

Applicability dates: This regulation is applicable for tax returns whose original due date falls on or after January 1, 1988.

FOR FURTHER INFORMATION CONTACT: Joan Thomsen, (202) 622-3850 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On January 13, 1997, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-208288-90 [1997-1 C.B. 722]) at 62 F.R. 1700, relating to the filing requirements for returns claiming the foreign tax credit (the proposed regulation).

Written comments responding to the proposed regulation were received. A public hearing was requested and scheduled but was later canceled when the one requester withdrew the request to testify. After consideration of all of the written comments, the proposed regulation under section 905(b) is adopted as revised by this Treasury Decision.

Summary of Comments and Final Regulations

The commenters argued that the interim credit notion incorporated in the proposed regulations from *Continental Illinois*, T.C. Memo 1991-66, 61 T.C.M. (CCH) 1916 (1991), *aff'd in part and rev'd in part*, 998 F.2d 513, 516-17 (7th

Cir. 1993), was misapplied and that the proposed amendment to §1.905-2(b)(3) denied district directors the flexibility to find compliance with section 905(b) unless the taxpayer produces receipts (or other direct evidence of payment) in order to prove that the taxes actually were paid to the foreign government. They argued that, even if the district director should be able to require such proof in cases such as *Continental Illinois*, district directors must have the flexibility to accept lesser proof. They argued that a portfolio holder of publicly-traded foreign securities, for example, will not be able to obtain proof in the form of receipts evidencing that the issuer of the securities actually paid the withheld taxes to the foreign government.

The comment letters are correct that the regulations historically have allowed the district director flexibility to determine that section 905(b) is satisfied without the production of tax receipts evidencing that the tax has been paid to the foreign government. Treasury and the IRS did not intend that the amendment to §1.905-2(b)(3), as proposed, deny the district director the flexibility to accept secondary evidence of the foreign tax payment where it has been established to the satisfaction of the district director that it is impossible to furnish a receipt for such foreign tax payment. The amendment was merely intended to clarify that proof of the act of withholding through secondary evidence is not, per se, equivalent to proof

Section 905.—Applicable Rules

26 CFR 1.905-2: Conditions of allowance of credit.

T.D. 8759

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Filing Requirements for Returns
Claiming the Foreign Tax Credit

AGENCY: Internal Revenue Service
(IRS), Treasury.

ACTION: Final Regulation.

SUMMARY: This document contains a final regulation relating to the substantiation requirements for taxpayers claiming foreign tax credits. The regulation is necessary to provide guidance to U.S. taxpayers who claim foreign tax credits.

DATES: *Effective date:* This regulation is effective January 27, 1998.

of payment of the foreign tax. Treasury and the IRS have now concluded, however, that such clarification is not necessary. *Continental Illinois v. Commissioner, supra.*

Therefore, in response to comments, the proposed regulation is finalized without its proposed amendment to §1.905-2(b)(3). Thus, the final regulations are identical to the final regulations currently in effect, except §1.905-2(a)(2) no longer requires a foreign receipt or return to be attached to a Form 1116 or Form 1118.

Treasury and the IRS will continue to review the foreign tax credit substantiation rules to assure that they are functioning adequately. For example, Treasury and the IRS are concerned that U.S. holders of foreign securities, including American Depositary Receipts (ADRs), may be claiming foreign tax credits in situations where an intermediary in the chain of ownership between the holder of a foreign security or an ADR and the issuer of the security (or the security underlying the ADR) has taken actions inconsistent with the ownership of the underlying security by the person claiming the credit, such as a disposition of such security. One approach to address this issue would involve modifying the substantiation, documentation and reporting rules with respect to payments on such securities and taxes withheld therefrom. For example, in order for a U.S. owner to be entitled to a credit for foreign taxes imposed on income with respect to a security, financial intermediaries (including custodians) could be required to substantiate that they have not taken any action inconsistent with beneficial ownership of the relevant security by such U.S. owner.

It should be noted that portfolio investors are not necessarily entitled to foreign tax credits for the full amount indicated on the Form 1099 as foreign taxes paid. Portfolio investors are only entitled to a foreign tax credit for the amount of tax that is legally owed, which may not be the same as the amount withheld. If, for example, a portfolio investor is entitled to a refund of foreign tax withheld because of a reduced treaty withholding rate, the investor is only entitled to a foreign tax credit for the reduced amount, whether or not the investor files a refund claim with the foreign tax authorities. The IRS has made changes to the Form 1116 Instructions and Publication 514 to clarify this

point and intends to make similar changes to the Form 1118 Instructions.

Explanation of Provisions

§§1.905-2(a)(1), 1.905-2(b)(1),(2), and (3), and 1.905-2(c)

Sections 1.905-2(a)(1), 1.905-2(b)(1), (2) and (3), and 1.905-2(c) are unchanged from the current final regulations.

§1.905-2(a)(2)

Under former §1.905-2(a)(2), taxpayers generally were required to attach to their income tax returns either (1) the receipt for the foreign tax payment or (2) a foreign tax return for accrued foreign taxes. Section 1.905-2(a)(2) removes the requirement that the documentation be attached to the income tax return. The regulation now provides that such evidence of payment of foreign taxes must be presented to the district director upon request.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to this regulation, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of this regulation is Joan Thomsen of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.905-2 is amended by revising the second through fourth sentences in paragraph (a)(2) to read as follows:

§1.905-2 *Conditions of allowance of credit.*

(a) * * *

(2) * * * Except where it is established to the satisfaction of the district director that it is impossible for the taxpayer to furnish such evidence, the taxpayer must provide upon request the receipt for each such tax payment if credit is sought for taxes already paid or the return on which each such accrued tax was based if credit is sought for taxes accrued. The receipt or return must be either the original, a duplicate original, or a duly certified or authenticated copy. The preceding two sentences are effective for returns whose original due date falls on or after January 1, 1988. * * *

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Michael P. Dolan,
*Deputy Commissioner of
Internal Revenue.*

Approved January 13, 1998.

Donald C. Lubick,
*Acting Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on January 26, 1998, 8:45 a.m., and published in the issue of the Federal Register for January 27, 1998, 63 F.R. 3812)