources
<ul style="list-style-type: none">▪ Treasury Regulations contain only general guidance on qualified sources of exchange rates that must be used for FTC computation purposes. However, this does not mean the IRS will not challenge the method or rate used by the taxpayer. Taxpayers should use a currency conversion rate that they could reasonably obtain if they were to actually exchange a foreign currency to U.S. dollars at the time foreign taxes were paid or accrued.▪ Typically, the interbank plus or minus 4 (+/- 4) is a median rate a taxpayer would likely receive if he or she went into a foreign institution and converted foreign currency into U.S. dollars. However, depending on how the taxpayer paid his or her foreign income taxes (for example by credit card), another rate may be acceptable.▪ The taxpayer should be consistent in using the same conversion rate of exchange or convention for the year under examination. If the taxpayer uses the interbank rate of plus or minus 4 to convert foreign source income and plus or minus 0 interbank rate for foreign expenses and foreign income taxes, that would be inconsistent.	<ul style="list-style-type: none">▪ Treas. Reg. 1.986(a)-1(a)(1)▪ Treas. Reg. 1.988-1(d)(1)▪ Treas. Reg. 1.989(b)-1 ▪ oanda.com

Step 3: Conversion Rates (cont'd)

Foreign Currency Translation

[Step 3](#)

Considerations	Resources
<ul style="list-style-type: none">▪ If there are questions regarding the rate the taxpayer used, ask the taxpayer to provide substantiation to support how the rate is chosen. Verify that the same rate has been applied consistently to income, expenses and foreign income taxes paid or accrued. ▪ There are many good foreign exchange websites, including the following:<ul style="list-style-type: none">- oanda.com- xe.com- irs.gov/individuals/international-taxpayers/yearly-average-currency-exchange-ratesThe examiner can use these sites or others to verify the rates used by the taxpayer.	<ul style="list-style-type: none">▪ IRC 905(b)▪ IRM Exhibit 4.61.10-1 - <i>Direct Taxes Audit Techniques</i>

Definitions

Foreign Currency Translation

Description

- **Functional Currency** – Generally means the U.S. dollar. But in the case of a QBU, it is the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records. IRC 985(b).
- **Nonfunctional Currency** - With respect to a taxpayer or a QBU, a currency (including the European Currency Unit) other than the taxpayer's or the qualified business unit's functional currency as defined in IRC 985 and the regulations thereunder. Treas. Reg. 1.988-1(c).
- **Qualified Business Unit** - Any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records. IRC 989(a).
- **Inflationary Currency** - The currency of a country in which there is cumulative inflation during the base period of at least 30 percent, as determined by reference to the consumer price index of the country listed in the monthly issues of *International Financial Statistics*, or a successor publication, of the International Monetary Fund. Base period means, with respect to any taxable year, the thirty-six calendar months ending on the last day of such taxable year. Treas. Reg. 1.986(a)-1(a)(2)(iii) and Treas. Reg. 1.985-1(b)(2)(ii)(D).

Other Considerations / Impact to Audit

Foreign Currency Translation	
Considerations	Resources
<ul style="list-style-type: none">▪ When a taxpayer using the accrued method receives a foreign tax refund, or otherwise had to reduce a previously-accrued foreign income tax due to a credit, a correction of an over accrual, or adjustment due to not paying the accrued foreign taxes within 24 months after the close of the taxable year to which such taxes relate, the reduction shall be translated using the exchange rate that was used to translate such amount when originally claimed as a credit or added to PTEP group taxes.	<ul style="list-style-type: none">▪ Treas. Reg. 1.986(a)-1(c)

Index of Referenced Resources

Foreign Currency Translation
IRC 905
IRC 985(b)
IRC 986
IRC 989(a)
Prop. Treas. Reg. 1.905-3
Treas. Reg. 1.905-3T
Treas. Reg. 1.985-1(b)
Treas. Reg. 1.986(a)-1
Treas. Reg. 1.988-1
Treas. Reg. 1.989(b)-1
CCA 201145015
Form 1116 - Foreign Tax Credit (Individual, Estate, or Trust)
Pub. 514 - <i>Foreign Tax Credit for Individuals</i>
IRM Exhibit 4.61.10-1 - <i>Direct Taxes Audit Techniques</i>
oanda.com
xe.com
irs.gov/individuals/international-taxpayers/yearly-average-currency-exchange-rates

Training and Additional Resources

Foreign Currency Translation	
Type of Resource	Description(s)
Saba Meeting Sessions	<ul style="list-style-type: none">▪ <i>How to Audit FTC - Form 1116, Part 3</i> - 2015 CPE Saba Meeting
Databases / Research Tools	<ul style="list-style-type: none">▪ <i>Kuntz & Peroni – U.S. Int'l Tax</i> Para B4.08[6] - Foreign Currency Translation▪ <i>Mertens law of Fed. Income Tax's</i> Para 45D:27 - Conversion of Foreign Taxes into United States Dollars▪ Foreign Currency Translation Websites:<ul style="list-style-type: none">- oanda.com- xe.com- irs.gov/individuals/international-taxpayers/yearly-average-currency-exchange-rates

Glossary of Terms and Acronyms

Term/Acronym	Definition
FTC	Foreign Tax Credit
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
QBU(s)	Qualified Business Unit or Qualified Business Units

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9432.01	<i>FTC General Principles</i>
9470.02-01	<i>Definition of Appropriate Exchange Rate</i>