



LB&I International Practice Service Process Unit – Audit

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Sub-Chapter	N/A	N/A	–	–

Unit Name	Sourcing of Salary and Compensation
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Process Overview

Sourcing of Salary and Compensation

Process Description

This process Unit applies to any U.S. individual taxpayer claiming a foreign tax credit offset on Form 1116 against the U.S. tax on foreign salary and compensation (whether an employee or an independent contractor). The purpose of this unit is to determine whether an individual taxpayer properly sourced their worldwide income from compensation for services performed partly within and partly without the United States for foreign tax credit purposes. This unit will cover the methods that are available to source the income.

Determining the source of income, U.S. or foreign, is essential in determining U.S. tax consequences for all individuals. In general, the United States taxes U.S. citizens and resident aliens on their worldwide income from whatever source derived. The Supreme Court has held worldwide taxation is justified because the benefits of citizenship extend beyond territorial boundaries, as the U.S. seeks to protect its citizens anywhere in the world (*Cook v. Tait*, 265 U.S. 47 (1924)). It does not matter where a U.S. citizen resides for their income to be taxable. If an individual taxpayer were to overstate their foreign source income, the amount of the foreign tax credit could be overstated on their federal income tax return.

Example Circumstances Under Which Process Applies

An examiner receives a case involving an individual taxpayer with one or more potential audit issues as follows: (1) the taxpayer failed to include all their earned and unearned income, (2) the taxpayer reported their net wages instead of their gross wages, (3) the taxpayer failed to properly allocate their worldwide income, (4) the taxpayer failed to reduce their gross foreign source income on Form 1116 (General Category (b)) for the foreign earned income exclusion amount that he or she reported on Form 2555 or Form 2555-EZ, (5) the taxpayer failed to properly apply any applicable treaty article provisions for FTC purposes. The examiner must determine if the taxpayer accurately sourced their worldwide income as it directly affects the computation of the foreign tax credit limitation.

This Process-Audit unit will not cover the following topics, as they are covered in separate units as follows: Sourcing of Fringe Benefits for FTC Limitation, Multi-year Compensation Arrangements Including Stock Options, Tax Equalization, Proper Foreign Source Income Reporting, and Unique Income Sourcing issues of Seamen, Air Flight Crews, Outer Continental Shelf Workers Signing Bonuses (review the specific tax treaty and contact the Treaties IPN if questions arise).

Process Overview (cont'd)

Sourcing of Salary and Compensation

Process Description

To alleviate situations of potential double taxation, IRC § 901 Taxes of foreign Countries and of Possessions of United States allows, subject to limitations, a credit for foreign taxes paid or accrued by U.S. taxpayers. Under IRC § 904, the credit is limited to that portion of the U.S. tax liability on worldwide income that is attributable to the taxpayer's foreign-source income. Sourcing directly affects the computation of the foreign tax credit limitation. The limitation establishes a ceiling on the amount of foreign taxes that can offset U.S. taxes and is designed to prevent U.S. persons operating in high-tax countries from claiming those higher foreign taxes against the U.S. tax on domestic income and tax on lower-taxed foreign income. The Code sources particular types of income by allocating them in whole or in part to the United States or jurisdictions outside the United States. The rules for determining the source of some types of income are based on the concept that income arises at the geographic location of the activity that produces it (statutory principle is the situs concept). The U.S. tax system contains rules to identify items of income (or expense) derived from U.S. or foreign sources. The sourcing of income rules are the foundation of the U.S. international tax system. The source rules and other general rules relating to foreign income are contained primarily in IRC §§ 861 – 865 and Treas. Reg. §§ 1.861-1.865 Determination of Sources of Income.

 **CAUTION:** A taxpayer may not get a double benefit by taking a foreign tax credit attributable to amounts excluded from gross income under IRC § 911(a) foreign earned income exclusion, Treas. Reg. § 1.911-6(a) Disallowance of deductions, exclusions, and credits and Rev. Rul. 79-199 Foreign tax credit; foreign earned income exclusion.

Determination of Process Applicability

Sourcing of Salary and Compensation

To determine if the sourcing of salary and compensation process applies, an examination of Form 1116 is required. The Form 1116 for salary and compensation will be a “General Category” Form 1116 and Part I, line g, 1a should have wages or some similar description listed.

Criteria	Resources	6103 Protected Resources
<p>Has taxpayer filed a Form 1116 claiming foreign tax credit on foreign source salary and compensation?</p> <p>Has taxpayer claimed use of an “alternative basis” to source their employee compensation income?</p> <p>Is the U.S. and foreign income sourced correctly on Forms 1116?</p> <p>Has taxpayer shown wages and salary (as employee) or shown compensation for services as an independent contractor? Resource: Form 1040, Line 7 on Schedule C or C-EZ attached to Form 1040.</p>	<ul style="list-style-type: none"> ▪ Form 1116 Category (b) General Income ▪ Form 1040 Line 7 Salary, Wages, etc. ▪ Form 1116, Part I, line g, 1b. ▪ Form 1040 Line 7 Salary, Wages, etc. ▪ Form 1040, Line 7 and Schedule C or C-EZ attached to Form 1040. ▪ Form 2555 or 2555-EZ 	

Determination of Process Applicability (cont'd)

Sourcing of Salary and Compensation

To determine if the sourcing of salary and compensation process applies, an examination of Form 1116 is required. The Form 1116 for salary and compensation will be a "General Category" Form 1116 and Part I, line g, 1a should have wages or some similar description listed.

Criteria	Resources	6103 Protected Resources
<p>Did the taxpayer claim exemption for Foreign Earned Income?</p> <p>See the IPS Units titled (Tax Home for Purposes of IRC § 911, Bona Fide Residence Test for Purposes of Qualifying for IRC § 911 Tax Benefits, Calculating Foreign Earned Income Exclusion – Self Employed Individual, and Calculating Foreign Earned Income Exclusion Employee), In-Process as of 02/2015.</p>	<ul style="list-style-type: none"> ▪ Tax Home for Purposes of IRC § 911 ▪ Bona Fide Residence Test for Purposes of Qualifying for IRC § 911 Tax Benefits ▪ Calculating Foreign Earned Income Exclusion – Self Employed Individual ▪ Calculating Foreign Earned Income Exclusion Employee 	

Summary of Process Steps

Sourcing of Salary and Compensation

Step 1	Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.
Step 2	Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.
Step 3	Determine whether the taxpayer has sourced any bonus they may have received in the current tax year.

Step 1

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Did the individual taxpayer include all their worldwide income? The examiner is looking for any difference of income between years. The examiner will want to follow up with the taxpayer if a significant difference is identified and unexplained.

Considerations	Resources	6103 Protected Resources
<p>Prior, Current, and Subsequent Year Analysis</p> <ul style="list-style-type: none"> ▪ Compare current year income to prior, looking for any differences of income between the years. Look for changes in both amounts, source and type of income received in the salary breakdown. Ask the taxpayer for an explanation for any differences. Do not rely on the foreign tax return to confirm income. Foreign paystubs usually provide more information with regard to the compensation breakdown. ▪ In some cases, the Examiner may want to obtain foreign tax-related information through Exchange of Information (see IRM 4.60.1). ▪ Compare retirement plans. When a U.S. person participates in a foreign pension plan, it is likely that the plan will not meet the U.S. domestic rules for qualified plans. The employee may be subject to U.S. tax on the employer's contributions to the foreign retirement plan and its earnings. 	<p>Request complete copies of:</p> <ul style="list-style-type: none"> ▪ Employee and non-employee contracts ▪ Prior and subsequent year income tax returns (U.S. & Foreign) ▪ Income Sourcing Schedule U.S.- Foreign ▪ Foreign earnings statements or paystubs ▪ Tax assessments and receipts ▪ IRM 4.60.1 Exchange of Information ▪ IRC 409A Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans (U.S. & Foreign Retirement Plans) ▪ U.S. Model Treaty Article XVIII, para.4 	

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Did the individual taxpayer include all their worldwide income? The examiner is looking for any difference of income between years. The examiner will want to follow up with the taxpayer if a significant difference is identified and unexplained.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none">Some treaties will allow deduction of the contribution and deferral of tax on the earnings of the plan.		

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Did the individual taxpayer include all their worldwide income? The examiner is looking for any difference of income between years. The examiner will want to follow up with the taxpayer if a significant difference is identified and unexplained.

Considerations	Resources	6103 Protected Resources
<p>Compensation Breakdown</p> <p> CAUTION: Original documents are best. If photocopies are made, ensure that you copy the entire document. It is recommended that you make the following notations on the back of the photocopy as it is important to establish a trail of evidence: 1) who copied it, 2) the date it was copied, and 3) indicate from whom and how it was obtained.</p> <p>The Examiner will want to compare the travel records provided by the taxpayer with those travel records in the TECS Database.</p>	<p>Request copies of:</p> <ul style="list-style-type: none"> ▪ Travel records (U.S. and foreign) such as copies of passports ▪ Treas. Reg. 1.905-2(a)(2) Documents should be translated into English ▪ IRM 5.1.18.14 Treasury Enforcement Communications System or TECS Database 	

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Typical compensation information reported on W-2's or foreign reporting equivalent

Considerations	Resources	6103 Protected Resources
<p>The process for sourcing income is dependent upon the facts and circumstances surrounding each case. Generally, the source of services income depends on the location of the performance of the service under IRC §§ 861(a)(3) and 862(a)(3). Fringe benefits received in connection with the performance of services are included in income as compensation, unless they are paid for by the employee at fair market value or they are specifically excluded by tax law.</p> <p>Example-Overseas Assignment Contract:</p> <ol style="list-style-type: none"> 1. Compensation: <ol style="list-style-type: none"> A. Base Salary B. Senior Executive Annual Incentive Plan (<u>request a copy of the Annual Incentive Plan</u>) C. Equity Compensation (<u>request a copy of the Equity Compensation Plan</u>) 		

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Typical compensation information reported on W-2's or foreign reporting equivalent

Considerations	Resources	6103 Protected Resources
2. Benefits: A. Health Insurance Plans B. Work Schedules/Holidays/Vacation (request a copy of the Expatriate Policy)		

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Typical compensation information reported on W-2's or foreign reporting equivalent

Considerations	Resources	6103 Protected Resources
<p>3. Relocation Benefits:</p> <ul style="list-style-type: none"> A. Relocation Allowance B. Work Permits/Visas C. Mobility Bonus D. International Service Allowance or Cost of Living Adjustment (Goods & Services Allowance) E. Housing Allowance F. Other Benefits such as Transportation to the Host Country, Automobile, Home Leave, Education, etc. <p>4. Tax Reimbursement/Tax Service: <u>Request a copy of the Employer's Tax Equalization Policy and the calculations</u> that explain how the employer estimated the hypothetical tax at the beginning of the overseas assignment, the year-end actual tax equalization settlement, the repatriation tax gross-up (when applicable), the foreign taxes paid, and any tax preparation fees.</p>		

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Did the individual taxpayer include all their compensation? The examiner is looking for any difference of income between years. The examiner will want to follow up with the taxpayer if a significant difference is identified and unexplained.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Did the taxpayer report their worldwide income from self-employment, wages and salaries, bonuses, stock options, allowances, etc.? Does the income reported on the return make sense? Is there a difference between the current income compared to prior years? Are there any unexplained differences in income? If so, what are they and how do they impact the foreign tax credit? ▪ Did the taxpayer earn income in both the U.S. and abroad? Is the income reported on net or gross basis? Did the taxpayer properly allocate their worldwide income between the U.S. and the foreign countries pursuant to Treas. Reg. § 1.861-4(b)(2)? ▪ Is the employer paying for the taxpayer's expenses? If so, are they included in his or her income? 	<ul style="list-style-type: none"> • Treas. Reg. 1.861-4(b)(2) • IRC 409A 	

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Did the individual taxpayer include all their compensation? The examiner is looking for any difference of income between years. The examiner will want to follow up with the taxpayer if a significant difference is identified and unexplained.

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ If the taxpayer is married and filed MFJ return, is the spouse also living in the foreign country? If so, is the income included? Did the taxpayer move to a foreign country? What is the cost of living in that country? Is it expensive? Did the taxpayer and their spouse file Forms 2555 or 2555-EZ? ▪ Did the taxpayer participate in a pension or retirement plan in a foreign country? Is the taxpayer employed by a foreign employer? When a U.S. person participates in a foreign pension or retirement plan provided by a foreign employer, it is likely that the plan will not meet the U.S. domestic rules for qualified plans (See IRC § 409A). 		

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Did the individual taxpayer include all their compensation? The examiner is looking for any difference of income between years. The examiner will want to follow up with the taxpayer if a significant difference is identified and unexplained.

Considerations	Resources	6103 Protected Resources
<p>T TREATY IMPLICATION: There may be provisions in the treaty between the U.S. and the treaty country that may modify the taxation of pensions or retirement plans (See U.S. Model Treaty Article XVIII, para.4). In addition, certain dual resident taxpayers might be allowed to exclude certain compensation from taxable income under a treaty's Dependent Services or Income from Employment (See U.S. Model Treaty Article 14, Income From Employment and U.S./Canada Treaty Article XVIII, para.13). Independent Contractors performing services in another country might be exempt from tax under U.S. Model Treaty Article 5, Permanent Establishments. The applicable treaty should be reviewed to determine whether U.S. domestic law is overridden by the treaty. The examiner should contact the Treaties IPN with further questions.</p>		

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.

Did the individual taxpayer include all their compensation? The examiner is looking for any difference of income between years. The examiner will want to follow up with the taxpayer if a significant difference is identified and unexplained.

Considerations	Resources	6103 Protected Resources
 CAUTION: Although foreign laws may vary on what type of income is taxable, differences should be noted and reconciled, if possible. For example, it is common to see differences between domestic and foreign tax law with regard to Stock Based Compensation (“SBC”) both when it becomes taxable and how to measure the amount that is taxable (inclusive of any foreign exchange differences).		

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.



DECISION POINT: Did the individual taxpayer include noncash income and allowances? The examiner is looking for any difference of income between years. The examiner will want to follow up with the taxpayer if a significant difference is identified and unexplained.

Considerations	Resources	6103 Protected Resources
<p>Noncash Income:</p> <ul style="list-style-type: none"> ▪ Certain noncash income and allowances or reimbursements are considered earned income. The fair market value of property or facilities provided by the employer in the form of airfare, lodging, meals, or use of a car is earned income. <p>Allowances or Reimbursements:</p> <ul style="list-style-type: none"> ▪ Earned income includes amounts paid as allowances or reimbursements for the following items: cost of living, overseas differential, family education, home leave, housing, moving, etc. 	<ul style="list-style-type: none"> ▪ IRC 61 Gross Income defined ▪ Treas. Reg. 1.61-21 Taxation of Fringe Benefits ▪ Pub. 17, Your Federal Income Tax (For Individuals) ▪ Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad ▪ Pub. 514, Foreign Tax Credits for Individuals 	

Step 1 (cont'd)

Sourcing of Salary and Compensation

Step 1: Determine whether all salary and compensation (e.g., wages, bonuses, stock options, and allowances) are included on the U.S. individual income tax return.



DECISION POINT: Did the individual taxpayer include noncash income and allowances? The examiner is looking for any difference of income between years. The examiner will want to follow up with the taxpayer if a significant difference is identified and unexplained.

Considerations	Resources	6103 Protected Resources
<p>Review Compensation Contracts and Foreign Paystubs:</p> <ul style="list-style-type: none"> ▪ Does the employment contract include a provision for bonuses and did the taxpayer include this income on their U.S. tax return? Did the taxpayer include fringe benefits such as allowances, reimbursement for education costs for children, moving expenses, etc., that are included in the compensation breakdown schedule for the U.S. return? <p> CAUTION: The examiner will want to ensure that the taxpayer reported their gross amount of compensation and not the net amount that may be allowable in the foreign country.</p>	<ul style="list-style-type: none"> ▪ Employee and non-employee contracts ▪ Annual incentive plans or bonuses ▪ Equity compensation plan or stock option plan ▪ Summary of income sourcing ▪ Foreign income tax returns ▪ Foreign paystubs ▪ Tax Equalization Policy and calculations 	

Step 2

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.



DECISION POINT: Did the individual taxpayer properly source performance of service income between U.S. source income and foreign source income pursuant to IRC 861(a)(3), 862(a)(3), and 863(b)(1) and Treas. Reg. 1.861-4(b)(2)(i) Non-employee or (b)(2)(ii)(A) Employee?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ For services performed partly inside the U.S. and partly outside of the U.S., income must be allocated between U.S. and foreign source (IRC § 863(b)(1)). Treas. Reg. § 1.861-4 provides rules relating to the sourcing of compensation from labor or personal services performed partly within and partly without the U.S. Determining the sourcing of compensation is dependent on whether the individual taxpayer is a non-employee or employee pursuant to Treas. Reg. § 1.861-4(b)(2)(i) - (ii). 	<ul style="list-style-type: none"> ▪ Form 1116, Part I, line g, 1b Taxpayer Checked Box for Alternative Method ▪ IRC 863(b)(1) Personal Services performed partly within and partly without the U.S. ▪ IRC 861(a)(3) Personal Services performed in the U.S. ▪ Treas. Reg. 1.861-4(b)(2)(i) and (ii) Non-employee and employee 	

Step 2

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.

 **DECISION POINT:** Did the individual taxpayer properly source performance of service income between U.S. source income and foreign source income pursuant to IRC 861(a)(3), 862(a)(3), and 863(b)(1) and Treas. Reg. 1.861-4(b)(2)(i) Non-employee or (b)(2)(ii)(A) Employee?

Considerations	Resources	6103 Protected Resources
<p>The sourcing is determined under the following methods:</p> <ul style="list-style-type: none">▪ Treas. Reg. § 1.861-4(b)(1)(i) Compensation for labor or personal services performed by persons other than individuals such as a Domestic Corporation. The facts and circumstances method most correctly reflects the proper source of income based on the specific facts and circumstances. Time basis may be applicable.		

Step 2 (cont'd)

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.



DECISION POINT: Did the individual taxpayer properly source performance of service income between U.S. source income and foreign source income pursuant to IRC 861(a)(3), 862(a)(3), and 863(b)(1) and Treas. Reg. 1.861-4(b)(2)(i) Non-employee or (b)(2)(ii)(A) Employee?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Treas. Reg. § 1.861-4(b)(2)(i) Compensation for labor or personal services performed by a non-employee. The facts and circumstances method most correctly reflects the proper source of income based on the specific facts and circumstances. Time basis may be applicable. ▪ Treas. Reg. § 1.861-4(b)(2)(ii)(A) Compensation for labor or personal services performed by an individual employee is determined using a time basis formula, (B) Certain Fringe Benefits is determined on a geographic basis, and (C) Alternative facts and circumstances method may be used if this method more properly determines the source of compensation. 	<ul style="list-style-type: none"> ▪ IRC 862(a)(3) Personal Services performed outside the U.S. ▪ Treas. Reg. 1.861-4(b)(2)(i) and (ii) Non-employee and employee 	

Step 2 (cont'd)

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.

Generally, the source of services income depends on the location of the performance of the service under IRC 861(a)(3) & 862(a)(3).

Considerations	Resources	6103 Protected Resources
<p>Definition of the United States: Generally, the U.S. includes the 50 states and the District of Columbia plus the territorial waters adjoining its coastline.</p> <p> CAUTION: U.S. possessions are included in the territorial definition of the U.S. for purposes of the Foreign Earned Income Exclusion (IRC § 911). There may be differences between what is foreign earned income for FEIE purposes and what is foreign source income for foreign tax credit (FTC) purposes. In part, because FEIE requires that the income be earned in a foreign country, whereas foreign source income for FTC purposes may be earned in international waters.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.861-4(a)(5) For definition of the term “United States”, when used in a geographical sense, see IRC 638 Continental shelf areas and IRC 7701(a)(9). The term “United States” when used in a geographical sense includes only the States and the District of Columbia. 	

Step 2 (cont'd)

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.

Generally, the source of services income depends on the location of the performance of the service under IRC 861(a)(3) & 862(a)(3).

Considerations	Resources	6103 Protected Resources
<p>Did the taxpayer properly source their worldwide income (U.S. or Foreign)?</p> <ul style="list-style-type: none"> ▪ Ask the taxpayer to provide the following information: 1) where the services were performed, 2) the number of work days spent in the U.S., and 3) total work days. ▪ Request copies of travel records to support the taxpayer's location and total workday figures to validate the number of works days in the U.S. ▪ The Examiner will want to compare the travel records provided by the taxpayer with those travel records in the TECS Database. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.861-4(b)(2)(ii)(D) Fringe benefits sourced on a geographical basis ▪ Treas. Reg. 1.861-4(b)(2)(ii)(G) Examples ▪ Travel records (passports, receipts, calendars, itineraries. ▪ IRM 5.1.18.14 Treasury Enforcement Communications System or TECS Database 	
<p>T TREATY IMPLICATIONS: Entertainers and Sportsman may be paid by event so an allocation based on the number of days worked may not be accurate (See U.S. Model Treaty Article XVI). Also, the <i>Relief from Double Taxation</i> article often has rules that re-source U.S.-source income received by U.S. citizens who are treaty residents of the treaty partner (See U.S. Model Treaty Article 23). The Examiner can contact the Treaties IPN with questions about how these rules apply.</p>		

Step 2 (cont'd)

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.

Generally, the source of services income depends on the location of the performance of the service under IRC 861(a)(3) & 862(a)(3).

Considerations	Resources	6103 Protected Resources																																										
<p>Sourcing Example: Below is a hypothetical IDR response from a taxpayer that he/she used to source their U.S. & foreign source compensation.</p> <table border="1"> <thead> <tr> <th style="text-align: center;">Income Type</th> <th style="text-align: center;">Total Compensation</th> <th style="text-align: center;">U.S. Source</th> <th style="text-align: center;">Foreign Source</th> </tr> </thead> <tbody> <tr> <td>Regular Pay</td> <td style="text-align: right;">150,000</td> <td style="text-align: right;">39,000</td> <td style="text-align: right;">111,000</td> </tr> <tr> <td>Mobility Premium</td> <td style="text-align: right;">7,500</td> <td style="text-align: right;">1,950</td> <td style="text-align: right;">5,550</td> </tr> <tr> <td>Performance Award</td> <td style="text-align: right;">75,000</td> <td style="text-align: right;">19,500</td> <td style="text-align: right;">55,500</td> </tr> <tr> <td>Cost of Living Differential</td> <td style="text-align: right;">26,000</td> <td style="text-align: center;">-</td> <td style="text-align: right;">26,000</td> </tr> <tr> <td>Moving Expense Reimbursement</td> <td style="text-align: right;">30,000</td> <td style="text-align: center;">-</td> <td style="text-align: right;">30,000</td> </tr> <tr> <td>Automobile Allowance</td> <td style="text-align: right;">26,000</td> <td style="text-align: center;">-</td> <td style="text-align: right;">26,000</td> </tr> <tr> <td>Overseas Housing Allowance</td> <td style="text-align: right;">130,000</td> <td style="text-align: center;">-</td> <td style="text-align: right;">130,000</td> </tr> <tr> <td>Education Assistance</td> <td style="text-align: right;">26,000</td> <td style="text-align: center;">-</td> <td style="text-align: right;">26,000</td> </tr> <tr> <td>Utilities Allowance</td> <td style="text-align: right;">13,000</td> <td style="text-align: center;">-</td> <td style="text-align: right;">13,000</td> </tr> </tbody> </table>			Income Type	Total Compensation	U.S. Source	Foreign Source	Regular Pay	150,000	39,000	111,000	Mobility Premium	7,500	1,950	5,550	Performance Award	75,000	19,500	55,500	Cost of Living Differential	26,000	-	26,000	Moving Expense Reimbursement	30,000	-	30,000	Automobile Allowance	26,000	-	26,000	Overseas Housing Allowance	130,000	-	130,000	Education Assistance	26,000	-	26,000	Utilities Allowance	13,000	-	13,000		
Income Type	Total Compensation	U.S. Source	Foreign Source																																									
Regular Pay	150,000	39,000	111,000																																									
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Overseas Housing Allowance	130,000	-	130,000																																									
Education Assistance	26,000	-	26,000																																									
Utilities Allowance	13,000	-	13,000																																									

Step 2 (cont'd)

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.

Generally, the source of services income depends on the location of the performance of the service under IRC 861(a)(3) & 862(a)(3).

Considerations				Resources	6103 Protected Resources
Income Type	Total Compensation	U.S. Source	Foreign Source		
Tax Reimbursement (40% of income & allowance)	193,400	-	193,400		
401(k) Deduction	(12,000)	(3,120)	(8,880)		
Medical/Dental Deduction	(1,750)	(455)	(1,295)		
Hypothetical Federal Tax	(31,942)	-	(31,942)		
Hypothetical NY State Tax	(9,666)	-	(9,666)		
Hypothetical FICA Tax	(8,582)	-	(8,582)		

Step 2 (cont'd)

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.

Generally, the source of services income depends on the location of the performance of the service under IRC 861(a)(3) & 862(a)(3).

Considerations	Resources	6103 Protected Resources
 <p>DECISION POINT: The examiner will need to determine if the taxpayer properly sourced their regular pay, mobility premium, performance award, 401(k) and medical/dental deductions by requesting all the proper documentation as previously discussed. The taxpayer is required to reduce their total foreign source income for foreign earned income to arrive at their net foreign source income on Forms 1116, Part I, Line 1a for category (b) General.</p>	<ul style="list-style-type: none"> ▪ Form 1116, Line 1a 	

Step 2 (cont'd)

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.

 **DECISION POINT:** Did the individual taxpayer properly source performance of service income between foreign source compensation and U.S. source compensation pursuant to Treas. Reg. 1.861-4(b)(2)(ii)(E)?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Determine the proper source of compensation - Time Basis (Treas. Reg. § 1.861-4(b)(2)(ii)(E). <p> CAUTION: It is important to note that days for which no services were performed such as holidays, vacation days, weekends and temporary leaves of absence are excluded from both the numerator and the denominator of the calculation.</p>		

Step 2 (cont'd)

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.

 **DECISION POINT:** Did the individual taxpayer properly source performance of service income between foreign source compensation and U.S. source compensation pursuant to Treas. Reg. 1.861-4(b)(2)(ii)(E)?

Considerations	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Example: Janice Smith, a U.S. citizen, worked 240 days for a U.S. company during the tax year. She received \$80,000 in compensation. None of it was for fringe benefits. Janice performed services in the United States for 60 days and performed services in the United Kingdom for 180 days. <p style="margin-left: 40px;">Using the time basis formula for determining the <u>Foreign Source Compensation</u> is \$60,000 = $(\\$80,000 \times \frac{180}{240})$.</p>		

Step 2 (cont'd)

Sourcing of Salary and Compensation

Step 2: Determine whether the taxpayer correctly sourced their total worldwide salary and compensation income between U.S. and foreign sources.

 **DECISION POINT:** Did the individual taxpayer properly source performance of service income between foreign source compensation and U.S. source compensation pursuant to Treas. Reg. 1.861-4(b)(2)(ii)(E)?

Considerations	Resources	6103 Protected Resources
<p style="text-align: center;"> $\text{Compensation} \times \frac{\text{Number of Days Taxpayer Performed Services in the Foreign Country During the Year}}{\text{Total Number of Days Taxpayer Performed Services During the Year}} = \text{Foreign Source Compensation}$ </p> <p>Using the time basis formula for determining the <u>U.S. Source Compensation</u> is \$20,000 = (\$80,000 x 60/240).</p> <ul style="list-style-type: none"> ▪ Note: You can use a unit of time less than a day in the above fraction, if appropriate. 		

Step 3

Sourcing of Salary and Compensation

Step 3: Determine whether the taxpayer has sourced any bonus they may have received in the current tax year.

Did the individual taxpayer properly include their income from bonuses and stock options?

Considerations	Resources	6103 Protected Resources
<p>Bonuses constitute wages if paid as compensation for services performed during employment.</p> <p>Issues arising from the sourcing of bonuses are what services performed were attributable to the bonus and where those services were performed. Under the Treasury Regulations, a bonus attributable to services performed partly within and partly without the United States is allocated according to the facts and circumstances of the case to either U.S. source or foreign source income.</p>	<ul style="list-style-type: none"> ▪ IRC 3121(a) The term “wages” means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. ▪ Treas. Reg. 31.3401(a)-1(a)(2) Compensation for services includes salaries, fees, bonuses, commissions, pensions, and retired pay are wages if performed by the employee for his/her employer. 	

Step 3 (cont'd)

Sourcing of Salary and Compensation

Step 3: Determine whether the taxpayer has sourced any bonus they may have received in the current tax year.

Did the individual taxpayer properly include their income from bonuses and stock options?

Considerations	Resources	6103 Protected Resources
<p>Determine When and How Bonuses are Earned:</p> <ul style="list-style-type: none"> ▪ Bonuses are to be allocated according to the facts and circumstances of the case. Look at the taxpayer's employment contract to see if the bonus is spelled out somewhere or on what it is based. <p><u>Example:</u> Taxpayer receives a bonus that was calculated on a period of April 1 through March 31. The bonus would be sourced based on the ratio of days worked in the U.S. and outside of the U.S. from 4/1 – 3/31 because that is the period to which the bonus was attributable.</p>	<p>Request a copy of:</p> <ul style="list-style-type: none"> ▪ Employee contracts ▪ Compensation plan ▪ Bonus schedule(s) ▪ Treas. Reg. 1.861-4 Compensation for Labor or Personal Services ▪ Treas. Reg. 1.861-4(b)(2)(ii)(F) Multi-Year Compensation Arrangements 	

Step 3 (cont'd)

Sourcing of Salary and Compensation

Step 3: Determine whether the taxpayer has sourced any bonus they may have received in the current tax year.

Bonuses and Stock Options

Considerations	Resources	6103 Protected Resources
<p>Bonuses constitute wages if paid as compensation for services performed during employment. The examiner will want to request a copy of the taxpayer's bonus plan and stock option plan.</p> <p>Consideration should be given for two common bonus situations:</p> <ol style="list-style-type: none"> 1. Payment of a bonus as an incentive to take a foreign assignment which is often paid prior to starting the foreign assignment to avoid foreign tax on the payment. 2. Payment of a bonus at the end of an overseas assignment to return to the U.S. and stay with that employer. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.861-4(b)(2)(ii)(F) Multi-Year Compensation Arrangements 	

Step 3 (cont'd)

Sourcing of Salary and Compensation

Step 3: Determine whether the taxpayer has sourced any bonus they may have received in the current tax year.

Bonuses and Stock Options

Considerations	Resources	6103 Protected Resources
<p>Potential audit issues related to sourcing of bonuses are: 1) what services performed were attributable to the bonus, and 2) where the services were performed (U.S. or foreign). Under the Treasury Regulations, a bonus attributable to services performed partly within and partly without the United States is allocated to either US source or foreign source income based on facts and circumstances of the case. Multi-year compensation arrangement rules in the regulations may apply to determine the source of bonuses where the services are performed in more than one year and the bonus is paid in one or more years pursuant to Treas. Reg. § 1.861-4(b)(2)(ii)(F).</p>	<ul style="list-style-type: none"> ▪ Compensation Plan Including Stock Options 	

Step 3 (cont'd)

Sourcing of Salary and Compensation

Step 3: Determine whether the taxpayer has sourced any bonus they may have received in the current tax year.

Bonuses and Stock Options

Considerations	Resources	6103 Protected Resources
In the case of stock options, the facts and circumstances generally will be such that the applicable period to which the compensation is attributable is the period between the grant of an option and the date on which all employment-related conditions for its exercise have been satisfied (the vesting of the option).		

Other Considerations / Impact to Audit

Sourcing of Salary and Compensation

Considerations	Resources
<ul style="list-style-type: none"> ▪ If applicable, the Examiner will want to review the claimed Foreign Earned Income Exclusions for eligibility and correct calculation. Please note, if the taxpayer checked the box Married Filing Jointly (MFJ) and both taxpayers work abroad; then both taxpayers must file a separate Form 2555 or 2555-EZ. 	<ul style="list-style-type: none"> ▪ Form 2555 or 2555-EZ Foreign Earned Income ▪ Form 2555 or 2555-EZ Instructions Foreign Earned Income
<ul style="list-style-type: none"> ▪ The foreign source income on Form 1116 line 1a should be gross foreign source income less the foreign earned income exclusion for Category (b) General income. 	<ul style="list-style-type: none"> ▪ Form 1116 Instructions Foreign Tax Credit for Individuals ▪ Publication 514 Foreign Tax Credit for Individuals
<ul style="list-style-type: none"> ▪ If the taxpayer files Form 2555 or Form 2555-EZ Foreign Earned Income; then, the taxpayer is required to reduce their foreign taxes on Form 1116, Part III, Line 12. Please note that the reduction of FTC applies only to foreign tax on the FTC related to the excluded Foreign Earned Income. 	<ul style="list-style-type: none"> ▪ Form 2555 or 2555-EZ Foreign Earned Income ▪ Form 2555 or 2555-EZ Instructions Foreign Earned Income ▪ Form 1116 Instructions Foreign Tax Credit for Individuals ▪ Publication 514 Foreign Tax Credit for Individuals

Training and Additional Resources

Part 10.2 Calculation of Amount of Allowable FTC

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	07/31/2012 IIC FTC Centra Event (KRP260984) This course provides a brief overview of income and deduction sourcing for FTC purposes followed by detailed discussions of issues raised by the field. Specific issues include fringe benefits and flow thru entities. 12/17/2013-FTC Workbook Training (WLN967076) 02/14/2014-FTC Workbook Training II recorded session (LHS193548) 02/18/2014-FTC Workbook Training III (HVR308928) 06/12/2014-FTC Workbook Training IV-Adjustments (LQP387992) 07/22/2014-FTC Workbook Training V-Per Exam (HPM417809) FY14 CPE – IIC Matrix Application Training (Weeks 1-3)	
Issue Toolkits	FTC Workbook – Used to assist agents in computing FTC limitation for Form 1116. The FTC Workbook is available on the IIC FTC IPN SharePoint site under “Best Practices.”	
Databases / Research Tools	Westlaw - BNA Tax Management Portfolios - Outbound U.S. Taxation, The Foreign Tax Credit in Overview LexisNexis – The Foreign Tax Credit in Overview CCH – The Foreign Tax Credit in Overview	

Glossary of Terms and Acronyms

Acronym	Definition
FTC	Foreign Tax Credit
IIC	International Individual Compliance
IPN	International Practice Network
IPS	International Practice Service
USBA	U.S. Business Activities (IIC) IPN
IDR	Information Document Request

Index of Related Issues

Issue	Associated UIL(s)	References
<ul style="list-style-type: none"> ▪ Tax Home for Purposes of IRC § 911 ▪ Bona Fide Residence Test for Purposes of Qualifying for IRC § 911 Tax Benefits ▪ Calculating Foreign Earned Income Exclusion – Self Employed Individual ▪ Calculating Foreign Earned Income Exclusion Employee 	<ul style="list-style-type: none"> ▪ 9431.06-05 ▪ 9431.06 ▪ 9431.06-05 ▪ 9431.06-05 	<ul style="list-style-type: none"> ▪ “In-Process” as of 2/2015
<ul style="list-style-type: none"> ▪ Categorization of Income into Proper Income Category 	<ul style="list-style-type: none"> ▪ 9432.02 	<ul style="list-style-type: none"> ▪ “In-Process” as of 2/2015
<ul style="list-style-type: none"> ▪ Multi-year Compensation Arrangements Including Stock Options 	<ul style="list-style-type: none"> ▪ 9432.02 	<ul style="list-style-type: none"> ▪ “In-Process” as of 2/2015
<ul style="list-style-type: none"> ▪ Sourcing of Fringe Benefits for FTC Limitation 	<ul style="list-style-type: none"> ▪ 9432.02 	<ul style="list-style-type: none"> ▪ “In-Process” as of 2/2015
<ul style="list-style-type: none"> ▪ Tax Equalization 	<ul style="list-style-type: none"> ▪ 9432.02 	<ul style="list-style-type: none"> ▪ “In-Process” as of 2/2015