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INTERNAL REVENUE SERVICE
NATIONAL OFFICE
TECHNICAL ADVICE MEMORANDUM

AUG 26 1998

Taxpayers:

Taxpayer's Address:

Years Involved:

Conference Held:

Foreign Country:

Date:

Amount A:

Year 2:

Amount B:

Year 1:

Amount C:

Amount D:

Amount E:

Amount F:

Year 3:

This memorandum is in reply to your request for technical advice dated January 26, 1998.

FACTS

Taxpayers, husband and wife, are U.S. citizens who have lived and worked in Foreign Country since Date. Taxpayers are cash basis, calendar year taxpayers. For purposes of Foreign

Country income tax, Taxpayers are cash basis taxpayers and use a fiscal year that begins on April 6 and ends on the following April 5.

Taxpayers' foreign earned income consists principally of salary received throughout the year. Taxpayers received Amount A in foreign earned income in Year 2. Of that amount, Amount B, described as a tax equalization payment, was attributable to services performed in Foreign Country in Year 1. In Year 2, Taxpayers excluded Amount C from income under section 911 of the Internal Revenue Code and paid Amount D in Foreign Country income taxes. In Year 1, Taxpayers received Amount E in foreign earned income and excluded Amount F.

The examiner proposes that, under section 1.911-6(c)(1)of the Income Tax Regulations, the denominator of the formula for the disallowance of the foreign tax credit consists only of Amount A, total foreign earned income received in Year 2, less Amount B, foreign earned income attributable to services performed in Year 1, because Amount B, though received in Year 2, was earned in Year 1.

The examiner cites section 911(b)(1)(A) of the Code, which defines the term "foreign earned income" as amounts received by an individual from sources within a foreign country attributable to services performed while the individual was a qualified individual, and section 1.911-3(e)(1) of the regulations, which provides that foreign earned income is considered earned in the taxable year in which the individual performed the services giving rise to the income. The examiner proposes that Amount B is not within the definition of foreign earned income for purposes of determining the denominator of the section 911 disallowance fraction in Year 2, because Amount B is attributable to Year 1.

Section 911(b)(2)(A) of the Code is also cited. It provides that, for purposes of determining the limitation on the exclusion, amounts received are considered received in the taxable year in which the services to which the amounts are attributable are performed. It is proposed that this rule requires that Amount B must be considered received in Year 1, and so excluded from the denominator of the disallowance fraction in Year 2.

If the numerator of the fraction remains the same, then decreasing the amount of the denominator results in a larger fraction and so a larger amount of foreign tax attributable to the excluded income. This would reduce the amount of Taxpayers' creditable foreign tax for Year 2.

ISSUE

Whether Taxpayers correctly included Foreign earned income earned in Year 1 but received in Year 2 in the denominator of their foreign tax credit disallowance fraction for Year 2.

DISCUSSION

LAW

Section 911(a) of the Code provides that a qualified individual may elect to exclude the individual's foreign earned income and the housing cost amount from the individual's gross income for the taxable year.

Section 911(b)(1)(A) of the Code provides that "[t]he term "foreign earned income" with respect to any individual means the amount received by such individual from sources within a foreign country or countries which constitutes earned income attributable to services performed by such individual during the period...[that such individual was a qualified individual]."

Section 911(b)(2)(A) of the Code limits the amount of the exclusion. Section 911(b)(2)(B) provides: "For purposes of applying subparagraph (A), amounts received shall be considered received in the taxable year in which the services to which the amounts are attributable are performed."

Section 911(d)(6) of the Code provides that no deduction or exclusion from gross income under Subtitle A or credit against the tax imposed by chapter 1 (including any credit or deduction for taxes paid or accrued to a foreign country or possession of the United States) shall be allowed to the extent the deduction, exclusion or credit is properly allocable to or chargeable against amounts excluded from gross income under section 911(a).

Section 1.911-6(c)(1) of the regulations provides, in part:

> ...To determine the amount of disallowed foreign taxes, multiply the foreign tax imposed on foreign earned income (as defined in section 1.911-3(a)) received or accrued during the taxable year by a fraction, the numerator of which is amounts excluded under section 911(a) in such taxable year less deductible expenses properly allocated to such amounts (see paragraphs (a) and (b) of this section), and the denominator of which is foreign earned income (as defined in section 1.911-3(a)) received or accrued during the taxable year less deductible expenses properly allocated or apportioned thereto...

Section 1.911-3(a) of the regulations, restating section

911(b)(1)(A) of the Code, defines foreign earned income as earned income as defined in section 1.911-3(b) of the regulations from sources within a foreign country that is earned during a period for which the individual qualifies to make an election. It further elaborates:

> Earned income is from sources within a foreign country if it is attributable to services performed by an individual in a foreign country or countries. The place of receipt of earned income is immaterial in determining whether earned income is attributable to services performed in a foreign country or countries.

Section 911(d)(2) of the Code and section 1.911-3(b) of the regulations provide, in general, that the term "earned income" means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered.

Section 1.911-3(e)(1) of the regulations provides, in part:

> Foreign earned income is considered to be earned in the taxable year in which the individual performed the services giving rise to the income. If income is earned in one taxable year and received in another taxable year, then, for purposes of determining the amount of foreign earned income that the individual may exclude under section 911(a), the individual must attribute the income to the taxable year in which the services giving rise to the income were performed. Thus, any reimbursement would be attributable to the taxable year in which the services giving rise to the obligation to pay the reimbursement were performed, not the taxable year in which the reimbursement was received. For example, tax equalization payments are normally received in the year after the year in which the services giving rise to the obligation to pay the tax equalization payment were performed. Therefore, such payments will almost always have to be attributed to the prior year. Foreign earned income attributable to services performed in a preceding taxable year shall be excludable from gross income in the year of receipt only to the extent such amount could have been excluded under paragraph (d)(1) in the preceding taxable year, had such amount been received in the preceding taxable year. The taxable year in which income is attributable will be determined on the basis of all the facts and circumstances.

Section 1.911-3(d)(1) of the regulations provides that foreign earned income may be excluded only to the extent of the limitation of section 1.911-3(d)(2), which defines the limitation as the amount of foreign earned income for a taxable year which

may be excluded under section 911(a)(1) of the Code.

Section 1.911-3(e)(2) of the regulations provides ordering rules for applying the limitation. That section provides, generally, that:

> Foreign earned income that is earned in one year and received in another year shall be applied to the section 911(a)(1) limitation for the year in which it was earned, on a year by year basis, in any order that the individual chooses.

Section 1.911-6(c)(2)(i) of the regulations provides that the term "taxable year" means the individual's taxable year for U.S. tax purposes. Such term includes the portion of any foreign taxable year within the individual's U.S. taxable year, and excludes the portion of any foreign taxable year not within the individual's U.S. taxable year.

Section 1.911-6(c)(2)(ii) of the regulations provides that, for purposes of determining the amount of foreign taxes disallowed, foreign taxes imposed on foreign earned income shall be deemed to accrue, on a pro rata basis, to income as the income is received or accrued. The taxes so accrued shall be apportioned to the taxable year during which the income is received or accrued.

Section 1.911-6(c)(2)(iii) of the regulations provides that the disallowance of foreign taxes under paragraph (c) shall not affect the time for claiming any deduction or credit for foreign taxes paid. Rather, the disallowance shall affect only the amount of taxes considered paid or accrued to the foreign country.

Section 451(a) of the Code provides that the amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 901 of the Code generally allows a credit against the tax imposed by chapter 1, subject to the limitation of section 904, for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States.

Section 905(a) of the Code provides that the section 901 credit may, at the option of the taxpayer and irrespective of the method of accounting employed in keeping his books, be taken in the year in which the foreign taxes accrued.

Section 1.905-1(a) of the regulations provides in part:

> The credit for taxes provided in subpart A (section 901 and following), part III, subchapter N, chapter 1 of the Code, may ordinarily be taken either in the return for the year in which the taxes accrued or in which the taxes were paid, dependent upon whether the accounts of the taxpayer are kept and his returns are filed using an accrual method or using the cash receipts and disbursements method. Section 905(a) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued...

ANALYSIS

Taxpayers are cash basis taxpayers. It is believed that they also claim their foreign tax credits on a cash basis.

Section 1.911-6(c)(1) of the regulations by its terms ("...the denominator ...is foreign earned income...received... during the taxable year...") requires a cash basis taxpayer to include foreign earned income in the denominator of the disallowance fraction in the year of receipt.

Section 911(b)(1)(A) of the Code by its terms ("...attributable to services performed by such individual during the period...") requires in pertinent part that "foreign earned income" be classifiable as compensation for the performance of personal services in a foreign country by a qualified individual. Section 911(b)(2)(B) of the Code by its terms ("For purposes of applying subparagraph (A)...") applies only for purposes of determining the limitation on the amount excludable. Neither section changes the taxable year in which the taxpayer may include or exclude the compensation or claim foreign tax credits for taxes paid or accrued on the compensation. See section 451, section 1.911-3(e)(1)of the regulations, section 905(a), section 1.905-1(a), and section 1.911-6(c)(2). Thus, neither section changes the meaning of "received...during the taxable year" in the definition of the denominator of the disallowance fraction.

Therefore, Taxpayers properly included Amount B in the denominator of the disallowance fraction in their return for Year 2, because Taxpayers received Amount B in Year 2. Section 1.911-6(c)(1) of the regulations.

Amount B is attributable to personal services performed in Foreign country while Taxpayers were qualified individuals. Section 911(b)(1)(A) of the Code and section 1.911-3(a) of the regulations. This rule relates the income to the personal services that generated it, for purposes of determining whether the income is earned income. Section 911(d)(2) and section 1.911-3(b). This rule also relates the income to the foreign

country where the services were performed, for purposes of determining whether the income is foreign source income. Section 1.911-3(a). Finally, this rule relates the income to the period during which the Taxpayers were qualified individuals, for purposes of determining whether this specific foreign earned income is foreign earned income that Taxpayers may elect to exclude. Section 911(a).

Amount B is considered received in the year in which the services to which Amount B is attributable were performed, Year 1. Section 911(b)(2)(B) of the Code and section 1.911-3(e)(1) of the regulations. This rule relates foreign earned income, whenever it is received, to the year in which it was earned so that the limitation for that year is applicable. It applies only for purposes of determining the limitation on the amount excludable. Section 911(b)(2)(B) and section 1.911-3(e)(1). This rule does not specify the year in which the exclusion may be taken for U.S. tax purposes. See section 1.911-3(e)(2). In the case of Taxpayers, who are cash basis taxpayers, foreign earned income is excludable in the year of receipt. Section 1.911-3(e)(1).

The disallowance fraction is used only to determine the amount of foreign tax attributable to the excluded income so as to eliminate the double benefit of applying both the section 911 exclusion from gross income and the section 901 foreign tax credit to the same income. It does not affect the timing of the deduction or credit for foreign taxes paid or accrued, nor does it affect the timing of the income inclusion. Section 1.911-6(c)(2)(iii) of the regulations, section 905(a) of the Code, section 1.905-1(a) and section 451.

Although we agree with the Taxpayers that Amount B is included in the denominator of the disallowance fraction for Year 2, we have noted other problems with the Taxpayers' computations. Because neither Examination nor the Taxpayer have submitted these other issues to us for review, these other issues are beyond the scope of this Technical Advice Memorandum.

CONCLUSION

Taxpayers properly included Amount B in the denominator of the disallowance fraction in their return for Year 2, because Taxpayers received Amount B in Year 2. Section 1.911-6(c)(1) of the regulations.

This technical advice memorandum is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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