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Almost There: The New and Improved Relation-Back Doctrine

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In this article, Brewer and McBee examine how the new foreign tax credit regs affect the relation-back doctrine.

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Over a year ago, we made a prediction that some changes in the foreign tax credit rules made by the Tax Cuts and Jobs Act were likely to elevate the importance of the relation-back doctrine (RBD).[1] In particular, we suggested that the RBD, which deals with the timing for recognizing FTCs, can and should be applied when U.S. taxpayers or controlled foreign corporations have different foreign and U.S. tax years. We are pleased to report that the IRS has now fulfilled, at least in part, our prediction. Perhaps the IRS can be persuaded to go all the way toward adapting this 86-year-old judicial doctrine to properly align with today's statutory framework for the FTC mechanism.[2]

I. Background

As a product of case law, the precise meaning of the RBD is subject to interpretation.

A. The Narrow, Conventional Interpretation

Various pre-TCJA authorities that have applied the RBD use language that indicates it might be interpreted to apply only in situations involving contested foreign taxes or foreign tax redeterminations. When the RBD applies — that is, the foreign taxes in question are deemed to accrue under the all-events test (which governs the accrual of liabilities for expense items) — they are then deemed to relate back to a prior foreign tax year (not to be confused with a prior U.S. tax year) to properly match the foreign tax with the income on which the tax was imposed.

B. The Less Conventional Interpretation

As we explained in our previous article on this subject, we believe there is adequate room for a less conventional (but nonetheless legitimate) interpretation of the RBD case law under which the RBD should be applied when necessary to prevent the application of the all-events test from frustrating the purpose of the FTC mechanism. Also, we believe the case law can be interpreted to mean that the foreign taxes might be deemed to relate back, not to a foreign tax year but to one or more prior U.S. tax years, again if necessary to prevent the all-events test from frustrating the purpose of the FTC mechanism.

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[1] Ken Brewer and Nicolaus F. McBee, "Tax Reform Expands the Scope of the Relation-Back Doctrine," *Tax Notes Federal*, Sept. 30, 2019, p. 2243.

[2] The enactment of the global intangible low-taxed income regime (as part of the TCJA), coupled with a new rule preventing the carryover or carryback of excess FTCs in the GILTI basket, has greatly increased the need to properly match foreign taxes with the related foreign income that is reported for U.S. tax purposes.

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II. Fulfillment to Date

A. The 2013 FTC-Related Regulations

Even before the TCJA, back in 2013, Treasury and the IRS had incorporated a limited aspect of the RBD (albeit by a different name) in regulations under sections 901, 336, and 338. Under those regulations, foreign taxes that accrue for a single foreign tax year are allocated (as opposed to related) to two different U.S. tax years in the following situations:

- reg. section 1.901-2(f)(4) provides that when a partnership's U.S. tax year terminates under U.S. rules but not under foreign rules, the foreign tax accrued for the single foreign tax year is allocated between the two U.S. tax years;
- reg. section 1.901-2(f)(5) provides that when there is a change in the ownership of a disregarded entity during the entity's foreign tax year and that change doesn't result in a closing of the disregarded entity's foreign tax year, foreign tax paid or accrued regarding that foreign tax year is allocated between the transferor and the transferee;
- reg. section 1.336-2(g)(3)(ii) provides rules regarding the allocation of foreign taxes in connection with elections made under section 336(e) that result in the termination of a target corporation's U.S. tax year but not its foreign tax year; and
- reg. section 1.338-9(d) provides rules regarding the allocation of foreign taxes in connection with elections made in accordance with section 338.

We freely admit here that we can't take credit for predicting those adaptations of the RBD because they occurred before our prediction, and they have nothing to do with the FTC changes brought about by the TCJA.

B. The 2020 Proposed FTC Regulations

On September 9 Treasury and the IRS released new proposed FTC regulations. Regardless of whether they read our prior article on the subject, Treasury and the IRS went considerably further in these new regulations toward fulfilling our prediction regarding the RBD. For that, we'll claim full credit.

To begin with, new prop. reg. section 1.905-1(d)(1)(ii) would adopt the RBD by name, but only the more narrow, conventional interpretation described above. In addition, prop. reg. section 1.905-1(d)(2) would provide special rules for taxpayers that elect to use a 52-53 week tax year for U.S. tax purposes but that use a foreign tax year that ends on the last day of a given month. That change would represent a somewhat expanded, less conventional version of the RBD that would apply to a significant category of situations in which different tax years are used for foreign and U.S. tax reporting purposes, and it wouldn't restrict its application to foreign tax redeterminations.

The new proposed regulations also rearrange the rules in reg. section 1.901-2(f)(4) and (5) by adding a rule that allocates (that is relates) foreign taxes attributable to a single foreign tax year of an entity that undergoes a change of entity classification for U.S. tax purposes resulting in one U.S. tax year ending and another U.S. tax year beginning in the same foreign tax year.

C. Common Theme

The case law version of the RBD and each of the above-described instances in which Treasury and the IRS have incorporated elements of the RBD in regulations reflect an overriding principle that the all-events test shouldn't be strictly applied to determine the U.S. tax year when foreign taxes are creditable if doing so would frustrate the purpose of the FTC mechanism.

III. To Be Fulfilled

The proposed regulations fall short of completely fulfilling our prediction that the RBD would apply to all (or at least most) cases in which there is a difference between the foreign tax year and the U.S. tax year (not just when the different foreign and U.S. year-ends are caused by any of the situations described above). So, for example, if a CFC is required by foreign law to use a March 31 year-end, but it uses a calendar year-end for U.S. tax purposes, the proposed regulations wouldn't cause any of the foreign taxes that accrue on March 31 to relate back to the U.S. tax year that ended on the prior December 31. The nonapplication of the RBD to that type of fact pattern is likely to create many situations in which

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the purpose of the FTC mechanism will be frustrated because the TCJA repealed section 902 and prevents carrybacks and carryovers of section 960 credits in the GILTI basket. The application of the RBD to that type of fact pattern would allow the FTC mechanism to function as intended and shouldn't involve undue complexity.

IV. Authority (and Need) to Go All the Way

As noted above, some may argue that the RBD applies only in situations involving contested foreign taxes and foreign tax determinations, and that the taxes in question relate back to the relevant foreign tax year, not to a different U.S. tax year.

Those who subscribe to that position may also question whether the IRS has the authority to expand the RBD to apply to situations not involving contested foreign taxes or foreign tax determinations and to require the taxes in question to relate back to the relevant U.S. tax year. The IRS must believe it has the authority to expand the RBD in this manner because the proposed rules dealing with 52-53 week U.S. tax years do precisely that. We would argue that the magnitude of mismatches between the time foreign income and foreign taxes are recognized for U.S. tax purposes can thwart the intended purpose of the FTC in any case in which there is a different foreign and U.S. tax year, not just when the different foreign and U.S. tax years result from a 52-53 week U.S. tax year election.

V. Fulfillment by Other Means

Even though the proposed regulations would apply the RBD only to specific enumerated situations, that doesn't necessarily preclude using the doctrine in other appropriate situations not covered by the proposed regulations. So even if the proposed regulations are finalized without changes, we're not prepared to abandon the unfulfilled portion of our prediction just yet. There's always the courts.

As for the prospect of fulfillment by court decisions, we should note that during its creation and evolution, the technical legal basis for the judge-made RBD seemed to be that the mechanical application of a rule imposed by a regulation (that is, the all-events test) shouldn't be permitted to thwart the very purpose that Congress intended for the statutory provisions governing the application of the FTC mechanism.

That technical legal basis for the RBD might be argued to have been eliminated in 1984 when Congress elevated the legal position of the all-events test from a regulation to a statutory provision, by incorporating that long-standing administrative position in section 461(h)(4). Under that argument, the RBD should no longer apply (except as incorporated in regulations) because, after the enactment of section 461(h)(4), the all-events test is no longer a product of administrative regulation; it is the product of a statutory provision enacted by Congress. Thus, it can and should be applied to the determination of when taxes accrue for any other statutory provisions (including the FTC provisions) that deal with the timing for accruing an item of deduction or credit, unless those other statutory provisions alter or eliminate the all-events test.

But we would also note the argument that the RBD shouldn't apply for periods after the enactment of section 461(h)(4) in 1984 is likely to be a losing argument. There is ample case law recognizing the continuing existence of the RBD even after the enactment of section 461(h)(4).[3] Moreover, the IRS acknowledged its continuing existence in 2018 prop. reg. section 1.960-1(b)(4) and more recently in the reproposed FTC regulations released on September 29, which expanded the scope for the application of the doctrine from that in the 2013 proposed regulations. But even the expanded scope doesn't interpret this 86-year-old FTC doctrine in a manner that adequately addresses today's FTC rules.

VI. Conclusion

With the enactment of the TCJA, Congress charged Treasury and the IRS with a seemingly impossible mission to fill in a seemingly endless series of blanks left by the legislation and to explain the incredible complexity of many of the new statutory provisions. From our perspective Treasury and the IRS have done an amazing job in attempting to complete that mission. But in a few

[3] *See, e.g.*, *Albemarle v. Commissioner*, 118 Fed. Cl. 549 (2014), *aff'd*, 797 F.3d 1001 (Fed. Cir. 2015).

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areas, their efforts to deal with mission impossible may have added unnecessarily to the complexity[4] without necessarily filling in all the blanks. We believe the adaptation of the RBD to today's FTC mechanism is one such area. ■

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[4]This seems like a fitting place to repeat a quote that we included in one of our recent A&M tax alerts on an entirely different subject of TCJA change: "There is an ancient belief that the gods love the obscure and hate the obvious. Without benefit of divinity, modern men of similar persuasion draft provisions of the Internal Revenue Code. Section 341 is their triumph."

That quote is from an article written by Martin D. Ginsburg (late husband of recently deceased Justice Ruth Bader Ginsburg) way back in the 1970s. Section 341 was later repealed in 2003. But its offering to the gods has been more than replaced by the many efforts by Congress at "simplification" (quotation fingers added). The TCJA is their most recent triumph, and its FTC rules and the regulations thereunder have played a significant role in that offering.

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