Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Process Unit
Knowledge Base – International

Library Level	Number	Title
Shelf		Individual Outbound
Book	10	Foreign Tax Credit
Chapter	10.1	Creditability of Foreign Tax Credit Claimed
Section	10.1.1	Reduced Foreign Tax Under Treaty
Subsection		

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Process Overview

Reduced Foreign Taxes Under Treaty Provisions

The United States (U.S.) taxes individual residents and citizens on their worldwide income. To prevent double taxation, U.S. taxpayers are allowed a credit for foreign income taxes "paid or accrued," known as the Foreign Tax Credit (FTC). The U.S. has also negotiated tax treaties with many countries. Under these treaties, residents or citizens of the U.S. are taxed at a reduced rate, or are exempt from foreign taxes, on certain types of income they receive from sources within these foreign countries. This Practice Unit takes an in-depth look at how reduced foreign taxes under tax treaties affect the U.S. taxpayer's ability to claim the FTC.

One of the requirements in qualifying for the FTC is that the foreign tax must be a legal and actual liability, in other words, the foreign country can legally enforce payment from the taxpayer. See Treas. Reg. 1.901-2(e)(5). If a taxpayer paid a foreign tax (or a portion of that tax) he or she is not legally liable to pay, then that amount is considered a noncompulsory payment. Noncompulsory payments are not eligible for the FTC. When claiming the FTC, the taxpayer must not include noncompulsory foreign taxes.

Example:

Taxpayer D, a U.S. citizen, received 10x interest income from investment activities in country Z. The payer of this interest income in country Z withheld 3x (30 percent) in foreign taxes in accordance with the internal law of country Z. However, the U.S. has a tax treaty with country Z, and under this treaty, tax on interest income is zero percent. Even though 3x of foreign tax was withheld and paid to country Z, this amount is noncompulsory and therefore not eligible for the FTC. Taxpayer D should request a tax refund from country Z for the amount withheld in excess of the treaty rate, or 3x.

In the above example, the foreign tax that qualifies for the FTC is the amount figured using the lower treaty rate, not the amount paid. Examiners should review tax treaties as part of their audit procedures, especially when investment income (interest, dividend) is reported, in order to determine whether the FTC was claimed with regard to noncompulsory payments.

Detailed Explanation of the Process

Reduced Foreign Taxes Under Treaty Provisions
Analysis
Tax treaties affect the rate of tax withheld from various types of income, but the following types are most commonly addressed: ▪ Interest ▪ Dividends ▪ Pension and Annuities ▪ Social security ▪ Royalties The U.S. person who receives income from a treaty country needs to check if a tax treaty might affect the tax to be paid to that foreign country, usually at a reduced rate from that which is established by the foreign country's internal law. It is important to note that the treaty rate on a particular type of income is reciprocal, meaning the reduced rate applies equally to both parties to the treaty. Any foreign tax paid in excess of the amount of liability under foreign tax law (including applicable tax treaty) is a noncompulsory payment and therefore is not eligible for the FTC. See Treas. Reg. 1.901-2(e)(5). The taxpayer should find out in advance whether there is a way to inform the withholding agent in the foreign country of the lower treaty rate. Foreign tax authorities sometimes require certification from the U.S. government that the taxpayer files an income tax return as a U.S. citizen or resident, as proof of entitlement to the treaty benefits. A taxpayer can file Form 8802 - *Application for United States Residency Certification*, to request a certification. If foreign taxes are withheld or paid in excess of the treaty rate on a particular item of income, the taxpayer should file a refund claim with the foreign taxing authority. It is worth repeating that foreign taxes eligible for the FTC are limited to the lower treaty rate, even if these taxes were withheld and paid at a higher statutory rate.

Detailed Explanation of the Process (cont'd)

Reduced Foreign Taxes Under Treaty Provisions
Analysis
Sometimes taxpayers find that it is easier to claim the FTC from the U.S. government based on the higher statutory withholding rate, than it is to file a claim for the overpaid tax from the foreign country. This may be because they don't want to complete forms and returns in a foreign language, or pay a preparer to do so. It could be because the taxpayers are unaware of the tax treaty provisions. Regardless, if a lower treaty rate applies, taxpayers are only allowed to claim the lower treaty rate. The U.S. Department of the Treasury is not responsible for subsidizing taxpayers on foreign taxes that are noncompulsory. It is therefore extremely important for the examiner to be aware that taxpayers can only claim the FTC based on the lower treaty rate, regardless of what was withheld or paid. Tax treaties may also limit the imposition of tax by requiring that a permanent establishment exist in the other country before income is subject to tax in that country. Administrative provisions and remedies, such as competent authority and exchange of information, are also included in tax treaties. **CONSULTATION:** Consult the Treaties Practice Network if there are any questions or ambiguities related to any tax treaty.

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Reduced Foreign Taxes Under Treaty Provisions

Reduced foreign taxes generally occur when a tax treaty between the U.S. and a foreign country reduces the tax rate of a certain category of income, or exempts that income from taxation altogether. Interest and dividend income are the two types of income most often associated with a reduced treaty rate. When claiming the FTC, the U.S. taxpayer can only claim foreign taxes equal to the lesser of the rate provided under a tax treaty, or the amount withheld or paid.

Criteria	Resources
▪ Is there a tax treaty with a foreign country to which the U.S. taxpayer paid foreign taxes and claimed the FTC?	▪ Treas. Reg. 1.901-2(e)(5) ▪ U.S. Bilateral Income Tax Treaty (in force) with Applicable Country ▪ Pub. 901 - *U.S. Tax Treaties*
▪ If a tax treaty exists between the U.S. and the foreign country, does the treaty provide for a lower rate of taxation on the type of income reported by the taxpayer?	▪ Treas. Reg. 1.901-2(e)(5) Ex. 6 ▪ U.S. Bilateral Income Tax Treaty (in force) with Applicable Country ▪ Pub. 901- *U.S. Tax Treaties* ▪ YouTube - *Foreign Tax Credit- Statutory Withholding Rate vs. Treaty Rate*
▪ If the lower treaty rate applies, did the taxpayer claim foreign taxes in excess of the treaty rate?	▪ Treas. Reg. 1.901-2(e)(5) Ex. 6 ▪ U.S. Bilateral Income Tax Treaty (in force) with Applicable Country ▪ Pub. 901 - *U.S. Tax Treaties* ▪ Form 1116 – *Foreign Tax Credit*

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Summary of Process Steps

Reduced Foreign Taxes Under Treaty Provisions
Process Steps
The examiner should first determine whether there is a tax treaty in force between the U.S. and the foreign country to which the taxpayer paid taxes on income sourced in that foreign country. Depending on the type of income sourced in the foreign country, if a tax treaty exists, the treaty may provide a reduced rate of taxation on that income. If the taxpayer paid a higher rate of tax to the foreign country than what is agreed to in the tax treaty, the examiner should disallow the excessive foreign taxes claimed for FTC purposes.

Step 1	Identify the applicable foreign country and investigate whether there is a tax treaty between the U.S. and the foreign country.
Step 2	If a tax treaty exists, check the treaty to determine if special provisions apply to the type of foreign source income reported by the taxpayer on Form 1116.
Step 3	Review the taxpayer’s Form 1116 to determine if the foreign tax claimed for FTC is in accordance with the rate established by the tax treaty. If the taxpayer claimed foreign taxes in excess of the treaty rate, disallow the excess.

Step 1: Determine if a Tax Treaty is in Force

Reduced Foreign Taxes Under Treaty Provisions
Step 1
Identify the applicable foreign country and investigate whether there is a tax treaty between the U.S. and the foreign country.

Considerations	Resources
▪ The foreign country or countries in question should be shown on Form 1116.	▪ Form 1116 – *Foreign Tax Credit*
▪ Sometimes the taxpayers indicate "various" on Form 1116 instead of naming the foreign country or countries. If this is the case, ask the taxpayer to provide the name of the foreign country or countries.	▪ IDR – Foreign Countries
▪ After the foreign country or countries are identified, check if there is a tax treaty in force between the U.S. and the particular foreign country.	▪ Table 1 - *Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties* (www.irs.gov/pub/irs-utl/Tax_Treaty_Table_1.pdf)
▪ If it is determined that there is no tax treaty in force, the examiner should proceed with other audit procedures for the FTC.	
▪ If there is a tax treaty in force, the examiner should continue to Step 2.	▪ Pub. 901- *U.S. Tax Treaties*

Step 2: Tax Treaty Application

Reduced Foreign Taxes Under Treaty Provisions
Step 2
If a tax treaty exists, check the treaty to determine if special provisions apply to the type of foreign source income reported by the taxpayer on Form 1116.

Considerations	Resources
▪ Various types of income, such as interest, dividends, royalties, compensation, etc., may be covered under a tax treaty. The treaty may provide for a lower rate of taxation or even exemption, if certain conditions are met. These conditions may include residency of the taxpayer, permanent establishment in a foreign country, and other stipulations. ▪ The examiner will need to establish the taxpayer's unique facts and circumstances in order to determine whether the taxpayer met the conditions stipulated in the treaty. The examiner may need to interview the taxpayer and/or obtain the necessary information through an Information Document Request (IDR). **CONSULTATION: C**onsult the Treaties Practice Network if there are any questions or ambiguities related to any tax treaty.	▪ U.S. Bilateral Income Tax Treaty (in force) with Applicable Country ▪ IDR for Issue

Step 3: Determine if Taxpayer Complied with Tax Treaty

Reduced Foreign Taxes Under Treaty Provisions
Step 3
Review the taxpayer's Form 1116 to determine if the foreign tax claimed for FTC is in accordance with the rate established by the tax treaty. If the taxpayer claimed foreign taxes in excess of the treaty rate, disallow the excess.

Considerations	Resources
▪ Foreign taxes claimed by the taxpayer on a particular type of income can not exceed the tax rate provided by the tax treaty, regardless of the amount paid to or withheld by the foreign country. Excess foreign taxes are considered noncompulsory and ineligible for the FTC. ▪ The creditable foreign taxes are limited to the lower treaty rate, even if taxes were withheld at a higher statutory rate. If a lower treaty rate applies, taxpayers are required to claim the treaty rate.	▪ Treas. Reg. 1.901-2(e)(5) ▪ Form 1116 - *Foreign Tax Credit,* Part II

Other Considerations / Impact to Audit

Reduced Foreign Taxes Under Treaty Provisions

Considerations	Resources
▪ If taxpayers overpaid their foreign taxes, the examiner can advise them to seek administrative remedies with the foreign country, including filing for a refund.	▪ Treas. Reg. 1.901-2(e)(5) Ex. 6 ▪ Relevant Foreign Substantive and Procedural Law (Statutes, Administrative Rulings and Court Cases)
▪ Depending on the internal law of a foreign country, if the foreign source income is a repeated transaction in the future, the examiner can advise the taxpayer to find out in advance whether there is a way to inform the withholding agent in the foreign country of the lower treaty rate, thereby avoiding overpaying foreign taxes through withholding.	▪ Relevant Foreign Substantive and Procedural Law (Statutes, Administrative Rulings and Court Cases)
▪ Some treaty countries require U.S. citizens and residents to pay the statutory tax rate and then claim a refund for the difference between the statutory rate and the lower treaty rate. Nonetheless, the qualified foreign tax is the amount figured using the lower treaty rate and not the amount paid or withheld, because the excess tax is refundable.	▪ Pub. 514 – *Foreign Tax Credit for Individuals*

Index of Referenced Resources

Reduced Foreign Taxes Under Treaty Provisions
Treas. Reg. 1.901-2(e)(5)
U.S. Bilateral Income Tax Treaty (in force) with Applicable Country
YouTube - *Foreign Tax Credit - Statutory Withholding Rate vs. Treaty Rate*
Table 1 - *Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties* (www.irs.gov/pub/irs-utl/Tax_Treaty_Table_1.pdf)
Relevant Foreign Substantive and Procedural Law (Statutes, Administrative Rulings, and Court Cases)
Pub. 514 – *Foreign Tax Credit for Individuals*
Pub. 901 - *U.S. Tax Treaties*
Form 1116 - *Foreign Tax Credit*
Form 1116 - *Foreign Tax Credit*, Part II
Form 8802 - *Application for United States Residency Certification*
IDR for Issue
IDR – Foreign Countries

Training and Additional Resources

Reduced Foreign Taxes Under Treaty Provisions	
Type of Resource	**Descriptions**
SABA Meeting Sessions	▪ *How to Audit FTC - Form 1116, Part II Lesson #3* 2015 CPE
Databases / Research Tools	▪ *Kuntz & Peroni - U.S. Int'l Tax* Para B4.03[3][c] ▪ *Bittker & Lokken - Fed. Tax'n Inc*, *Est and Gift* Para 72.4.6.4
Reference Materials – Treaties	▪ Applicable Tax Treaty http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/treaties.aspx

Glossary of Terms and Acronyms

Term/Acronym	Definition
FTC	Foreign Tax Credit
IDR	Information Document Request

Index of Related Practice Units

Associated UIL	Related Practice Unit	DCN
9432.01	*FTC General Principles*	FTC/C/10_01-05