An Introduction to US Foreign Tax Credits: The Transcript

Our panelists were:

- John Richardson, Lawyer, Citizenship Solutions, Canada
- Dr. Karen Alpert, Finance Lecturer, University of Queensland Business School, Australia

Introductory Remarks

John Richardson: Although Karen and I have done these before, I think it might be good to begin with some introductions. Karen, do you want to introduce yourself and include some of your tax background and all those great things?

Karen Alpert: I'm a finance lecturer at the University of Queensland in sunny Brisbane, Australia. I come to these tax issues from a different perspective. At one point, in a prior life, I was a CPA in California in a tax practice. Then I saw the light, had some kids and decided to move into academia, so I'm no longer a qualified tax preparer, but I have a Master's degree in tax and have previously prepared corporate tax returns and HNWI tax returns. So I come at this from a more academic point of view, what does the law say, how does it read. I mean, I can follow the compliance stuff but I'm not really a compliance expert, more of a big picture, what does the law say.

John: Which is what makes your perspective so tremendously valuable. I would add that Karen is also the founder and chief administrator of the Fix The Tax Treaty blog, which is largely, although not exclusively, for Australian residents who are accused, even if they are not, of being American citizens, which is of course, as we know, one of the most dangerous accusations in the world today because of citizenship-based taxation. In a previous time, at cocktail parties, people would talk about, "Well, my new house, my new swimming pool, my new car." Today, in the 21st century, the most interesting thing about a person is country or countries of tax residency. And we'll be talking about some of those things today.

For those of you who don't know me, I'm John Richardson and I live in Toronto, Canada. I'm a lawyer who runs a very small boutique practice helping US citizens and green card holders dig their way out of the mess they find themselves in for having the temerity to move from the US.

The title of the topic today is "Introduction to US Foreign Tax Credits," but when Karen and I were talking about this, a better title might be "Non-US Income and Taxation for Americans Abroad and How that Impacts their US Tax Responsibilities," for which, of course, the foreign tax credit scheme is extremely important. Now, by foreign I mean anything that takes place outside the US, and Americans abroad by definition live outside the US. So I think that probably where we ought to begin is to talk a little bit about where income is sourced—what's US, what's foreign, how do we determine? Would you agree with that as the appropriate starting point, Karen?

Question 1: Where is income sourced? How is this determined?

Karen: That's really important because the source of the income, first of all, it's not always intuitive, and second of all, whatever it is, it determines who has the primary right to tax that income. So if it's

US-sourced income, the US has the right to tax it, and your country of residence, if they are taxing you on worldwide income, should give you a credit for the US tax paid on US-sourced income.

John: So hitting a pause button there for one second, to be clear, what you're saying is that the country where the income is sourced has the primary or first right of taxation. Is that what you're saying?

Karen: That's right. And the other country should give you a credit for the tax paid by that country with the primary right of taxation. Which means, if you've got a mix of US and foreign source income, you may be taking credits on your home income tax return for US tax paid and credits on your US tax return for foreign tax paid.

John: So would it be fair to say that for every kind of income the initial determination is: What's the source of that income? If someone handed you a shoebox of issues, is that how you would begin to start sorting it out?

Karen: Well, you really cannot begin thinking of foreign tax credits until you know how much income is US-sourced and how much income is not US-sourced.

John: I think that's exactly right. One of the things that occurred to me thinking about this issue today is: Do you realize that all of the tax problems in the world are really because of taxation of people as opposed to source? In other words, if the whole world just worked on a source-based system of taxation, everything would be easier, wouldn't it?

Karen: If you're just taxing on source, you could withhold at source and it'd be done, it'd be nice and easy.

John: So really the problem is, countries, of which most of them do, define tax jurisdiction in terms of people in addition to source, right?

Karen: Yes, in fact, most of the countries in the world now are taxing their residents on their worldwide income, so where you live determines who has the right to tax your worldwide income, but any income you have outside of that country is going to be taxed by the source country as well.

John: So the country of residence would be sort of second-level down because they would be moving, when we get the tax credits, they'd be recognizing the right of the source country to have primary taxing rights, correct?

Karen: For the most part. How they do that depends on local law and that affects everyone differently depending on where they live.

Question 2: How do countries define residence?

John: Right. Now you had also talked about residence-based taxation and, since you mention that, would I be correct to say that there's no such thing as one definition of residence-based taxation, that different countries define residence in different ways?

Karen: Certainly different countries define residence in different ways and different countries have different scopes of what they want to tax.

John: Ok. So the definition of residency would be who's subject to taxation and, then we'd move on to scope, what do they tax. That's a separate issue.

Karen: And both of those are going to be different from country to country.

John: If the definition of residency can be different from country to country, then I suppose it would be entirely possible for people to be tax residents in more than one country. Is that correct?

Karen: It certainly is possible. Now most tax treaties have a tiebreaker. If you're living in a treaty country, generally there's a tiebreaker that says which of those two countries you're considered a resident of.

John: For the purpose of making sure that you're not completely double taxed. Does that help US citizens?

Karen: Not US citizens because the US does not tax based on residence. The US imposes its jurisdiction based on citizenship instead of residence and in every single US treaty they carve out their citizens with the savings clause saying that US citizens can be taxed wherever they live. So even if they are tax residents of another country. So, generally, US citizens who're living outside the US are tax residents of two countries, the US and wherever they live.

John: I think this is an extremely important point. Any American citizen who's a tax resident of a country outside the US is at least a dual tax resident. Correct? And because of the savings clause and the standard US tax treaty, a US citizen cannot use a tax treaty tiebreaker to get rid of the US tax residency. Correct? So, I guess, to whom much has been given, much is expected, and if US citizenship is such a great citizenship, then why should they not be expected to always be a US tax resident, right?

Karen: It's a big problem because of the incompatibility of various countries' laws.

John: Well, as we've discussed many times, the problems are not just tax. It leads to a huge issue in investment, financial planning, pension opportunities, etc. Would you agree that, as a general principle, the effect of US citizenship-based taxation is actually to disable the vast majority of Americans living outside the US from the kind of retirement and financial planning opportunities that are available to other people?

Question 3: What are the different kinds of income and what do the rules say on how they are sourced?

Karen: Definitely, retirement planning is difficult. But going back to source, there are some common misperceptions. Let's kind of go through different kinds of income and see what the rules say about how they are sourced.

Let's start with dividends and interest. So those are basically sourced depending on where the payer is. So if you have shares in Apple Corporation, it's a US corporation, their dividends are US-sourced dividends. If you have shares in West Farmers, which is an Australian corporation, then when they pay dividends, that's Australian-sourced income.

Similarly, interest is sourced where the payer is located. That's not necessarily a trivial question if you have corporate payers that are paying out of branches in different countries but generally you can tell where the payer is for dividends and interest.

John: What about employment income?

Karen: Employment income is sourced where the services are performed. So if you are working in Australia, that's Australian-sourced income. But if you're working in Australia and you go do a weeklong seminar in Boston, well, that week's income is US-sourced income. Unless there's a specific code section that pulls that out of being US-sourced, the US has primary taxing rights on that.

John: The area where I think there's the greatest misunderstanding is in the area of property capital gains. Would you agree?

Karen: So those Apple shares, if I'm living in Australia and I own Apple shares, the dividends are US-sourced, but when I sell the Apple share, which is a capital gain, it's Australia-sourced. Because the source is based on where the person is tax resident, where their tax home is. And basically as an Australian resident I have provided, the capital gain is Australian-sourced income. Even for a US citizen living in Australia. It's still Australian-sourced income.

John: And the reason for that is because that's what the internal revenue code says. I think that's extremely important because if it were in the treaty we'd have issues with the savings clause and that sort of stuff.

Before we move on from that, for a non-resident alien living outside the US with Apple shares, that would be income sourced in the country of residence. But isn't there some rule that if a non-resident alien were to spend 183 days or more in the US, which would shift the source of the capital gains?

Question 4: What's the substantial presence test?

Karen: First of all, if you have 183 days in the US, you have passed the substantial presence test and you might become a resident alien. The only time you wouldn't is if you're on a special visa like a student visa that says that you aren't subject to the substantial presence test. But even if you're not subject to that substantial presence test and you're there for 183 days, the source of the capital gains becomes the US and the US wants to collect tax on the entire gain.

John: This is unbelievable. So for example a citizen resident in Switzerland, I believe they don't have capital gains tax. Well, assuming that there's no capital gains tax in a country, say, Switzerland, if a Swiss resident were to spend 183 days in the US and sold the Apple shares, that would become US-sourced income.

Karen: Right. And similarly a resident of Australia, assets purchased before 1982 there's no capital gains. So if you've got IBM shares or something that your grandfather gave you that were purchased before 1982, there's no capital gains tax on it in Australia. So you trigger that 183-day rule, you'll pay a lot more tax.

John: This has clear implications for immigration and I appreciate that we're not talking about this today.

Karen: The other thing we should say about capital gains is that the rules we're talking about using residence of the owner as source, that applies to personal property. If you have real property like a house, an apartment building or whatever, the source is the location of the property. And if you have business assets, so you're running a business via a permanent establishment in the US, those business assets when sold, even though they are personal property, are US-source gained.

John: So shall we say then that it is a presumption of source where the country of residence, that there are a number of rules that would reverse that presumption? How can anybody do anything in relation to the US without tax advice? It's incredible.

Alright, so let's say we have a US citizen living outside the US with various income streams, let's say, a job, employment income, outside the US.

Question 5: What's the foreign earned income exclusion?

Karen: Well, so the first thing everyone will tell you, "Hey, you're so lucky you'll get to exclude that employment income." That's the one thing most Americans know about the taxation of US expats, that there is a foreign earned income exclusion. Probably more people know about that than anything else.

In 2019 you can exclude the first 105,900 dollars of foreign earned income from your US taxes. But that doesn't rule out paying tax where you live. You can do that instead of taking out a foreign tax credit for that income.

John: You used the words earned income, which sounds like not all income can be excluded. What would earned income be?

Karen: Earned income would be, basically, if you're drawing a salary, that's earned income. If you're running a business and it's generating income because of your personal services, such as a consulting business, that would be earned income. There's certain pass-through income from partnership where it's actually your personal service income.

John: Would I be more or less accurate by saying that earned income is stuff that has to do with delivery of services?

Karen: It has to do with using your human capital to deliver services and receive compensation for that.

John: What if we're not looking at human capital, we're looking at income generated from other kinds of capital, would that be excluded under the foreign earned income exclusion?

Karen: No, that's not earned income so it's not excluded, so you'd still pay US tax on that. There are a couple of things to think about when you're looking at this. First of all, there's a difference between an exclusion and a credit. With the exclusion, you just pull it completely off the US tax returns, it's not in your addressed income, but the way US taxes are computed on the rest of your income, you kind of stack it and you pay the higher marginal rate on any income that is not earned.

John: But an exclusion means it does not factor into your tax. It's just out.

Karen: Your alternative is to do a credit, so include the income in your US tax return and then when you figure the amount, you subtract out the foreign tax on that.

John: A couple of mistakes I see all the time. First of all, a tremendous number of people include investment income under the foreign earned income exclusion. It's very common to do that. I guess don't do that.

But the second thing that's interesting, is that a lot of people running a small business, let's say their revenue is 200 thousand dollars and their profit is 100 thousand dollars, would include the 100 thousand dollar figure under the foreign earned income exclusion. Is that correct?

Karen: Yeah, you use the gross income from your services. And you've excluded the first 105 thousand of gross income and you are not allowed to take any of the deductions that relate to that income because you've excluded that income.

John: I think the key point here is that it's not the net but the gross.

Karen: And it's only for self-employment income that's based on human capital, so if a large portion is based on investment and other capital, then you're going to have to allocate out how much is for human capital.

John: Even then, it's not all that simple. What about the housing exclusion? That's in addition to the 100 thousand dollars?

Karen: That's a completely different part of the rules but it's all on the same. The first page of the handout is the top of form 2555, which is just the basic identifying information you have to fill in to take this exclusion. You can see that you need to talk about whom your employer is, they need to know whether you've previously filed and when because if you revoke—it's an election to exclude the earned income—if you revoke that election you cannot make the election for 5 years. So they collect all that information and that's just the beginning of a 3-page form.

Question 6: What is the bona fide residence test and how does it differ from the substantial presence test?

John: There's two general ways to qualify this: One is the bona fide residence test; the other is the substantial presence. Can you comment on each of those?

Karen: The physical presence test is that you're not physically present in the US for more than 30 days. But that's quite useful the first year you move to a foreign country because the 330 days you are in that foreign country does not have to be the same as your tax year. So if you move in November, a year later you can file your return with this exclusion, get extra extensions to do this, but file a return when you qualify for this exclusion.

John: And you can base that on a number of different countries?

Karen: It doesn't have to be in one country and the time of physical presence does not have to be all within a single tax year.

John: Ok. And significantly you can do this without becoming a tax resident of another country as well. Which makes it sort of the official modus operandi of a digital nomad, I guess, as an American citizen. Travel around the world going from one to the next to the next and take the foreign earned income exclusion and never become a tax resident in another country.

Karen: Now, you need to have a tax home in another country, which means you don't have a place of abode in the US. So you can't leave your house in the US and go camping around the world.

John: You cannot have an abode in the US. I'm not sure that's quite linked to a tax home in another country. But, yeah, you must have a tax home in another country and no abode in the US. So that's one way of qualifying. The second is I believe the bona fide residence test. What's the deal?

Karen: The bona fide residence test, which is what it sounds like, is where you really live. This is where you have the ties, your house, you're settled there in that foreign country.

John: Which means you're almost certainly going to be a tax resident of that other country.

Karen: And once you meet that, you don't have to worry about the physical presence test anymore.

John: Yes, exactly. Which means you can still spend more than 30 days in the US and still qualify for this.

We have a question that has come in here: Can you decouple the income, for section 911, right, we have 105 thousand income and we have the foreign housing exclusion. Can you decouple those things? Can you just take the foreign housing exclusion and not the foreign earned income exclusion?

Karen: I don't know and I haven't any experience seeing that.

John: I think the reason someone would ask that question is because they specifically want the housing exclusion but want to be able to build up tax credits on a forward basis, but I don't know the answer for that either.

Before leaving the foreign earned income exclusion, I think it'd be good to comment on the issue of green card holders, your permanent residents of the US. In order to keep their immigrant visa, they have to intend to reside permanently in the US. If they lose the intention, at least in theory, they lose their immigrant visa, their green card. The national anthem of green card so to speak is "By God, you better file a US tax return."

First of all, what would be a tax return they probably should not file, period?

Question 7: What would be a tax return green card holders probably should not file?

Karen: Well, if you say you're a bona fide resident of another country, you're kind of admitting you're not planning on living in the US.

John: I think that can be a problem. I think that for green card holders who want to continue filing the 1040, I would be very cautious with: a) I think using the foreign earned income exclusion, but; b) if you're going to use it, don't use the bona fide residence test because you're essentially declaring that you're a bona fide resident of another country, which undermines your claim of permanent residency in the US. If you're going to use it at all, use the physical presence test.

Karen: There's another question here about unemployment compensation. If you're unemployed, how are you earning anything? So, no, it's not earned income. That can be a problem.

John: I think that's right. It can also be a problem because in many countries unemployment income is not taxed but in the US it's taxed. Putting it another way, am I right in saying that unemployment income outside the US is always going to be taxable on the US tax return?

Karen: I don't like using the word always because I think there might be cases in which it might be considered a social security type benefit or it might be excludable under a treaty as a social security benefit. But it would have to depend on the laws of the specific country but I couldn't give you a specific example.

John: Or the specific treaty. But in any case that's one example of possible incompatibility.

One last thing on the green card, be careful not to file a 1040NR even if you're temporarily living outside the US because that could well be construed to be an expatriating event, subjecting you to exit taxes and all that stuff.

Karen: And potentially losing your green card.

John: That too. But moving on from the foreign earned income exclusions, should we talk a little about totalization agreements?

Question 8: What are totalization agreements?

Karen: I think we should just mention it. If you're self-employed, the US has a self-employment tax, which qualifies you for social security but it's not an income tax, so you cannot offset it with foreign taxes, you cannot use foreign tax credits to reduce it, and you can only get out of it if the country you're living in has a totalization agreement. I think there's about 14 countries that have totalization agreements?

John: It's more than 14, it's not a large number of countries. They are with enough countries so that it covers percentage wise a large part of the world, but it is a problem. For example, in Israel, a country with many American citizens, which makes self-employment very difficult in the country because I think it has its own set of self-employment taxes.

Karen: Right, so you end up paying into two social security systems if you don't have a totalization agreement.

So let's talk a bit about how the foreign earned income exclusion differs from the foreign tax credit.

Question 9: How does the foreign earned income exclusion differs from the foreign tax credit?

John: The starting point is that if we don't exclude the income, it appears in your tax return and it's foreign–sourced.

Karen: Right, so that means that if your foreign tax rate is less that the US tax rate, the exclusion may be good because it's going to eliminate US tax that will not be eliminated completely by the foreign tax credit.

But if you're in a country like Australia, Canada, most of Europe, where the foreign tax rate is higher than the US federal tax rate, then by using the foreign tax credit, you will be generating excess credit and you will have to pay more taxes where you live than the US is going to charge.

John: Why don't we take a very simple example? Let's say, 1000 dollars of income earned in Canada. Let's say, the US would tax that at 30%, that would be 300 dollars. Let's say Canada would tax that at 50%, that would be 500 dollars. So if the income is included in both returns, we have a 300-dollar US tax liability and a 500-dollar Canadian tax liability. How do the foreign tax credit rules deal with that?

Karen: So I'm assuming we're talking about Canadian-sourced income, in which case, Canada has first right to tax. The US has to allow a credit to the Canadian tax. You've paid 300 dollars in US tax, you can offset that full 300 dollars with 300 of the 500 you paid in Canada. And the remaining 200 that you paid in Canada is excess and you can carry that forward to use anywhere up to 10 years in the future or you can carry it back one year.

John: So that's really quite extraordinary that for that type of income, by using the foreign tax credit rules, you're actually producing a possible benefit down the road. You're producing 200 dollars of US tax paid, which can be used to offset a future US tax bill. Is that correct?

Karen: That's right. So if you have that unemployment income that's not taxed where you live, you might have excess tax credits from the past that you could use to offset the US tax on that income.

There are several situations in which having a balance of excess credits can be very helpful. A lot of people were able to use excess credits for their transition tax.

John: Yes, I've seen that a lot. The transition tax is where the US made up some fake income and forced people to put it in as real income on their tax return, so they would have to pay real tax on fake income. There were a number of people who had these credits that they carried forward and said, "Oh, really? I will pay that real tax generated on the fake income by past tax credits, right?"

Karen: So, yeah, that's one place that it's useful. Sometimes when you get a bonus or a termination payment that's either taxed beneficially where you live, maybe it's taxed using some averaging rule or might be tax free, but the US is going to tax it. So if you have excess foreign tax credits, I've heard several people who were retrenched, got a huge payout and were able to offset most of that with foreign tax credit carryovers, even though that was not taxable here in Australia.

Another Australian example is superannuation. So if you're using what most tax preparers are using as standard treatment for superannuation, what happens is you end up paying US tax on distributions when you start withdrawing your retirement. But in Australia, once you turn 60, they do not tax withdrawals from superannuation at all. So you have 0 Australian tax but the US is taxing the money that's coming out of your superannuation. So for the first 10 years of your retirement you could be using foreign tax credit carryovers to offset some or all of that extra tax.

John: Very interesting. As a general rule, would you agree that all other things being equal use the foreign tax credit and not the foreign earned income exclusion?

Karen: You should be maximizing your foreign tax credit carryovers because you never know when you'll end up with some income that's taxed on the US return and not taxed locally.

John: Or you'll never know when the US will make up some more fake income. Americans abroad are not paying enough US tax so we better give them some more income.

Karen: The other place that you could use it, if you have enough credits in the right basket, on the sale of principal residence.

Question 10: How can one apply foreign tax credits to the sale of principal residence?

John: Let's get into that a little bit. The principal residence is a consistent problem for Americans abroad in all countries that do not tax the gain on the sale of the principal residence. There's a 250 thousand dollar exclusion and, in our conversation yesterday, you said it might be good for them to move every few years to make sure they're without gain. But the point is that for Americans abroad, they are either downwardly mobile people because they have to pay a capital gains tax when they sell or they are permanently mobile people because they have to move and move and move.

Karen: Yeah, you do get to exclude on an individual return 250 thousands dollars of gain, and that's a fair amount of gain on a principal residence. In a lot of places, that'd be sufficient. But in Sydney, Vancouver or Toronto, maybe not.

John: Definitely not if you've owned it for a significant length of time.

Karen: Which is why moving more frequently could be a strategy to avoid the problem as well.

John: Let's get back to the foreign tax credit carryover to offset the capital gain on the principal residence, how might that work?

Question 11: What are the different foreign tax credit baskets?

Karen: I think before we can really do that in detail, we have to talk about these FTC baskets. Because you don't just do this all as one big lump sum, you have to allocate that tax to the type of income that generated that tax.

The second document of the handout shows the very top of the foreign tax credit form for 2018 and 2017. The purpose of doing that was to highlight the differences. If you look at 2018, there are a couple of new categories that weren't there before.

So there's passive category income. Passive is interests, dividends, capital gains. General category income is anything that is not in the other baskets, which would include employment income. You have section 901J income, whenever they put an internal revenue code section on a form you know you have to be careful. That's income from countries that are subject to sanctions. It's sanctioned income, basically.

John: So if the US wanted to stop Americans abroad from getting foreign tax credits what they could do is just start sanctioning different countries, right?

Karen: Yes, they could do that but there are other implications to sanctions that they probably wouldn't do.

D is certain income resources by treaty, which we'll talk about a bit.

John: Why don't we begin by keeping it exceptionally simple and let's imagine we only have two baskets, the passive and the general?

Karen: Before 2018, that's basically all expats had to worry about.

John: Before 2018, general would include self-employment income and employment income, right?

Karen: Yeah, that would be self-employment income, employment income, anything that wasn't passive.

John: Let's come back to the discussion on the sale of the principal residence.

Karen: So the principal residence is a capital gain so it goes in the passive basket. So you'd have to have enough carryover tax credits from interest and dividends and capital gains from prior years that were taxed more heavily in your country of residence than in the US and that weren't US-sourced.

John: What if you're savvy and knew this was coming along and you wanted to sell some of your foreign stocks, would it make sense then to sell those things to generate excess foreign tax credit to carry forward before selling your principal residence?

Karen: Or sell them in the same year as the principal residence because they'd go in the same.

John: This seems to me a very important and relatively simple tax planning considerations for Americans abroad. If you're able to offset in some way a capital gains tax on a principal residence through carry-forward credits or even by selling in the same year, right?

Karen: Yeah, maybe you need to sell the shares to get the deposit to trade up.

John: Think about when you do it and how much the tax would be and how to use those tax credit carry-forwards.

Karen: Basically, what this points out is that everything that's in a single basket all is lumped together so you have the total income in that basket and the total foreign taxes paid on the income in those baskets. That means that if you can put more into that basket either in a year that you sell the house or in prior years, you could have carryovers that could help mitigate.

John: And to be clear, though, you will not be able to use a tax credit carry forward from the general basket.

Karen: No, you wouldn't be able to use carry forward from your employment income against your house.

John: So really the effect of these baskets is to restrict your use of foreign tax credits against US tax, correct?

Karen: That's right. If you have just one big category and don't have to put them into separate baskets, by definition you'll be able to use more tax credits. The more baskets we have, the more restrictive it is and the harder it is to match up your tax basket by basket.

John: That's totally interesting, particularly given that the Tax Cuts & Jobs Act was to create two additional baskets in the foreign tax credit thing. Pure evil.

Karen: That's right. We've got section 951A income, again we're using a section number, which means it's trouble, the section for GILTI tax. And the other new one is foreign branch income.

Question 12: What is the foreign branch income basket?

John: What in God's name is foreign branch income?

Karen: You read all the reports that talk about if you're a multinational company and instead of having a subsidiary in another country, you decide to have a branch in that other country, it's not a separate corporation, and that branch is taxed at a low rate, you could use foreign tax credits from branches in high tax countries to offset income from branches in low tax countries and then offset income in the US from branches, etc. They wanted to avoid that tax planning opportunity for multinationals, so they did it by adding another basket. As we said, more baskets, harder to use the foreign tax credits.

John: The US really does hate the foreign tax credits. They regard foreign tax credits as an erosion of the US tax base. Remember a couple years ago, the brouhaha over Ireland's non-taxation of Apple and how the powers to be made a decision that Ireland had to impose taxes on Apple. Do you remember how upset US Secretary of Treasury Jack Lew was over that?

Karen: Right because if Ireland imposes taxes, Apple can use that as a credit to reduce their US tax.

John: I mean, that's just stealing money from the homeland, isn't it? Outright theft. Imagine Ireland taxing Apple on Irish profits.

Karen: So we've got four baskets that we have to worry about—the passive basket, the general basket, the GILTI basket if you have a foreign controlled corporation, and the foreign branch basket, the way they defined it it's any income from a qualified business unit in a foreign country that you keep separate books and records for.

John: The triggering criteria for this is keeping or having to keep separate books or records. So, practically speaking, what kinds of business would be keeping separate books and records?

Karen: Well, if you're running a schedule C business—a sole trader as they'd call them here in Australia—and your gross revenue is more than 75 thousand Australian dollars, you're subject to the goods and services tax, you have to keep separate records so you can tell the ATO how much your GST liability is. So now you're keeping separate books and records, it's got an establishment in a foreign country, it's a foreign branch. So now all of a sudden your schedule C is a foreign branch.

John: Already I think in Canada it's 30 thousand dollars, so some small business in Canada is now all of a sudden a foreign branch.

Karen: I mean, if your gross income is 75 thousand dollars, you've got expenses, you're not really making a lot of money after you pay the expenses, but what that does is it takes all that schedule C income and puts it in that separate basket and now it can no longer offset anything that's in the general basket.

John: Very significant. This is a very good and interesting example of how, by adding… Of course, we know with GILTI, ok, that it cannot be carried forward anyway. The addition of these two baskets has actually diminished the ability to use non-US taxes as US tax credits.

Karen: For an Australian resident, you'd use your tax credits to offset super but it seems to me that your super withdrawals are going to be in the general basket. And if you've generated the carry forwards in the foreign branch basket, you're going to have trouble offsetting.

John: I think that's exactly right. I think this foreign branch stuff probably affects a lot more people than GILTI and transition tax. And it's in a lot of ways more insidious.

Karen: I think a lot of people just don't know. They have no clue.

John: Now, you can tell from the form 1116 that it's usual, anything that has to do with the US—it's not called "Form Nation" for nothing, there's a lot of forms and paperwork—so certainly I thought the tax reform would make things easier, this is one more example that, just on that level, there are more forms required. Which doesn't surprise me all that much because the US has a long history of… clearly the whole concept of the baskets is indicative of a real hostility towards the foreign tax credit.

Australia: So Australia doesn't have any baskets.

John: I think Canada has two, either business or non-business. There's nothing like the complexity of the US tax system.

Question 13: How is income that has been resourced by treaty handled?

Karen: So the one topic that we have left that we really don't want to miss here is income that has been resourced by treaty.

John: If it's resourced, it has to mean that it's not foreign to begin with?

Karen: So basically what we're talking about here is US-sourced income. So a good example is dividends on your Apple stock. That's clearly US-sourced income. But if you're an Australian resident, the Australian treaty says that for non-US citizens, the US has the right to tax 15% of dividends. The Australian treaty in article 27 has a provision that says that any tax that the US has that's in excess, or that's due solely to being applied based on citizenship taxation and the savings clause, the US has to allow a credit for Australian tax paid other than that 15%.

Example, let's say you have 100 dollars worth of Apple dividends and you'd pay 45 dollars of tax in Australia on that and if you were a US tax resident or citizen you'd pay 30 dollars of tax on that. But the treaty says the US can only take 15 dollars of tax because it's a 15% treaty rate on dividends. So the US has to rework its foreign tax credit so that it's only taking 15 dollars of tax and it has to allow you to use anything over the 15 dollars that you paid to Australia. So you paid 45 to Australia, so you paid 30, the 15 that you can offset with the US tax credit with the 15 dollars that the treaty says you can pay. And then there's another 30 of Australian tax and that becomes a credit for income resourced by treaty and it offsets the extra 15 dollars you paid on the US return.

John: So it gives you a bit of an excess. Can those be carried forward?

Karen: But there's a separate basket.

John: It can be carried forward in a separate basket. The resource basket.

The resourcing is by far the most complex area and it depends on the kind of income and the kind of treaty.

Karen: It depends on the treaty. I was reading the instructions, there's a little worksheet in, I think, publication 515, anyway, one of the publications for foreign residents, and there's a little worksheet at the end for income resource by treaties and the instructions says use this one unless you're from Australia and New Zealand and then absolutely silent on what you're supposed to do if you're from Australia or New Zealand. But both countries clearly have these rules that allow this resourcing, so I'm not sure what the deal is there. I couldn't find anything that said why Australia was any different.

John: Yeah, well, I think the bottom line on the resourcing, it's an extremely broad area, and the general principle is to define US income as foreign income for the purposes of the treaty, which then generates foreign tax and that foreign tax can then be used to offset the US tax on it.

Karen: And it has to be resourced because the US rules only allow a foreign tax credit against foreign source income. Your Apple dividend is certainly US-sourced income. The treaty allows enough of it to be resourced that you're only paying 15 dollars of tax in the US.

John: Right, I would point out also that this provision, although it's buttressed and given life by the tax treaty, it's actually found in the internal revenue code itself. It's not going to have any impact without a tax treaty but the point is the internal revenue code creates and defines this resource. It's just a way for somebody to be able to use foreign taxes as a tax credit when they normally wouldn't be able to because it starts as being US-sourced income. That's the general principle behind that.

Karen: And it's different based on the different kind of income, the rules are different. So there might be some employment income, normally when you work in the US, it's US-sourced income, but the treaty may say that if you're working for a foreign employer for less than X number of days, the US cannot tax it. It's to be treated as Australian-sourced or whatever, that'd be another example of income being resourced by the treaty because the treaty explicitly says that it can only be taxed by the resident country.

John: If you want to see an example of the complexity of this, take a look at article 24 of the US-Canada tax treaty, it's simply unbelievable. But it's clear, I mean, it's a good thing, the general principle is to avoid double taxation. And the avoidance of double taxation is a carve out from the savings clause, so US citizens of course get the benefit of that as well.

Any closing thoughts on this, Karen?

Concluding Remarks

Karen: This is one of the more complex areas of US tax; anything foreign, if you have the word foreign, complex is there. The more I look at this, the more I see. If somebody tells you they know it backwards and forwards and understand every little nuance, they're wrong because I don't think it's humanly possible.

John: A few years ago, one of the IRS compliance campaigns was on this whole foreign tax credit brouhaha, and I could see that they'd recover money from audits in this area, it's not well understood, and then when you get the treaties involved and the resourcing, oh my God, it's like a carve out specialty.