**DEPARTMENT OF THE TREASURY**
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

May 25, 2000
UILC: 861.08-15
894.00-00
904.00-00

Number: **INFO 2000-0082**
Release Date: 6/30/2000

The Honorable Carolyn B. Maloney
Member, U.S. House of Representatives
1651 Third Ave., Suite 311
New York, N.Y. 10128-3679

Attention: Ms. Kristin Harrison

Dear Congresswoman Maloney:

This letter responds to your inquiry of January 18, 2000. Your constituent, [redacted], refers to a letter I sent to your office on February 2, 1999. [redacted] says that letter did not provide the statutory authority for reducing foreign source income by a portion of a pension deduction when computing the foreign tax credit limitation. My office has corresponded with [redacted] several times since February 2, 1999. These correspondences address various issues of concern to [redacted], including the statutory basis for reducing foreign source income by a portion of a pension deduction.

The February 2, 1999, letter (copy enclosed) addressed the foreign tax credit and its interaction with the deduction for retirement contributions. In particular, it discussed the limitation of the credit to the amount of U.S. tax attributable to foreign source taxable income. We explained, in detail, the requirement to allocate and, if necessary, apportion deductions to determine foreign source taxable income.

On December 28, 1999, my office sent [redacted] a letter (copy enclosed) that detailed the statutory and regulatory bases for allocating and apportioning deductions for the foreign tax credit limitation. In particular, we described the requirement in section 862(b) of the Internal Revenue Code (the Code) that foreign source gross income must be reduced by expenses, losses, and other deductions that are properly allocated or apportioned to that income. We pointed out the language in the regulations that provides that a deduction is considered definitely related to a class of gross income if it is incurred as a result of, or incident to, an activity. With regard to the deduction for a pension plan for a self-employed individual, about which [redacted] inquired, we said a deduction for contributions to a defined contribution Keogh plan is considered definitely related to a class of gross income consisting of self-employment earned income. When calculating the foreign tax credit limitation, that deduction is

allocated (and apportioned, if necessary) to earned income from U.S. and/or foreign sources.

We have also corresponded with [redacted] on two other occasions. (Copies of these letters are also enclosed.) On July 15, 1999, we explained how the U.S.-Canadian Tax Treaty affirms the right of the United States to apply the Code's limitations on the foreign tax credit. As noted in that letter, the Treaty applies the principle that a taxpayer's country of residence may limit the foreign tax credit that it allows in a manner that appropriately considers its domestic tax base and rates. Finally, our February 24, 2000, letter expressed regret that [redacted] had not found our responses to her previous inquiries to be satisfactory. It explained that information letters written by the National Office of Chief Counsel are intended to call attention to well-established interpretations or principles of tax law without applying them to specific facts. In our past four letters to [redacted], we have given her all the information we have on this subject.

I hope this information is responsive to your letter and [redacted]'s concerns. If you have any further questions or comments, please call Teresa B. Hughes (Identification number 50-03477) at (202) 622-3850.

Sincerely,

John M. Staples
Assistant Chief Counsel (International)

Enclosures (4)

February 2, 1999
UILC: 861.08-15
894.00-00
904.00-00

The Honorable Carolyn B. Maloney
Member, U.S. House of Representatives
1651 Third Ave., Suite 311
New York, N.Y. 10128-3679

Attention: Ms. Susan Branagan

Dear Congresswoman Maloney:

We are responding to your letter of December 17, 1998, in which you enclosed a letter from [redacted]. [redacted] expresses concern about the Internal Revenue Code's ("Code") application of the foreign tax credit and pension rules to income earned abroad. This letter responds to the foreign tax credit aspects of [redacted] inquiry; a copy of both your and [redacted]'s letters has been sent to the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations), which will address the pension-related issues.

[redacted] expresses concern that the Code's rules (as stated on Form 1116) do not allow her husband a sufficient foreign tax credit. In particular, she points out that the allocation of her husband's retirement contribution deductions against foreign source income effectively reduces his allowable foreign tax credit, notwithstanding the fact that Canada does not allow a concomitant deduction. As a result, [redacted]'s foreign tax credit computation can be seen as understating his foreign source income and, as a result, allowing an insufficient foreign tax credit.

[redacted]'s letter accurately points out that the United States allows a credit for foreign taxes paid based on its understanding of the source of income and deductions attributable to that income, which may be inconsistent with foreign law. These differences can reduce a taxpayer's allowable foreign tax credit under U.S. law. Underlying these rules is the generally accepted principle that a taxpayer's country of residence may limit the foreign tax credit that it allows in a manner that appropriately considers its domestic tax base and rates. In general, the Code implements this principle by limiting the amount of foreign taxes that may be credited against U.S. tax to the amount of U.S. tax that is attributable to a taxpayer's foreign source taxable income. Computing foreign source taxable income requires dividing a taxpayer's deductions between U.S. and foreign source gross income.

The first step in dividing a taxpayer's deductions is to allocate the deductions to a class of gross income. For deductions to be allocated to a class of gross income, they must have been incurred as a result of, incident to, or in connection with an activity or property from which the class of gross income is derived. Where, for purposes of the foreign tax credit, a class of income includes income from both U.S. and foreign sources, the deduction must then be apportioned to (i.e., divided on a pro rata basis between) both types of income.

Certain expenses, such as a deduction for retirement contributions, are allocated to both U.S. and foreign source gross income because they were incurred in connection with income that is from both U.S. and foreign sources. Thus, a pro rata part of the expenditure for a U.S. retirement plan reduces foreign source income. Because this reduction is made with regard to the Code's determination of U.S. and foreign source income, this reduction occurs whether or not the expense is deductible in the country where the income was earned.

Further, the foreign tax credit is limited to the lower of the foreign tax paid on the foreign source income or the U.S. tax attributable to that income. This limitation is necessary to prevent the foreign tax credit from offsetting U.S. tax on domestic source income, which would otherwise occur where the tax rate imposed by a foreign country on income earned in that country is in excess of the U.S. rate of taxation imposed on comparable U.S. source income.

Application of the allocation and apportionment rules and of the foreign tax credit limitation may result in foreign taxes not being creditable for the year in which they were paid. To the extent that a portion of foreign taxes is not creditable in any particular year, the unused amount of taxes can be carried back to the two prior taxable years and then carried forward to the five succeeding taxable years. Taxes that are carried back or carried forward are subject to the above-described foreign tax credit limitations, as applied to the "carry to" year.

We hope that these comments are responsive to your letter and [redacted] concerns. If you have any further questions or comments, please call Teresa B. Hughes (employee ID 50-03477) at (202) 622-3850.

Sincerely,

John M. Staples
Assistant Chief Counsel (International)

July 15, 1999
CC:INTL:THughes
COR-103378-99
UIL: 894.00-00

Dear :

We have received a copy of your letter of January 25, 1999 to Mr. Alan Pipkin of the Employee Plans division of the IRS and have been asked to address the impact of the U.S.-Canada Income Tax Convention (the Treaty) on the foreign tax credit and on deductions allocated to foreign source income. In our letter of February 2, 1999 (a copy of which is attached) to Congresswoman Carolyn Maloney, which we understand she forwarded to you, we discussed the Internal Revenue Code's foreign tax credit limitation. This letter supplements our February 2 letter to consider specifically the Treaty.

Our February 2 letter described, and the Treaty similarly applies, the principle that a taxpayer's country of residence may limit the foreign tax credit that it allows in a manner that appropriately considers its domestic tax base and rates. In particular, Article XXIV(1) provides that the United States shall grant its citizens and residents a credit for Canadian taxes, "(i)n accordance with the provisions and subject to the limitations of the law of the United States...." The Treasury Department's Technical Explanation of the Treaty, 1986-2 C.B. 275, 289, confirms that the "limitations of U.S. law" includes the foreign tax credit limitation imposed by the Code. As a result, the Treaty provisions do not vary the general application of the principles and rules described in our February 2 letter.

We hope that these comments are responsive to the issues you raised. If you have any further questions or comments, please call Teresa B. Hughes (employee ID 50-03477) at (202) 622-3850.

Sincerely,

Irwin Halpern
Senior Technical Reviewer, Branch 3
Associate Chief Counsel (International)

December 28, 1999
CC:INTL:Br3TBHughes
COR-112798-99
UIL: 861.08-15
904.00-00
911.10-00

Dear [redacted]:

This letter responds to your letter dated July 23, 1999, and supplements our letters dated February 2 and July 15, 1999. Your letter expresses certain specific concerns about the allocation and apportionment of expenses for purposes of computing the foreign tax credit. In an attempt to address your concerns, this letter utilizes a question and answer format.

Q. What is the basis for allocating and apportioning a portion of a deduction to foreign source income?

A. Section 862(b), titled "Taxable income from sources without the United States," provides, "From the items of gross income specified [as foreign source] in subsection (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income." One of the items specified in section 862(a) to which expenses may be apportioned or allocated is compensation for labor or personal services performed without the United States.

Section 861(b) contains analogous language with regard to U.S. source income. Because the statutory language of sections 861 and 862 does not provide specific rules on how expenses are properly allocated and apportioned to items of gross income, Treasury regulations address these issues. A single set of regulations address the computation of taxable income (i.e., gross income less deductions) from U.S. and foreign sources.

Under §1.861-8(a)(2), a taxpayer is required to allocate deductions to a class of gross income and then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income between the statutory grouping and the residual grouping of gross income. Section 1.861-8(b)(2) provides that a deduction is considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to,

an activity or in connection with property from which such class of gross income is derived.

For purposes of the foreign tax credit limitation, the statutory grouping is foreign source income and the residual grouping is U.S. source income. Thus, when computing this limitation, where the class of gross income to which a deduction is allocated has both U.S. and foreign source income, the deduction will be apportioned between U.S. and foreign source income on a pro rata basis.

Q. Where in the regulations does it specifically state that a portion of retirement deductions is apportioned to foreign source income?

A. As you note in your letter, the §1.861-8 regulations do not specifically address allocating and apportioning Keogh or other retirement contribution deductions for purposes of the foreign tax credit limitation. Instead, the apportionment of retirement contributions on the basis of the taxpayer’s earned income represents an application of §1.861-8's general rule that a deduction is considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity. In the case of a self-employed individual, the deduction for retirement plan contributions to a defined contribution Keogh plan is considered definitely related to a class of gross income consisting of self-employment earned income. As a result, when calculating the foreign tax credit limitation, the deduction with respect to that contribution is allocated (and apportioned, if necessary) to that earned income from U.S. and/or foreign sources. Thus, if an individual has self-employment earned income from U.S. and foreign sources and makes a qualified pension contribution, the deduction for that contribution is allocated to the self-employment earned income and then apportioned on a pro rata basis between the U.S. and foreign source components of that earned income.

Q. What is the statutory authority for the allocation and apportionment rules?

A. As previously stated, sections 861(b) and 862(b) provide the general rules that gross income from U.S. sources and foreign sources, respectively, are to be reduced by the deductions properly allocated or apportioned thereto and by a ratable part of any deductions that cannot definitely be allocated to some item or class of gross income. Where a statute does not provide specific rules for implementing its provisions, section 7805(a) authorizes the Secretary of the Treasury to prescribe “all needful rules and regulations for the enforcement of this title.”

Administrative regulations, including Treasury regulations, are subject to judicial review. Generally stated, the courts will uphold an agency’s statutory interpretation in a regulation if the interpretation is reasonable and does not conflict with the plain language and purpose of the statute. We are aware of no judicial opinions concerning the application of §1.861-8 to retirement contributions. However, in Chevron Corp. v. Commissioner, 104 T.C. 719 (1995), the U.S. Tax Court upheld the validity of the

portion of the §1.861-8 regulations that addresses allocating and apportioning state income taxes. The court held that the regulations contain a reasonable basis for allocating the state tax deduction for purposes of section 904. The rules concerning the allocation and apportionment of state income taxes apply §1.861-8's general rule that focuses on the factual relationship between deductions and a class of gross income.

Q. Why is there a special rule for qualified retirement contributions under section 911?

A. The section 911 regulation referred to in your letter, §1.911-6(a), was issued under section 911(d)(6) of the Code. Section 911(d)(6) provides that a taxpayer who claims the foreign earned income exclusion may not claim a deduction, exclusion, or credit to the extent it is "properly allocable to or chargeable against" excluded foreign earned income. Section 911(d)(6) attempts to prevent an inappropriate double benefit: taxpayers who benefit from the foreign earned income exclusion should not receive a second benefit by reducing their nonexcluded income by deductions considered to be attributable to the excluded foreign earned income. Thus, the section 911 regulations require taxpayers to allocate and apportion their deductions to determine the portion of their deductions related to section 911 excluded income. This allocation and apportionment is done under the rules of section 861.

As an exception to this rule and solely for purposes of section 911(d)(6), §1.911-6(a) lists certain "personal deductions," including qualified retirement contributions, that are not considered chargeable to section 911 excluded income. Our research has not revealed the specific rationale behind §1.911-6(a)'s personal deductions exception or the reason why qualified retirement contributions were included therein. Moreover, our research has not revealed why the section 911 regulations characterize all qualified retirement contributions as not definitely related to any class of gross income. We note, however, that the section 911 rule provides an exception to the generally applicable rules in §1.861-8, which apply for purposes of computing the section 904 limitation. In Grunebaum v. Commissioner, the U.S. Tax Court and the Second Circuit Court of Appeals upheld the application of these rules for purposes of the section 904 foreign tax credit limitation. We have enclosed a copy of the Second Circuit and Tax Court opinions for your consideration.

We hope this letter responds to your concerns. If you have any further questions or comments, please call Teresa B. Hughes (employee ID 50-03477) at (202) 622-3850.

Sincerely,

Irwin Halpern
Senior Technical Reviewer, Branch 3
Office of the Associate Chief Counsel
(International)

Attachments (2)

February 24, 2000
CC:INTL:Br3TBHughes
COR-102384-00
UILC: 861.08-15
894.00-00
904.00-00

Dear :

Thank you for your letter and attachment of January 20, 2000. We appreciate your concerns about the interaction between retirement plan contribution deductions and the foreign tax credit allowed for taxes paid outside the United States and regret that you have not found our answers to your questions to be satisfactory.

Information letters are intended to call attention to well-established interpretations or principles of tax law (including tax treaties) without applying them to specific facts. Our letters to you have explained the principles and interpretations of tax law applicable to your inquiry. Specifically, in our letter of February 2, 1999, to Congresswoman Carolyn B. Maloney, a copy of which you received, we discussed the foreign tax credit, the limitation of the credit to the amount of U.S. tax attributable to foreign source taxable income, and the requirement that deductions be allocated and, if necessary, apportioned in order to determine foreign source taxable income. In our letter to you of July 15, 1999, we discussed how the U.S.-Canadian Tax Treaty affirms the right of the United States to apply the Internal Revenue Code's limitations on the foreign tax credit. Finally, our December 28, 1999, letter to you explained the bases for allocating and apportioning deductions, specifically retirement contribution deductions, for purposes of the foreign tax credit limitation.

The contact person for this letter is Teresa B. Hughes (employee ID 50-03477), who can be reached at (202) 622-3850.

Sincerely,

Irwin Halpern
Senior Technical Reviewer, Branch 3
Associate Chief Counsel (International)