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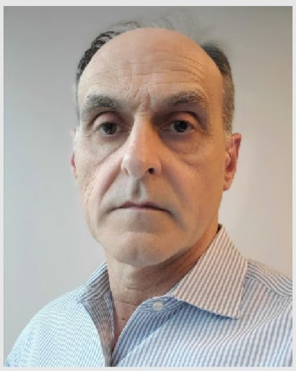

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In this article, the authors examine the creditability criteria of the new U.S. foreign tax credit final regulations.

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The new foreign tax credit rules may cause a major headache for individual taxpayers and tax preparers, adding even more stress to an already complicated 2022 filing season and potentially resulting in the loss of FTCs that were previously available.

I. Introduction

On November 12, 2020, the Treasury Department and the IRS published proposed regulations (the "2020 FTC proposed regulations")[1] addressing changes made by the Tax Cuts and Jobs Act[2] and other FTC issues, including, in particular, the definition of a creditable foreign tax. The 2020 FTC proposed regulations were finalized January 4, 2022 (the "2022 FTC final regulations").[3] Correcting amendments to the 2022 FTC final regulations were published July 27, 2022,[4] and further proposed regulations were published November 22, 2022 ("the 2022 FTC proposed regulations").[5]

The preamble to the 2022 FTC final regulations acknowledges that the number of Forms 1116, "Foreign Tax Credit (Individual, Estate or Trust)," filed by individual taxpayers, exceeds the number of Forms 1118, "Foreign Tax Credit — Corporations," filed by C corporations, by a ratio of over 500 to 1: In tax year 2018, 9.3 million Forms 1116 were filed compared with 17,500 Forms 1118.[6] Notwithstanding this significant disparity, the terminology and examples used in the regulations themselves focus almost exclusively on the activities of multinational corporations and largely fail to address the activities of individual taxpayers living and working abroad. Thus, for example, the preamble to the 2020 FTC proposed regulations explains some proposed changes to the creditability rules in the following terms,

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1 REG-101657-20.

2 P.L. 115-97 (2017).

3 T.D. 9959.

4 T.D. 9959 (correction).

5 REG-112096-22.

6 Preamble to T.D. 9959.

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which are applicable to the operations of multinational corporations but inapposite when applied to individuals who happen to work as employees in a foreign country:

> The Treasury Department and the IRS have determined that in order to qualify as a creditable income tax, the foreign tax law must require a sufficient nexus between the foreign country and the taxpayer's activities or investment of capital or other assets that give rise to the income being taxed. For example, a tax imposed by a foreign country on a taxpayer's income that lacks a sufficient nexus to such country (such as the lack of operations, employees, factors of production, or management in that foreign country) is not an income tax in the U.S. sense.[7]

The comments submitted in response to the various versions of the regulations have also focused almost exclusively on their effect on multinational corporations as opposed to individuals.[8]

It must be conceded that the 2022 FTC final regulations do include some significant concessions targeted at individual taxpayers. For example, the cost recovery rule includes a significant exception for wage income and investment income that is not derived in a trade or business.[9] However, the concessions to individuals are, on balance, insufficient to mitigate the complex and challenging issues faced by many individual taxpayers and their advisers in complying with these rules. Under the rules as drafted, many individuals face the real prospect of double taxation in that they will no longer be entitled to credits that were previously available to offset double tax under the prior regime. The issue is an urgent one because the changes to the creditability rules are effective for the 2022 tax year.[10] Taxpayers and their advisers are therefore already facing the challenge of how to apply the new creditability criteria of the 2022 FTC final regulations.

KPMG LLP submitted comments in response to the 2022 FTC proposed regulations, focusing on their impact on individual taxpayers and making proposals for how some of the unintended consequences of the rules could be mitigated.[11] The following sections of this article draw extensively on the substance of the KPMG comments and address specific issues raised by the new rules: the requirement to assess each foreign levy separately, the cost recovery requirement, the attribution requirement, the withholding exception for wages subject to legally required foreign income tax withholding, and the treaty coordination rule. The KPMG comments also requested that the effective date of the 2022 FTC final regulations be suspended for 12 months to permit Treasury and the IRS to address these issues.[12]

II. Assess Each Foreign Levy Separately

The 2022 FTC final regulations require all taxpayers who have activities or investment in a foreign country to determine separately for each foreign levy to which they may be subject whether that levy meets each of the four criteria (realization, gross receipts, cost recovery, and attribution) to qualify as a net income tax under reg. section 1.901-2(a)(3), and they potentially require all affected taxpayers to determine whether a levy that does not qualify as a net income tax is a tax paid in lieu of a tax on income under reg. section 1.903-1(b). As a result, an individual taxpayer trying to determine whether a foreign tax on employment income is a creditable foreign income tax would potentially have to analyze a "single levy" consisting of so many different "theoretical" types of income and different special rules that a "single" determination becomes untenable.

[7] Preamble to REG-101657-20.

[8] *See, e.g.*, Alliance for Competitive Taxation, "Recommendations Regarding 2022 Proposed Foreign Tax Credit Regulations," at 1 (Jan. 23, 2023) ("Notwithstanding the recent changes, income earned abroad by U.S. companies will still be subject to double taxation in many cases unless the Proposed Regulations are further modified. This double taxation inevitably will result in a loss of U.S. jobs, as U.S. companies will be forced to reduce their U.S. footprint or restructure their operations to avoid losing market share.").

[9] Reg. section 1.901-2(b)(4)(i)(C)(2), discussed in detail in Section III of this article.

[10] Reg. section 1.901-2(h).

[11] KPMG LLP, "Comments to the IRS: REG-112096-22: Regulations Relating to the Foreign Tax Credit," Jan. 23, 2023.

[12] *Id.* at 2.

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These requirements are disproportionately burdensome for individual (as opposed to corporate) taxpayers, even if they have the benefit of professional advisers, in that they would be required to obtain a detailed familiarity with foreign tax laws and their application to identify each separate levy and then determine whether it meets each of these criteria. In addition to foreign language issues, there are professional practice issues for U.S. tax advisers who are not licensed to practice in foreign jurisdictions and are therefore not qualified to advise on the meaning and effect of foreign tax laws for this purpose.

Individual taxpayers have limited resources to help them comply with these requirements. The instructions for Form 1116 only make passing reference to the 2022 FTC final regulations and do not provide guidance to individuals as to how these regulations affect their FTC.[13]

III. Cost Recovery

A foreign levy is a foreign income tax only if it is (1) a foreign tax and (2) a net income (or in lieu of) tax.[14] A foreign tax is a net income tax only if it satisfies the net gain requirement.[15] The regulations break the net gain concept into four component requirements: realization, gross receipts, cost recovery, and attribution.[16] For a foreign tax to satisfy the cost recovery requirement, the foreign country must allow gross receipts to be reduced by significant costs and expenses (including capital expenditures) attributable to these gross receipts when computing the taxable base. For employment or personal investment income of an individual, the regulations provide that "a foreign tax is considered to permit recovery of significant costs and expenses even if the foreign tax law does not permit recovery of any costs and expenses attributable to wage income or to investment income that is not derived from a trade or business."[17] This language was added in recognition that "the Code contains various limitations on the recovery of non-business expenses that have been modified from time to time."[18]

On its face, this exception appears to be intended to ensure that a levy imposed by a foreign country on the wage income of a U.S. citizen living or working in that country will satisfy the cost recovery requirement. If a foreign country assessed a levy only on wage income, this result would be achieved. However, few countries have a separate levy imposed on wage income alone. Many countries take an approach similar to the United States', assessing tax on a taxable base of combined income that combines wages with other kinds of income. Under the 2022 FTC final regulations, this tax on combined income would be viewed as a single levy.[19] This determination of what constitutes a separate levy is largely unchanged from prior regulations.[20] However, the significance of the separate levy determination is of greater importance under these regulations. Whereas under prior law the "predominant character" analysis allowed taxpayers to overcome minor differences in taxing principles, the cost recovery requirement adopts an "all or nothing" approach.[21]

Notwithstanding that U.S. citizens on foreign assignment may only have gross receipts attributable to employment in the foreign country where they live and work, the regulations provide that if, under the tax laws of that foreign country, this wage income would be combined with income from other sources if these individuals had income from other sources, and a standard deduction or general allowance is applied against

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[13] The only notice provided in the instructions (IRS, "Instructions for Form 1116" (Dec. 28, 2022)) is as follows:

> Final foreign tax credit regulations. Final foreign tax credit regulations were published January 4, 2022. The new regulations made changes to the rules relating to the creditability of foreign taxes under Internal Revenue Code section 901 and 903, the applicable period for claiming a credit or deduction for foreign taxes, and the new election to claim a provisional credit for contested foreign taxes. For more information, see Treasury Decision 9959, 2022-03 I.R.B. 328, available at IRS.gov/irb/2022-03_IRB#TD-9959.

[14] Reg. section 1.901-2(a)(1)(ii).

[15] Reg. section 1.901-2(a)(3).

[16] Reg. section 1.901-2(b)(1).

[17] Reg. section 1.901-2(b)(4)(i)(C)(2).

[18] Preamble to T.D. 9959.

[19] Reg. section 1.901-2(d)(1)(ii).

[20] *Compare* reg. section 1.901-2(d) (2022) *with* reg. section 1.901-2(d) (2013).

[21] The 2022 FTC proposed regulations would modify this to a substantially all-or-nothing requirement. However, there is no meaningful guidance, aside from the safe harbors included in the 2022 FTC proposed regulations, on how "substantially all" is to be determined.

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this combined income to arrive at taxable income, the tax on this combined income is a separate levy and must permit recovery of significant costs and expenses attributable to gross receipts from non-employment sources.[22] If the foreign tax law disallows any single "per se" significant cost or expense, and this disallowance is not consistent with any principles underlying the disallowances required under the IRC, including limiting base erosion and profit shifting and public policy concerns, the entire foreign levy (including the portion attributable to wage income) does not satisfy the cost recovery requirement and is potentially not a creditable foreign income tax.[23] Requiring an individual to make determinations about the foreign levy being consistent with principles of limiting BEPS and public policy just further illustrates how complicated the analysis can become for individual taxpayers, especially in light of their limited resources for this type of undertaking and potential lack of experience with tax law. This is just one more reason why a white list for individual foreign income taxes should be considered by Treasury and the IRS.

Imposing this burden may be the intended result of these regulations, but it seems overly punitive when applied in the context of a U.S. citizen working in a foreign country and for whom the only source of income is wages. But for deficiencies in the theoretical cost recovery of deductions as applied to theoretical additional sources of income that cause the failure to meet the cost recovery requirements for these individuals, this situation could otherwise satisfy those requirements. Also, the requirement to perform this analysis places an unreasonable burden on an individual (or the individual's U.S. tax services provider), who must now consider all theoretically possible outcomes under the tax laws of a foreign country and must determine whether this requirement is satisfied. This presumes access to reliable, translated resources and requires individuals or their U.S. tax advisers to interpret complex tax codes and related rules that they are likely not licensed or qualified to advise on.

A prominent example where these issues are particularly acute is Brazil, which has both a corporate income tax (CIT) levy and an individual income tax (IIT) levy.[24] Brazil's CIT rate is lower than the IIT, and it is seemingly easy to form a corporation in Brazil. Brazil's IIT is assessed on a Brazilian resident's worldwide income. Employment income, self-employment income (sole proprietorship), royalties, and income from immovable property are combined into one taxable base, and the IIT assessed would be one levy under the regulations.

While specific deductions are permitted for each income type, common personal deductions and allowances are applied against the sum of net income. The personal deductions and allowances are not specific to any one income type. Losses in one category can only reduce gains in the same category, but not below zero (for example, a loss attributable to self-employment activities would not reduce income from employment or gain from the sale of real property).

Limited or no deductions are available against employment income and royalties, but Brazilian resident individuals are allowed to deduct expenses incurred in connection with self-employment and rental activities. However, deductions for capital expenditures, such as buildings, machinery, and equipment, are limited. Specifically, a deduction for depreciation is disallowed in its entirety. And while deductions for rents are allowed, expenses related to finance lease agreements are not.

Given these limitations, Brazilian residents with self-employment income or sole proprietorships will typically incorporate, as these deductions are generally permitted for corporate entities and the CIT is lower than the IIT.

In applying the cost recovery requirement to Brazil's IIT, even though it is uncommon for Brazilian residents to subject gross receipts from their self-employment or sole proprietorship to Brazil's IIT, the 2022 FTC regulations require considering these gross receipts in the analysis of the IIT as a "foreign income tax" or not, on the

[22] Reg. section 1.901-2(b)(4)(i)(A) and (C).

[23] Reg. section 1.901-2(b)(4)(i)(C)(1).

[24] For related coverage, see Michael Smith, "Trade Groups Request Delay to FTC Disallowance for Brazil," *Tax Notes Int'l*, Jan. 30, 2023, p. 670.

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grounds that these amounts could theoretically be included in the base of the levy. Because these gross receipts would be part of the same combined tax base as wage income, the disallowance of depreciation or leasing expenses (per se significant costs or expenses) against these gross receipts may lead a non-Brazilian tax professional to conclude that the entire levy fails the cost recovery requirement (if this disallowance is not consistent with any principle underlying the disallowances required under the code). It would take a significant investment of time and expertise for an individual to gain sufficient understanding of the Brazilian IIT to determine whether it allows for alternative ways to recover any deductions for capital expenditures.

The complexity of this determination under the regulations will require individuals and their U.S. tax advisers to engage in extensive, time-consuming, and expensive research involving Brazilian tax and legal experts. This is not "readily available information"[25] and is an onerous financial and administrative burden to impose on individual U.S. citizens living and working in a foreign country who are being double taxed on their employment income. An alternative would be for the individuals or their U.S. tax advisers to attempt to review and interpret Brazil's tax laws, which they are not licensed or qualified to advise on, assuming they are able to locate a reliable translation of Brazil's law or can read and understand Portuguese. This a great deal of subjective analysis for a requirement intended to provide a "more objective" approach to the creditability analysis.[26]

But the analysis does not end there. If it is determined that the disallowance of depreciation and leasing expenses is not consistent with U.S. principles (which is potentially the case), and assuming that Brazil's IIT satisfies the arm's-length standard (which it does not, as discussed in Section IV below), a U.S. citizen would be left trying to determine whether Brazil's CIT, a tax an individual may not be subject to or have any experience with, satisfies all of the net income tax requirements. This analysis would need to be undertaken to determine whether the CIT is a "generally-imposed net income tax,"[27] and therefore whether the IIT satisfies the definition of a tax in lieu of a tax on income so that the U.S. citizen may claim an FTC for the Brazilian IIT assessed on the U.S. citizen's employment income for services performed in Brazil. Thus, the regulations require the individual, or the individual's U.S. tax adviser, in addition to becoming a Brazilian IIT tax expert, to also become a Brazilian CIT tax expert.

The result of this analysis for Brazil's IIT is that a U.S. citizen or resident living and working in Brazil, whose only source of income subject to Brazil's IIT is wage income, will potentially be denied an FTC and will be double taxed on this employment income because Brazil has a standard deduction that applies to a combined income tax base. Although this example focuses on Brazil's IIT, it seems reasonable to assume that, like the United States, other foreign countries levy an individual income tax on the combined income of an individual and allow for general deductions against this combined tax base or otherwise permit the netting of losses from one kind of activity against income from another kind of activity. Without a thorough review of every single country's tax law, it is impossible to determine whether a specific country's individual income tax regime satisfies the cost recovery requirement, and difficult to determine whether a particular disallowance provided under a foreign country's law is consistent with any principle reflected in the IRC.

Although the regulations appear to acknowledge the accepted U.S. and international tax principle that a country has a right to tax an individual's remuneration for services performed within that country,[28] and appear to except wage income earned by an individual from the cost recovery requirement,[29] in practice the regulations may deny a U.S. citizen who lives and works in a foreign country an FTC for foreign taxes imposed on wage income earned in that foreign country.

[25] Preamble to T.D. 9959.

[26] *Id.*

[27] Reg. section 1.903-1(c)(1)(i).

[28] Reg. section 1.901-2(b)(5)(i)(A) and (B); and reg. section 1.901-2(b)(5)(ii).

[29] Reg. section 1.901-2(b)(4)(i)(C)(2).

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The cost recovery requirement as written will mean U.S. citizens living or working in certain countries will be subject to double tax on employment income earned for services performed in that country. This is not an equitable result and is inconsistent with U.S. taxing principles.

For purposes of mitigating the effects of the cost recovery rules on individuals outlined above, the KPMG comments proposed that Treasury and the IRS should consider readopting the predominant character analysis for levies imposed on individuals. Alternatively, in instances in which the cost recovery requirement is not met because of the application of a standard deduction or general allowance against a combined tax base, the KPMG comments proposed that Treasury and the IRS should consider allowing an individual to allocate on a pro rata basis the total tax assessed on the combined income to wage income and personal investment income (income types excepted from the cost recovery requirement) and allow an FTC regarding the foreign tax attributable to wage income and personal investment income.[30]

IV. Attribution Requirement

The attribution requirement requires that a foreign tax be imposed on income that has a jurisdictional nexus (or an adequate connection) to the country imposing the tax. Separate nexus rules apply for residents and nonresidents of the foreign country. The 2022 FTC final regulations define "resident" and "nonresident" of a foreign country by reference to the foreign country's basis for imposing income tax on the individual. An individual is a resident of a foreign country "if the individual is liable to income tax in such country by reason of the individual's residence, domicile, citizenship, or similar criterion under such country's foreign tax law."[31] An individual is a nonresident of a foreign country if the individual is liable to income tax in a foreign country by reason of a criterion other than residence.[32]

The preamble to the 2022 FTC final regulations, in justifying the addition of its attribution requirements to the definition of a foreign income tax, states that "absent this rule, U.S. tax on net income could be reduced by credits for a foreign levy whose taxable base was improperly inflated by unreasonably assigning income to a taxpayer."[33] It should be noted that the definition of resident as used in the 2022 FTC final regulations considers "citizenship" an acceptable criterion by which a country may subject an individual to worldwide taxation. The United States is one of the only countries that impose tax on the worldwide income of its citizens, regardless of where those citizens actually reside and regardless of whether those citizens have income from activities, sources, or property within the United States. Notwithstanding "the principle that U.S. tax principles, not varying foreign tax law policies, should control the determination of whether a foreign tax is an income tax . . . is eligible for a U.S. foreign tax credit,"[34] imposing tax on the basis of citizenship alone is viewed, from the perspective of the rest of the taxing world, as extraterritorial. This is why the availability of an FTC is so important to U.S. citizens living and working outside the United States. The existing regulations relating to the FTC limitation under section 904 already ensure that the FTC is not subsidizing foreign jurisdictions at the expense of the United States regarding U.S. persons living and working overseas. For this reason, the attribution requirements as applied to U.S. citizens living and working abroad do not appear to be necessary to implement the policy concerns that Treasury and the IRS were trying to address in this context.

A. Tax on Residents

The 2022 FTC final regulations generally acknowledge a foreign country's authority to tax the worldwide income of its residents: "The base of a foreign tax imposed on residents of the foreign country imposing the foreign tax may

[30] KPMG comments, *supra* note 11, at 4-5.

[31] Reg. section 1.901-2(g)(6)(i).

[32] Reg. section 1.901-2(g)(6)(ii).

[33] Preamble to T.D. 9959.

[34] *Id.*

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include all of the worldwide gross receipts of the resident."[35] However, the foreign tax law must provide that "any allocation made pursuant to the foreign country's transfer pricing rules" is determined "under arm's length principles."[36]

From the discussion in the preamble to the 2022 FTC final regulations, it seems Treasury and the IRS added this requirement out of a concern that, regarding corporate profits, "many foreign jurisdictions have disregarded international taxing norms to claim additional tax revenue, resulting in the adoption of novel extraterritorial taxes."[37] However, the preamble does not address whether Treasury and the IRS considered the impact this requirement would have on U.S. citizens living and working in foreign countries that do not adhere to the OECD's arm's-length standard.

For example, Brazil does not adhere to the OECD's arm's-length standard.[38] Hence, a U.S. citizen resident in Brazil whose only income is wages subject to Brazilian income tax will be subject to double tax because Brazil's transfer pricing rules are inconsistent with international principles, and the entire Brazilian tax regime therefore fails this attribution requirement. This issue is not limited to Brazil and potentially extends to any U.S. citizen living and working in a foreign country that does not adhere to the arm's-length standard.

The KPMG comments proposed that Treasury and the IRS should consider adding a provision to the attribution requirement that exempts any portion of a levy assessed on wage income and personal investment income of an individual from this transfer pricing allocation requirement.[39]

B. Tax on Nonresidents

The definitions of resident and nonresident contained in the 2022 FTC final regulations are significant in that the 2022 FTC final regulations provide that a foreign levy imposed on nonresidents is always treated as a separate levy from that imposed on residents,[40] and the attribution requirement that applies to a foreign levy imposed on nonresidents of a foreign country must satisfy strict jurisdictional nexus requirements that do not apply to a foreign levy imposed on residents of a foreign country.[41] A levy imposed on a nonresident of a foreign country must apply on the basis of the nonresident's activities, source of income, or situs of property.[42]

The rules and definitions described above combine to lead to incongruous and unfair results. In particular, if individual A resides in Country X, which taxes its residents on a worldwide basis, then individual A can claim a U.S. FTC for Country X taxes on income earned anywhere in the world. In contrast, if individual B resides in Country Y, which taxes its inhabitants (and its nonresidents) on the basis of source but has a sourcing rule that materially differs from U.S. tax principles (for example, by including in the base all wages paid by an employer based in Country Y), then individual B is entitled to no U.S. FTC at all, even if all of individual B's income in fact arises from sources within Country Y as determined under U.S. principles. It is difficult to conceive of a policy rationale under which Country Y's more constrained assertion of taxing jurisdiction, when compared with Country X, should end up so severely disadvantaging individual B compared with individual A and is inconsistent with the statutory purpose of the FTC, which the preamble to the 2022 FTC final regulations states to be "to relieve double taxation of income through the United States ceding its own taxing rights only where the foreign country has the primary right to tax income."[43]

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[35] Reg. section 1.901-2(b)(5)(ii).

[36] *Id.*

[37] Preamble to T.D. 9959.

[38] On December 29, 2022, the Brazilian government released a presidential decree adopting the arm's-length principle and aligning Brazil's unique transfer pricing system with the OECD transfer pricing guidelines. Provisional Measure No. 1,152/2022; *see also* Stephanie Soong, "Brazil Publishes Draft Law to Adopt OECD Arm's-Length Principle," *Tax Notes Int'l*, Jan. 2, 2023, p. 87. If approved by Brazil's newly elected government, the proposed changes will be mandatory starting in 2024.

[39] KPMG comments, *supra* note 11, at 5.

[40] Reg. section 1.901-2(d)(1)(iii).

[41] Reg. section 1.901-2(b)(5)(i)(A)-(C).

[42] *Id.*

[43] Preamble to T.D. 9959, citing *Bowring v. Commissioner*, 27 B.T.A. 449, 459 (1932) ("In the case of the citizen and resident alien, the United States recognizes the primary right of the foreign government to tax income from sources therein and accordingly, grants a credit.").

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The special administrative region of Hong Kong provides a prime example of the operation of these rules. Hong Kong operates a territorial system and assesses "salaries tax . . . on every person in respect of his income arising in or derived from Hong Kong from the following sources — (a) any office or employment of profit; and (b) any pension."[44] An individual's "residence, domicile, citizenship, or similar criterion" under Hong Kong's tax law does not affect the imposition of salaries tax, and therefore any individual subject to salaries tax could be viewed as a "nonresident" under the 2022 FTC final regulations.[45]

Applying the net income tax requirements to the salaries tax, the realization, gross receipts, and cost recovery requirements appear to be satisfied, given the exception to the cost recovery requirement provided to wage income under reg. section 1.901-2(b)(4)(i)(C)(2). However, because the salaries tax is — for all individuals subject to the levy — a "foreign levy imposed on nonresidents" under the 2022 FTC final regulations, it is necessary to consider whether it satisfies any of the attribution requirements of reg. section 1.901-2(b)(5)(i).

The attribution based on situs of property test is not applicable in this situation because the salaries tax is not assessed on gain from the disposition of property.[46] The income attribution based on activities test does not appear to be satisfied, given that the salaries tax takes "into account as a significant factor" a destination-based criterion (that is, Hong Kong employment).[47] Nor does it appear that the income attribution based on source test is satisfied because, under Hong Kong tax law, gross income from services is not sourced on where the services are performed, but rather sourced based on whether an individual has Hong Kong employment.[48]

It therefore appears that the Hong Kong salaries tax may fail to be a "foreign income tax" for purposes of section 901.[49] If it is determined to fail the attribution requirement of reg. section 1.901-2(b)(5), it would also not appear to satisfy either the jurisdiction to tax excluded income requirement of reg. section 1.903-1(c)(1)(iv) or the source-based attribution requirement of reg. section 1.903-1(c)(2)(iii) and is potentially not a "tax in lieu of an income tax" for purposes of section 903. It appears that the 2022 FTC final regulations will deny an FTC to the many U.S. citizens who live and work in Hong Kong and pay salaries tax, with the result that these U.S. citizens will be subjected to double taxation on their income earned in Hong Kong.

This issue is not limited to Hong Kong. The KPMG comments indicated that U.S. citizens living and/or working in countries such as Angola, Guatemala, Honduras, Nicaragua, Panama, and Paraguay could also be subject to double taxation on remuneration for services performed within these jurisdictions because these countries adopt a territorial system and source services income in accordance with rules inconsistent with U.S. principles.[50] However, this issue potentially extends beyond these countries. Any territorial tax system that imposes income tax on the basis of source may run afoul of these rules if any class of income, not just services income, included in an individual's taxable base is sourced in accordance with rules inconsistent with U.S. principles.

Singapore presents an interesting case study of the difficulties practitioners face in applying these rules and the potentially inequitable outcomes for inhabitants compared with non-inhabitants of certain countries. If one were to rely solely on the Inland Revenue Authority of Singapore's website,[51] one might easily conclude that Singapore imposes income tax by reason of residence, given that the website has separate

[44] Hong Kong Inland Revenue Ordinance (IRO), section 8(1).

[45] Reg. section 1.901-2(g)(6)(i) and (ii).

[46] Reg. section 1.901-2(b)(5)(i)(C).

[47] Reg. section 1.901-2(b)(5)(i)(A).

[48] Reg. section 1.901-2(b)(5)(i)(B).

[49] The Hong Kong salaries tax does apply differently based on the number of days that an individual is present in Hong Kong during the tax year in which services are performed. IRO section 8(1B). Thus, it is possible, but not clear given that the stated basis of taxation is always with reference to source, that the tax as applied to individuals who are present in Hong Kong for the requisite number of days could be considered a tax on a "resident" of Hong Kong.

[50] Based upon a review of country profiles available on IBFD's tax research platform as well as KPMG's Global Taxation of International Executives webpage.

[51] Inland Revenue Authority of Singapore, "Working Out My Tax Residency" (last accessed Feb. 10, 2023).

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sections dedicated to tax residents and nonresidents and has separate tax forms for tax residents and nonresidents. However, technically Singapore adopts a territorial system of assessment, charging its national income tax "upon the income of any person accruing in or derived from Singapore or received in Singapore from outside Singapore."[52] In accordance with reg. section 1.901-2(g)(6)(i), an individual is not strictly "liable to [national] income tax in [Singapore] by reason of the individual's residence, domicile, citizenship, or similar criterion under [Singapore's] foreign tax law," and may not therefore be a resident for purposes of these rules. However, the amount of income tax an individual ultimately pays to Singapore is affected by an individual's tax residence status. Residence affects whether some income amounts are deemed to arise in Singapore,[53] whether some income amounts are exempt from national income tax,[54] and whether an individual qualifies for certain general deductions.[55]

If one were comfortable that, notwithstanding the plain language of reg. section 1.901-2(g)(6)(i), an individual who qualifies as a tax resident under Singapore law should be viewed as a resident under these rules, then Singapore's national income tax would appear to satisfy the net gain requirements regarding these resident individuals. However, if one were to apply these regulations strictly as written, it would appear that all individuals subject to the national income tax are "nonresidents," and therefore the national income tax must satisfy the attribution requirements of reg. section 1.901-2(b)(5)(i).

Unlike Hong Kong, Singapore seems to source services income based on place of performance.[56] However, Singapore's national income tax is assessed on more than just an individual's services income. Included in the taxable base of the national income tax is gross income from royalties. Unfortunately for Singapore inhabitants, Singapore sources gross income from royalties on a basis other than place of use of, or the right to use, the intangible property[57] and does not meet the income attribution based on source requirement of reg. section 1.901-2(b)(5)(i)(B). Although it is relatively rare for individual taxpayers to have gross income from royalties, the rules apply to any foreign tax "in its entirety, for all persons subject to the foreign tax."[58] Thus, the national income tax as imposed on inhabitants of Singapore may not be a foreign income tax under these rules, and U.S. citizens and green card holders who are tax residents of Singapore under Singapore tax law may be subject to double taxation on remuneration for services performed in Singapore.

However, the rules as written appear to provide an FTC to some individuals who are not tax residents of Singapore under Singapore law. The definition of a separate levy provides that "a withholding tax (as defined in section 901(k)(1)(B)) that is imposed on gross income of nonresidents is treated as a separate levy as to each separate class of income described in section 61 (for example, interest, dividends, rents, or royalties) subject to the withholding tax."[59] Section 901(k)(1)(B) generally provides that a withholding tax includes "any tax determined on a gross basis; but does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis."

Singapore imposes a final withholding tax on certain gross income of individuals who are nonresidents of Singapore under Singapore law. Because this withholding tax is viewed as a separate levy for each separate class of income subject to withholding and, but for gross income from royalties, Singapore largely sources income in a manner consistent with U.S. principles, a U.S. person subject to this final withholding tax may have creditable foreign income taxes, whereas a U.S. person residing in Singapore is denied an FTC. This seems like an unintended and inequitable result of these rules.

For the reasons set out above, the source-based attribution test as drafted may subject U.S.

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52 Singapore Income Tax Act 1947, as amended, section 10.

53 *Id.* at section 12.

54 *Id.* at section 13.

55 *Id.* at section 39.

56 *Id.* at section 12(4).

57 *Id.* at section 12(7). *See also* Singapore Ministry of Finance press release, "Income Tax (Amendment) Act" (Dec. 21, 1977).

58 Reg. section 1.901-2(a)(1)(i).

59 Reg. section 1.901-2(d)(1)(iii).

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citizens living or working in these countries to double taxation. Although these attribution requirements may ensure that the United States is not subsidizing a foreign country's corporate tax regime, this concern would not seem to extend to a foreign country's IIT regime, given that the foreign income tax limitation that applies to individuals regarding employment income already limits the credit to foreign income tax assessed on foreign-source general category amounts.

The KPMG comments included a proposal that Treasury and the IRS should consider exempting wage income of an individual from the source-based attribution requirement as they did for the cost recovery requirement under reg. section 1.901-2(b)(4)(i)(C)(2) to ensure that U.S. citizens living and working abroad are not needlessly subjected to double taxation on their remuneration for services performed outside the United States.[60]

Alternatively, the KPMG comments proposed that if Treasury and the IRS are concerned that the FTC limitation is not sufficient to protect U.S. tax on net income against a foreign levy assessed on an inflated tax base, they could, instead of denying an FTC to an individual in its entirety, limit the amount of foreign tax paid or accrued to a specific country available for credit to amounts allocable to gross receipts from activities, sources, or property within that foreign country, as determined under U.S. principles.[61] This approach would ensure that an individual's FTC limitation on an inflated foreign tax amount does not consider income from other jurisdictions and would prevent an individual from potentially benefiting from the inflated foreign tax through the excess FTC carryback and carryforward rules. However, it should be noted in this context that the existing FTC limitation rules help to ensure that U.S. citizens living or working overseas are not subject to double taxation because of timing differences between the United States' and the foreign country's tax systems. Also, the potential for individuals, particularly employees (who generally have limited control over where services are performed), to engage in any sort of abusive cross-crediting is limited.

As another alternative, the KPMG comments proposed that if Treasury and the IRS believe that repealing this requirement as applied to individuals may allow for some sort of abuse not addressed by the FTC limitation, they should consider defining the term "resident" in a manner other than solely by reference to a foreign country's basis for imposing income tax.[62] For example, reg. section 1.901-2(g)(6)(i) could be rewritten to provide as follows:

> An individual is a resident of a foreign country if the individual is a tax resident of the foreign country (liable to income tax in that country by reason of the individual's residence, domicile, citizenship, or similar criterion under that country's foreign tax law), or a deemed resident of that foreign country (has substantial presence, is domiciled in, or would satisfy the qualified individual definition (as defined in section 911(d))) regarding that foreign country.

This revision would ensure that inhabitants of territorial systems are treated in the same manner as inhabitants of resident-based systems under the 2022 FTC final regulations. However, adopting a "deemed resident" concept akin to the above would require consideration to be given to the treatment of multi-year compensation arrangements in which an individual may be a deemed resident at grant but a nonresident at vest, given the jurisdictional nexus issues presented by territorial tax systems.

V. Withholding Exception

Because U.S. citizens are subject to federal income tax on their worldwide income,[63] employers of U.S. citizens are generally required to report as wages all amounts paid for services performed by U.S. citizens[64] and are generally required to withhold federal income tax from

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[60] KPMG comments, *supra* note 11, at 7.

[61] *Id.*

[62] *Id.* at 7-8.

[63] Section I of this article; reg. section 1.1-1(b).

[64] Section 3401(a); reg. section 31.3401(a)-1(a); and reg. section 31.3401(a)-1(b)(7).

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those wages,[65] subject to limited exceptions.[66] A U.S. citizen who is on an international assignment in a foreign country, or who otherwise lives and works in a foreign country, is also likely to be subject to income tax withholding on wages in that foreign country.

Requiring an employer to withhold income tax on wage income in two countries presents payroll challenges and administrative burdens to the employer. Also, subjecting U.S. citizens to withholding in two countries concurrently presents a significant cash flow burden for these individuals. An exemption from withholding is available for amounts paid to a U.S. citizen employee for services performed in a foreign country (or U.S. possession) that are subject to legally required foreign income tax withholding.[67] However, to qualify for this federal income tax withholding exemption, amounts withheld from an employee's salary under foreign law must be "income taxes" creditable by the employee under section 901.[68]

For the reasons set out above, the FTC 2022 final regulations as written will cause some foreign withholding taxes no longer to be creditable foreign income taxes. However, Treasury and the IRS have not provided to employers or U.S. citizens a list of countries whose income taxes are no longer creditable. Employers may be relying on an exception no longer available to them, with the result that they would be underwithholding federal income tax and thus subjecting themselves and their employees to underpayment penalties.

VI. Treaty Coordination Rule

The 2022 FTC final regulations, as corrected by amendments published July 27, 2022,[69] include at reg. section 1.901-2(a)(1)(iii) a treaty coordination rule that provides (in part) as follows:

> A foreign levy that is treated as an income tax under the relief from double taxation article of an income tax treaty entered into by the United States and the foreign country imposing the levy is a foreign income tax if the levy is, as determined under such income tax treaty, paid by a citizen or resident of the United States that elects benefits under the treaty.

This provision was not included in the 2020 FTC proposed regulations but was added to the 2022 FTC final regulations in response to comments received concerning the interaction between income tax treaties and U.S. domestic FTC rules.[70] The effect of the treaty coordination rule is that a U.S. taxpayer is not required to demonstrate that a foreign levy is either a net income tax as defined in reg. section 1.901-2(a)(3) or a tax in lieu of an income tax as defined in reg. section 1.903-1(b), provided it is an income tax under the relief from double tax article of an applicable income tax treaty.

The policy underpinning this rule appears to be that income taxes imposed by foreign countries that have entered into income tax treaties with the United States can generally be presumed to be income taxes "in the U.S. sense" and are therefore in conformity with the overriding purpose of the revisions to the FTC regulations, which is to ensure that foreign levies should, in their essential characteristics, be similar to U.S. income taxes in order to be creditable.[71] As a result, they are not subject to the four-part net gain analysis imposed by reg. section 1.901-3(b). However, the treaty coordination rule as drafted lacks clarity and will not necessarily achieve its presumed objective. As drafted, it could result in double tax or other unintended consequences for individual taxpayers.

The most significant problem with the treaty coordination rule is the requirement that, to claim the benefit of this rule, a U.S. citizen or resident individual must "elect . . . benefits under the

[65] Section 3402(a).

[66] *See, e.g.*, section 3401(a)(8).

[67] Section 3401(a)(8)(A)(ii); reg. section 31.3401(a)(8)(A)-1(b)(1).

[68] *See* LTR 8129013.

[69] *See* T.D. 9959 (correction).

[70] *See* preamble to T.D. 9959.

[71] *See* preamble to REG-101657-20 ("The Treasury Department and the IRS have determined that it is necessary and appropriate to require that a foreign tax conform to traditional international norms of taxing jurisdiction as reflected in the Internal Revenue Code in order to qualify as an income tax in the U.S. sense, or as a tax in lieu of an income tax.").

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treaty." There are many situations in which it is either unnecessary or positively disadvantageous for an individual subject to income tax in a treaty country to claim the benefits of the income tax treaty between the United States and that country, as shown by the following examples.

Example 1: Taxpayer A is a lawful permanent resident of the United States (green card holder) who lives and works in France, where she is an income tax resident. All her income is from sources in France. Because she is a resident of both the United States and France under their respective domestic rules, she must apply the tiebreaker provisions of article 4, paragraph 4, if she wishes to claim any benefits under the France-U.S. income tax treaty that are dependent on her being a resident of one or other country.[72] Assuming that the tiebreaker tests would result in her being treated as a resident of France and a nonresident of the United States, this could cause her to be liable to the expatriation tax under section 877A if she meets the definition of a covered expatriate.[73] The cost to her of the expatriation tax liability might outweigh the benefit of being able to rely on the treaty coordination rule. Hence, if she wishes to claim FTCs on her U.S. income tax return regarding French tax paid or accrued on her French-source income, it appears that she and her advisers must separately evaluate each French levy for compliance with the net income tax requirements of reg. section 1.901-2(b).

Example 2: Taxpayer B is a U.S. citizen who lives and works in France, where she is an income tax resident. Because she is a U.S. citizen, she cannot invoke the tiebreaker provisions of the treaty and file her U.S. income tax return as a nonresident. If all her income is from French sources, she would be entitled to an FTC regarding the French tax paid on her French-source income, subject to the limitations of U.S. domestic law under sections 901 and 904. Hence, before the 2022 FTC final regulations, she generally would have no need to elect benefits under the relief from double tax article, and she would generally not meet the conditions to elect benefits under any other article of the treaty. Both her U.S. and French income tax liability would be the same regardless of whether she were to elect any benefits under the treaty. However, under the 2022 FTC final regulations, she may need to make a treaty election to apply the relief from double tax rules solely to ensure that any French income tax paid would remain creditable even though no other treaty benefits are claimed. It appears that the intent of the treaty coordination rule is specifically for taxpayers to elect the benefit of the relief from double tax article, but this is not how it is drafted. It therefore remains unclear whether electing an unrelated benefit under the treaty, such as the nondiscrimination article, would suffice for this purpose. In the absence of any election, taxpayer B and her advisers, like taxpayer A in Example 1, must separately evaluate each French levy for compliance with the net income tax requirements of reg. section 1.901-2(b).

The KPMG comments proposed that the treaty coordination rule could be modified so as to permit individuals living and working in treaty countries to rely on the list of taxes covered in the relief from double tax article and treat these taxes as an income tax for purposes of applying the section 1.901-2 regulations, regardless of whether these individuals actually claim benefits under that article. This would reduce the complexity that individual taxpayers who live and work overseas otherwise face in applying this rule.[74]

The KPMG comments also proposed that guidance should be provided as to whether reliance on the treaty coordination rule is disclosable under section 6114 and the corresponding regulations. If so, the IRS could provide guidance either by expressly requiring disclosure on Form 8833 or by adding a checkbox to Form 1116 for taxpayers to indicate that they are claiming the benefit of this rule. However, if the treaty coordination rule is viewed as a simplification measure under the section 901 regulations, the better view may be that the treaty

[72] *See* France-U.S. tax treaty (1994, as amended by protocols dated 2004 and 2009), art. 4, para. 4 ("Where, by reason of the provisions of paragraphs 1 and 2, an individual is a resident of both Contracting States, his status *shall be determined* as follows [by applying the successive tie-breaker tests of permanent home, center of vital interests, habitual abode, nationality, and mutual agreement].") (emphasis added).

[73] *See* sections 877A(g)(1)(A), 877(a)(2), 7701(b)(6).

[74] KPMG comments, *supra* note 11, at 9.

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itself is not invoked for purposes of a treaty-based claim, but that individual taxpayers who live and work overseas in treaty jurisdictions are able to rely on the treaty list of covered foreign taxes to treat the levy as a foreign income tax within the meaning of reg. section 1.901-2."

VII. Conclusion

The 2020 FTC proposed regulations expressly acknowledge that the fundamental purpose of the FTC is to "mitigate double taxation of income that is attributable to a taxpayer's activities or investment in a foreign country."[75] Also, one stated intent of the 2020 FTC proposed regulations was to "simplify and clarify" the application of the rules in relation to the net gain requirement.[76] However, the 2022 FTC final regulations as drafted risk having the opposite effect in practice. In many cases they will result in double taxation of individuals, and in all cases they introduce an unprecedented degree of complexity and confusion to the process of claiming FTCs on Form 1116.

These issues have real urgency for taxpayers and their advisers who are questioning how to complete Forms 1116 for 2022 individual income tax returns. It is to be hoped that Treasury and the IRS will suspend the effective date of the 2022 FTC final regulations to permit these issues to be addressed and clarified.[77] ■

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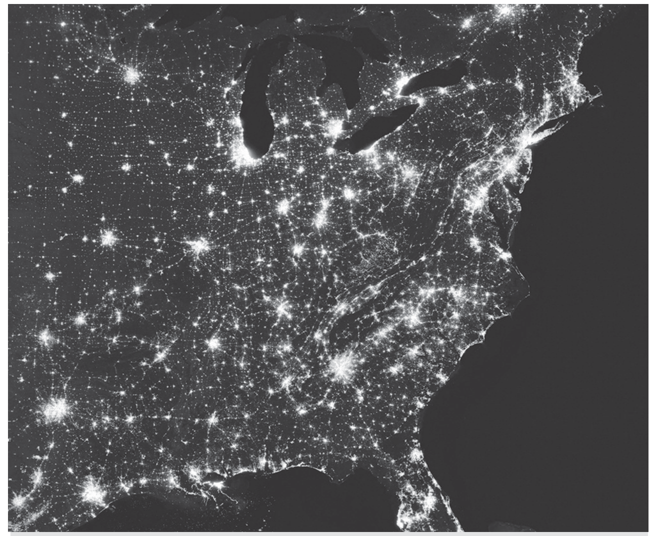

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[75] Preamble to REG-101657-20.

[76] *Id.*

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