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US International Tax Alert

New LB&I audit guidelines for foreign tax redeterminations

On August 6, 2024, the IRS Large Business and International Division (LB&I) issued interim guidance (the "Interim Guidance") to exam teams on the treatment of certain foreign tax redeterminations (FTRs) that occur during a year under examination and relate to a prior year that is not under examination. The guidance is drafted as a proposed addition to the Internal Revenue Manual and is intended to help examiners streamline examinations of FTRs. The guidance also may benefit taxpayers under exam by reducing the number of amended returns required to account for FTRs that would *increase* US tax liability for a prior year.

Taxpayers with FTRs for prior years that would increase US tax liability and that are currently under IRS examination should consider the potential impact of the Interim Guidance to determine whether it may be beneficial to them.

Background

Section 905(c) requires a taxpayer to notify the IRS of changes to its accrued foreign taxes if:

A. Accrued taxes when paid differ from the amounts claimed as credits by the taxpayer;
B. Accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate; or
C. Any tax paid is refunded in whole or in part.

As a result of the notification, the IRS then will "redetermine the amount of tax for the year or years affected." In practice, the IRS has historically interpreted the statute as requiring the taxpayer to file an amended return for the affected year or years.

The current final regulations recognize that the general rule creates significant administrative burdens for both taxpayers and the IRS and thus provide exceptions to the amended return requirement. The most broadly applicable exception provides that where the FTR does not change the US tax liability for the year to which it relates (the "relation-back year") or any other prior tax year, no amended return is required. See Treas. Reg. § 1.905-4(b)(1)(iv).

Treas. Reg. § 1.905-4(b)(4) provides an additional exception under which certain taxpayers can notify the IRS of an FTR that otherwise would require an amended return on audit. The exception, however, rarely applies because it requires five conditions to be met:

- The FTR occurs while the taxpayer is under audit within the jurisdiction of LB&I;
- The FTR *reduces* foreign tax liability for a prior year (thus potentially increasing US tax liability);
- An amended return otherwise would be required (*e.g.*, the reduction in foreign tax changes US tax liability for the relation-back year);
- The return for the *relation-back year* is under audit; and
- The due date for the amended return for the relation-back year has not passed before the audit of that year begins.

Finally, Treas. Reg. § 1.905-4(b)(3) provides that an amended return may not be required if "the taxpayer satisfies alternative notification requirements that may be prescribed by the IRS through forms, instructions, publications or other guidance." To date the IRS has not issued any alternative notification procedures, but the Interim Guidance itself may function as an alternative notification procedure. The stated purpose of the memorandum is:

> to help exam teams streamline their examinations of FTRs and ensure exam teams are analyzing and applying FTRs consistently. The existing notification requirements for FTRs have proved administratively burdensome for exam and taxpayers, and the IRS is evaluating approaches to alleviate this burden, including by providing alternative notification procedures under Treas. Reg. 1.905-4(b)(3) or Treas. Reg. 1.905-4(b)(4).

Interim Guidance

The Interim Guidance is relevant for taxpayers under LB&I exam that failed to file an amended return for a relation-back year by the date required in the regulations, and the FTR would increase US tax liability for the relation-back year or any other prior year up to the year in which the FTR occurs (an "affected year"). The Interim Guidance potentially applies more broadly than Treas. Reg. § 1.905-4(b)(4) (see above) because it does not require the relation-back year to be under audit and does not require notification before an amended return for the relation-back year would be due.

Under the Interim Guidance,

> If the FTR occurs during or before exam's audit, and the affected year is the exam year or a prior year, then exam may accept, as part of the examination, *immaterial FTRs* in an open exam year. If accepted, exam may include the FTR Liability in the exam year. However, in such case, the calculation of the FTR Liability is still determined based on the relation-back year and affected year(s) and such calculation must be provided by the taxpayer and established to the satisfaction of exam. [Emphasis added]

To assess whether an FTR is immaterial, agents are instructed to consider all of the facts and circumstances, including the:

- Amount of FTR Liability for each of the affected years
- FTR event type (for example, a difference between an amount accrued in year 1 and paid in year 2 versus an FTR arising from a foreign audit)

- Cooperation of the taxpayer (including if the taxpayer voluntarily disclosed the FTR to exam)
- Aggregate amount of the FTR and FTR Liability for all affected years
- Other factors

To make this assessment, agents are instructed to obtain a *pro forma* amended return from the taxpayer for the relation-back year which includes all of the information required to recompute tax liability (*i.e.*, the information listed in Treas. Reg. § 1.905-4(c)).

The Interim Guidance by its terms does not apply to an FTR that reduces US tax liability (*e.g.*, due to an additional assessment of foreign tax). However, if a taxpayer has multiple FTRs for prior affected years, some of which would increase and some of which would reduce US tax liability, the FTRs that reduce US tax liability may be relevant in determining materiality.

If an FTR is determined to be immaterial, the exam team may input any changes in US tax liability in the open exam year or allow the taxpayer to submit a payment to a "miscellaneous payments" account. The impact on state tax returns remains to be determined.

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