Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel (Washington, D.C., Group 2)
(Small Business/Self-Employed)

from: Branch Chief, Branch 3
(Associate Chief Counsel (International))

subject: Request for Assistance - Service Center Advice

This Chief Counsel Advice responds to your request for assistance dated April 8, 2004. This advice may not be used or cited as precedent.

ISSUES

1. How should foreign source income be calculated for purposes of the foreign tax credit limitation when a self-employed taxpayer makes deductible contributions to a U.S. retirement plan?

2. How is a U.S. retirement plan distribution, derived (in whole or in part) from foreign-sourced income, taxed?

CONCLUSIONS

1. Retirement plan contributions should be allocated to all of a self-employed taxpayer's earned income and ratably apportioned between earned income from U.S. and foreign sources.

2. Retirement plan distributions are taxable in their entirety when the contributions to the plan were deductible in the year of the contribution. The portion of the distribution that is attributable to contributions in respect of foreign source earned income is treated as foreign source income, and the remainder is U.S. source income.

FACTS

Your inquiry concerns an example involving a hypothetical single taxpayer, T, who lives in the United States and works both inside and outside the United States. T does not qualify for the foreign earned income exclusion under section 911(a) but is eligible to claim the foreign tax credit. Over a period of years, T makes contributions to a money purchase Keogh retirement plan, with the contributions made in whole or in part from foreign source earned income. The plan provides for a fixed formula for contributions and does not provide for after-tax elective employee contributions or matching contributions. The foreign source income earned by T is subject to foreign taxes, for which T claims foreign tax credits subject to the limitations of section 904. T has the following deductible expenses: expenses related to the production of his income, the self-employment tax, and retirement plan contributions. T also claims the standard deduction and personal exemption on his tax return.

LEGAL AUTHORITY

Sections 904(a) and (d) provide that the amount of the allowable foreign tax credit in any taxable year may not exceed the tentative U.S. income tax (i.e., determined prior to application of the foreign tax credit) multiplied by a fraction, the numerator of which is the taxable income from sources without the United States in a particular category of income described in section 904(d) and the denominator of which is the taxpayer's entire taxable income. In other words, the foreign tax credit is limited to the lower of the foreign tax paid with respect to income in the separate category or the U.S. tax attributable to foreign source income in that category. This limitation prevents the foreign tax credit from offsetting U.S. tax on U.S. 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. Section 904(b) provides rules for determining taxable income for the purpose of computing the foreign tax credit limitation, including a provision concerning personal exemptions, which is discussed below. Income from personal services and other income not described in section 904(d)(1)(A) through (H) is generally described in section 904(d)(1)(I), referred to as “general limitation income.”

Section 904(c) allows creditable foreign taxes in excess of the foreign tax credit limitation to be carried forward or carried back on a section 904(d) category-by-category basis. The excess credits can be used to the extent that the foreign tax credit limitation in the carryover year exceeds the amount of creditable foreign taxes paid or accrued in that year or carried over from earlier taxable years. Thus, for example, excess general limitation taxes can be used in another year if there is excess limitation with respect to general limitation income in either of the two preceding taxable years or in one of the succeeding five years. Excess credits are carried first to the earliest taxable year in which they can be used.

In order to determine the foreign tax credit limitation, the amount of foreign source gross income in each section 904(d) separate category and the deductions attributable to that income must be determined. Sections 861(a)(1) through (a)(8) and 862(a)(1) through (a)(8) provide source rules for interest, dividends, compensation, rents, royalties, certain sales of real property and inventory, insurance underwriting income, and social security benefits. Section 861(a)(3) and section 862(a)(3) treat compensation for labor or personal services as income from sources within or without the United States, respectively, based on where the labor or personal services are performed.

Sections 861(b) and 862(b) generally provide that taxable income from U.S. and foreign sources shall be determined by deducting from gross income "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." 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." Because the statutory language of sections 861 and 862 does not provide specific rules on how expenses are to be properly allocated and apportioned, Treasury regulations address these issues. A single set of regulations at §§1.861-8 through 17 addresses 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. Allocations and apportionments are made on the basis of the factual relationship of deductions to gross income. 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. Where a deduction is incurred as a result of, or incident to, an activity, which activity generates, has generated, or could reasonably have been expected to generate gross income, the deduction is considered definitely related to such gross income as a class. §1.861-8(b)(2).

Deductions that are definitely related to a class of gross income must be apportioned between the statutory and residual groupings in a manner that reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. §1.861-8T(c)(1). Deductions that do not bear a definite relationship to a class of gross income constituting less than all gross income are ordinarily treated as definitely related and allocable to all of the taxpayer's gross income. Section 1.861-8(b)(5). Similarly, certain specified deductions, none of which are at issue here, that are not definitely related to any gross income ordinarily are ratably apportioned to all gross income. Section 861-8(e)(9). Section 1.861-8(e)(11) provides that the deduction for personal exemptions allowed under section 151 is not taken into account for purposes of allocation and apportionment under this section.

For purposes of the foreign tax credit limitation, the operative section is section 904, the statutory groupings are foreign source income in each of the section 904(d) separate categories, 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 definitely related includes both U.S. and foreign source income, the deduction will be apportioned between U.S. and foreign source income on the basis of the factual relationship between the deduction and the grouping or, in the absence of any such relationship, ratably on the basis of gross income. Section 904(b)(1) provides that, for purposes of computing the foreign tax credit limitation, the taxable income of an individual is computed without any deduction for personal exemptions under section 151.

Section 401 provides that a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section if contributions are made to the trust by such employer, or employees, or both for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan.

Under section 401(c)(1), for purposes of section 401, the term “employee” includes, for any taxable year, an individual who is a self-employed individual for such taxable year. For this purpose, the term “self-employed individual” generally means, with respect to any taxable year, an individual who has earned income (as defined in section 401(c)(2)) for such taxable year. Section 401(c)(2) states, in part, that the term “earned income” means the net earnings from self-employment (as defined in section 1402(a)), but such net earnings shall be determined only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor.

Section 404(a) provides that, if contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, such contributions or compensation shall not be deductible under this chapter; but if they would otherwise be deductible, they shall be deductible under this section, subject to certain limitations as to the amounts deductible in any year. Under section 404(a)(8), the deduction limit for contributions to a Keogh plan by a self-employed individual for himself is measured by reference to the individual’s “earned income,” as defined in section 401(c)(2).

With respect to distributions from a U.S. pension plan, taxable income from foreign sources includes only the portion of the payment attributable to employer contributions made to a pension plan with respect to wages earned abroad. Income from U.S. sources consists of the portion of the payment attributable to employer contributions made to the pension plan with respect to wages earned in the U.S. and the portion attributable to earnings on all amounts contributed to the plan. Rev. Rul. 78-227, 1978-1 C.B. 242; Rev. Rul. 79-388, 1979-2 C.B. 270; Rev. Rul. 79-389, 1979-2 C.B. 281; Rev. Rul. 84-144, 1984-2 C.B. 129.

ANALYSIS

In determining the foreign tax credit limitation fraction, section 904(b)(1) and §1.861-8(e)(11) provide that neither the numerator (foreign source taxable income) nor the denominator (worldwide taxable income) is reduced by the deduction for personal exemptions. The taxpayer's other deductions must be allocated to a class consisting of all or a portion of the taxpayer's gross income, and then apportioned between U.S. and foreign source gross income in the class on the basis of the factual relationship between the deduction and the grouping of gross income, or in the absence of any such relationship, ratably among such groupings on the basis of gross income.

The §1.861-8 regulations do not specifically address the allocation and apportionment of retirement plan contribution deductions. Therefore, these deductions must be allocated under §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. The deduction for a self-employment retirement plan contribution is incurred as a result of the activity of being self-employed, as evidenced by the fact that, under section 401(a)(8), the deduction for retirement plan contributions when an individual is self-employed is measured by reference to the individual's earned income, which is defined in section 401(c)(2) as the individual's "net earnings from self-employment" (with certain adjustments). Therefore, the retirement plan contribution deduction is definitely related and allocable to the class of gross income from self-employment, which includes both U.S. and foreign source income. Since there is no factual relationship between the deduction and a particular grouping of income (i.e., either U.S. or foreign source income), the deduction must be apportioned ratably between U.S. source and foreign source gross income from self-employment.

Similarly, the deduction for self-employment tax is incurred as a result of the self-employment income and therefore is definitely related and allocable to that income. As with the retirement plan contribution deduction, the self-employment tax deduction is not factually related to a particular source of income and therefore must be apportioned ratably between U.S. source and foreign source gross income from self-employment.

Because the standard deduction does not bear a definite relationship to a class of gross income constituting less than all of gross income, under §1.861-8(b)(5) the deduction is treated as definitely related and allocable to all of the taxpayer's gross income and must be apportioned ratably to all of the taxpayer's U.S. and foreign source gross income.

T's self-employment income earned outside the United States is taxed in the year earned in the country where the services were rendered and T is entitled either to credit or deduct those taxes. For foreign tax purposes, no deduction is allowed in the foreign country for the pro rata portion of the retirement contribution that is deductible for U.S. tax purposes and apportioned to reduce foreign source income. Although T is subject to U.S. tax on his U.S. and foreign source income in the year earned, this worldwide taxable income is reduced by the deduction for the retirement plan contribution, which is allowed under section 404(a). Thus, the earned income used to fund the retirement contribution is not double taxed in the year earned because, although the foreign source portion of it is subject to foreign taxation, no U.S. tax has been imposed on the earnings used to fund the deductible contribution.

We assume that T remains a U.S. citizen or resident at the time he receives distributions from the plan and that he will not be subject to any foreign tax on the distributions. Under section 402(a), the distributions will be taxable to T in the year of distribution under the rules of section 72. Under section 72, the entire amount of each distribution will be subject to U.S. tax because T deducted his qualified plan contributions in the year made and will not have any "investment in the contract" within the meaning of section 72(c). The portion of each distribution that is attributable to contributions made with respect to wages earned abroad will be foreign source income, and the balance of the distribution will be U.S. source income. Rev. Rul. 78-227, 1978-1 C.B. 242; Rev. Rul. 79-389, 1979-2 C.B. 281; Rev. Rul. 84-144, 1984-2 C.B. 129.

Because the foreign country did not allow T any deduction in respect of the pension plan contributions when T's income was taxed in the foreign country in the year earned, in theory the foreign source portion of each distribution may effectively be subject to double taxation in the distribution year. This could occur to the extent foreign taxes imposed on the portion of T's earned income used to fund the deductible retirement contribution exceed the foreign tax credit limitation in the contribution year and in allowable carryover years, so that the credits expire unused before the foreign source portion of the plan contributions is distributed to T and subject to U.S. tax. However, double taxation would not occur to the extent T claimed excess foreign taxes paid on his earned income as a credit against the U.S. tax owed on other foreign source income in the same separate category, or used excess foreign taxes paid on other income to reduce the U.S. tax on the foreign source portion of the pension distributions.

Under the Code and regulations the foreign tax credit limitation operates properly to limit the allowable credit to the pre-credit U.S. tax imposed on the taxpayer's foreign source taxable income as computed under U.S. tax rules, within the carryover periods established in section 904(c). Taxable income (and the foreign source portion of U.S. taxable income) must be computed in accordance with U.S. rules, which may differ from the foreign tax law rules used to compute the amount of foreign tax owed. See, e.g., United States v. Goodyear, 493 U.S. 132 (1989). Income tax treaties may modify U.S. and foreign law to reduce the incidence of double taxation. See, e.g., Article 18(2) of the 2001 U.S.-U.K. Income Tax Treaty, in which the U.S. and U.K. agreed to allow deductions for contributions to qualified pension plans maintained in the other state. In addition, where income is subject to double taxation because of timing differences in how taxable income is computed under U.S. and foreign law, taxpayers may be able to apply for competent authority relief under the mutual agreement article of an applicable income tax treaty.

Please call (202) 622-3850 if you have any further questions.

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