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# Foreign Tax Credit for Individuals

For use in preparing

**1997** Returns

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## Important Change for 1997

**Holding period with respect to foreign dividends.** You cannot claim a foreign tax credit for withholding tax paid on foreign source dividends if you have not held the stock from the foreign corporation for at least 16 days. See *Withholding Taxes Imposed on Certain Dividends.*

## Important Reminders

**Change of address.** If your address changes from the address shown on your last return, use Form 8822, *Change of Address,* to notify the Internal Revenue Service.

**Simpler Form 1116 filing if you have only passive income.** If your only foreign income is passive income and the total of all your foreign taxes shown on Form 1099–DIV, 1099–INT, and similar statements is not more than $200 ($400 if married filing jointly), you may not need to show separately on Form 1116, *Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual),* the foreign income and taxes from each country. You may be able to report only the total foreign income and taxes. This simpler method of filling out Form 1116 may help you if, for example, your only foreign income is from mutual funds. See the Form 1116 instructions for more information.

## Introduction

If you have paid or accrued foreign taxes to a foreign country on foreign sourced income and are subject to U.S. tax on the same income, you may be able to take either a credit or an itemized deduction for those taxes. Taken as a deduction, foreign income taxes reduce your U.S. taxable income. Taken as a credit, foreign income taxes reduce your U.S. tax liability.

In most cases, it is to your advantage to take foreign income taxes as a tax credit. The

major scope of this publication is the foreign tax credit.

The publication discusses:

- Who can take the credit,
- What foreign taxes qualify for the credit, and
- How to figure the credit.

The amount of foreign tax credit you can take in a tax year is limited. The publication tells you how to carry back or carry over the unused foreign taxes to other tax years.

You claim the credit by filing Form 1116, *Foreign Tax Credit,* with your U.S income tax return. Two examples with filled-in Forms 1116 are provided at the end of the publication.

## Useful Items

You may want to see:

**Publication**

- ☐ **54** Tax Guide for U.S. Citizens and Resident Aliens Abroad
- ☐ **519** U.S. Tax Guide for Aliens
- ☐ **570** Tax Guide for Individuals With Income From U.S. Possessions

**Form (and Instruction)**

- ☐ **1116** Foreign Tax Credit

See *How To Get More Information* near the end of this publication for information about getting these publications and forms.

# What Is the Foreign Tax Credit?

The foreign tax credit is intended to relieve U.S. taxpayers of the double tax burden when their foreign source income is taxed both by the United States and the foreign country from which the income comes. Generally, if the foreign tax rate is higher than the U.S. rate, there will be no U.S. tax on the foreign income. If the foreign tax rate is lower than the U.S. rate, U.S. tax on the foreign income will be limited to the difference between the rates. Because the foreign tax credit applies only with respect to foreign source income, it cannot reduce U.S. taxes on U.S. source income.

## Choice To Take Credit or Deduction

You can choose each tax year to take the amount of any qualified foreign taxes paid or accrued during the year as a foreign tax credit or as an itemized deduction. You can change your choice for each year's taxes.

To choose the foreign tax credit, you must complete Form 1116 and attach it to your U.S. tax return. To choose to claim the taxes as an itemized deduction, use Schedule A, Itemized Deductions (Form 1040).

*Figure your tax both ways— claiming the credit and claiming the deduction. Then fill out your return the way that benefits you most. See* Why Choose the Credit, *later.*

## Choice Applies to All Qualified Foreign Taxes

As a general rule, you must choose to take either a credit or a deduction for all qualified foreign taxes. There are exceptions to this general rule, which are described under *Foreign taxes not allowed as a credit,* next.

Under the general rule, if you choose to take a credit for foreign taxes, you must take the credit for all qualified foreign taxes. You cannot deduct any of them. Conversely, if you choose to deduct qualified foreign taxes, you must deduct all of them. You cannot take a credit for any of them.

See *What Foreign Taxes Qualify for the Credit,* later, for the meaning of qualified foreign taxes.

*You cannot take a credit or a deduction for foreign taxes paid on income you exclude under the foreign earned income exclusion or the foreign housing exclusion.*

**Foreign taxes not allowed as a credit.** Even if you claim a credit for other foreign taxes, you can deduct any foreign tax that is not allowed as a credit because:

1) You participated in or cooperated with an international boycott (discussed later under *International Boycott),*
2) You paid the tax to one of certain countries for which a credit is not allowed because these countries provide support for acts of international terrorism, or because the United States does not have diplomatic relations with them or recognize their governments, or
3) You paid withholding tax on dividends from foreign corporations whose stock you did not hold for the required period of time.

For more information on items (2) and (3), see the discussion later under *Foreign Taxes for Which You Cannot Take a Credit.*

**Foreign taxes other than income taxes.** The deduction for foreign taxes other than foreign income taxes is not related to the foreign tax credit. You may be able to deduct foreign taxes for which you cannot take the credit, such as real and personal property taxes, even though you claim the foreign tax credit for foreign income taxes.

Generally, you can deduct these other taxes only if they are expenses incurred in a trade or business or in the production of income. However, you can deduct foreign real property taxes that are not expenses incurred in your trade or business as an itemized deduction on Schedule A (Form 1040).

**Carrybacks and carryovers.** There is a limit on the credit you can claim in a tax year. If your qualified foreign taxes exceed the credit limit, you can carry over or carry back the excess to another tax year. If you deduct qualified foreign taxes in a tax year, you cannot use a carryback or carryover in that year. That is because you cannot take both a deduction and a credit for qualified foreign taxes in the same tax year.

For more information on the limit, see *How to Figure the Credit,* later. For more information on carrybacks and carryovers, see *Carryback and Carryover,* later.

## Making or Changing Your Choice

You can make or change your choice to claim a deduction or credit at any time during the period ***within 10 years*** from the due date for filing the return for the tax year for which you make the claim. You make or change your choice on your tax return (or on an amended return) for the year your choice is to be effective.

***Example.*** You paid foreign taxes for the last 13 years and chose to deduct them on your U.S. income tax returns. You were timely in both filing and paying your U.S. tax liability. In February 1997 you file an amended return for tax year 1986 choosing to take a credit for your 1986 foreign taxes because you now realize that the credit is more advantageous than the deduction for that year. Because your return for 1986 was not due until April 15, 1987, this choice is timely (within 10 years) and you are able to take a credit for the 1986 foreign taxes against your 1986 U.S. tax liability.

Because there is a limit on the credit for your 1986 foreign tax, you have unused 1986 foreign taxes. Ordinarily, you first carry back unused foreign taxes and claim them as a credit in the 2 preceding tax years. If you are unable to claim all of them in those 2 years, you carry them forward to the 5 years following the year in which they arose.

Because you originally did not choose to take a credit for your foreign taxes and the time (10 years) for changing the choice for 1984 and 1985 has passed, you cannot carry the unused 1986 foreign taxes back as credits against your U.S. income tax for tax years 1984 and 1985.

However, because 10 years have not passed since the due date for your 1987 through 1991 income tax returns, you can still choose to carry ***forward*** any unused 1986 foreign taxes. You must reduce the unused 1986 foreign taxes that you carry forward by the amount that would have been allowed as a carryback if you had timely carried back the foreign tax to tax years 1984 and 1985.

## Why Choose the Credit

Although no one rule covers all situations, it is generally better to take a credit for qualified foreign taxes than to deduct them as an itemized deduction. This is because:

1) A credit reduces your actual U.S. income tax on a dollar-for-dollar basis, while a deduction reduces only your income subject to tax.
2) You can choose to take the foreign tax credit even if you do not itemize your deductions. You then are allowed the standard deduction in addition to the credit.
3) If you choose to take a credit for the foreign taxes paid, and the taxes paid exceed the credit limit for the tax year, you can carry over or carry back the excess to another tax year. (See *Limit on the Credit,* discussed later under *How To Figure the Credit.)*

***Example 1.*** For 1997, you and your spouse have adjusted gross income of $50,000, including $20,000 of dividend income from foreign sources. You file a joint return and can claim two $2,650 exemptions. You had to pay $2,000 in foreign income taxes on the dividend income from foreign sources. If you take the foreign taxes as an

itemized deduction, your total itemized deductions are $9,000. Your taxable income then is $35,700 and your tax is $5,359.

If you take the credit instead, your itemized deductions are only $7,000. Your taxable income then is $37,700, and your tax before the credit is $5,659. After the credit, however, your tax is only $3,659. Therefore, you have an additional tax benefit of $1,700 ($5,359 – $3,659) by taking the credit.

***Example 2.*** In 1997 you receive investment income of $5,000 from a foreign country, which imposes a tax of $3,500 on that income. You report on your U.S. return this income as well as $34,000 of income from U.S. sources. You are single, entitled to one $2,650 exemption, and have other itemized deductions of $4,400. If you deduct the foreign tax on your U.S. return, your taxable income is $28,450 ($5,000 + $34,000 – $2,650 – $4,400 – $3,500) and your overall tax bill is $4,769.

If you take the credit instead (you can take a credit of only $737 because of limits discussed later), your taxable income is $31,950 ($5,000 + $34,000 – $2,650 – $4,400) and your tax before the credit is $5,749. Your tax after the credit is $5,012 ($5,749–$737), which is $243 more than if you deduct the foreign tax.

If you choose the credit, you will have unused foreign taxes of $2,763 ($3,500 – $737). When deciding whether to take the credit or the deduction this year, you will need to consider whether you can benefit from a carryback or carryover of that unused foreign tax.

## Credit for Taxes Paid or Accrued

You can claim the credit for a qualified foreign tax in the tax year in which you pay it accrue it. The tax year referred to is the tax year for which your U.S. return is filed.

**When accrued.** If you use an accrual method of accounting, you can claim the credit only in the year in which you accrue the tax. You are using an accrual method of accounting if you report income when you earn it, rather than when you receive it, and you deduct your expenses when you incur them, rather than when you pay them.

Foreign taxes generally accrue when all the events have taken place that fix the amount of the tax and your liability to pay it. If you are contesting your foreign tax liability, you cannot accrue it and take a credit until the amount of foreign tax due is finally determined. However, if you choose to pay the tax liability you are contesting, you can take credit before a final determination of foreign tax liability is made. Once determined, the foreign tax credit is allowable for the year to which the foreign tax relates. If the amount of foreign taxes taken as a credit differs from the final foreign tax liability, you must make an adjustment to the credit, as discussed later under *Foreign Tax Redeterminations.*

**When paid.** If you use the cash method of accounting, you can choose to take the credit either in the year you pay the tax or in the year you accrue it. You are using the cash method of accounting if you report income in the year you actually or constructively receive it, and deduct expenses in the year you pay them.

**Choosing to accrue taxes.** Even if you use the cash method of accounting, you can choose to take a credit for foreign taxes in the year they accrue. You make the choice by checking the box in Part II of Form 1116. Once you make that choice, you must follow it in all later years and take a credit for foreign taxes in the year they accrue.

In addition, the choice to accrue foreign taxes applies to ***all*** foreign taxes qualified for the credit. You cannot take a credit for some foreign taxes when paid and take a credit for others when accrued.

If you make the choice to accrue foreign taxes and pay them in a later year, you cannot claim a deduction for any part of the previously accrued taxes.

***Cash method used in earlier year.*** If, in earlier years, you took the credit based on taxes paid, and this year you choose to take the credit based on taxes accrued, you may be able to take the credit this year for taxes from more than one year.

***Example.*** Last year you used the cash method of crediting foreign taxes. This year you chose to use the accrual method. During the year you paid foreign income taxes owed for last year. You also accrued foreign income taxes that you did not pay by the end of the year. You can base the credit on your return for this year on both last year's taxes that you paid and this year's taxes that you accrued.

***You may have to post a bond.*** If you claim a credit for taxes accrued but not paid, you may have to post an ***income tax bond*** to guarantee your payment of any tax due in the event the amount of foreign tax paid differs from the amount claimed.

This bond can be requested at any time without regard to the *Time Limit on Tax Assessment,* discussed later.

## Foreign Tax Redeterminations

A foreign tax redetermination is any change in your foreign tax liability that may affect your U.S. foreign tax credit claimed. This may occur if the amount of foreign taxes you accrued in one year is different from the amount you later pay for that year. It also may occur if you pay additional taxes for that year or receive a refund of taxes paid in that year.

In any case, the foreign tax you can take as a credit is the amount you actually paid to the foreign country. The time of the credit remains the year to which the foreign taxes paid or accrued relate, even if the change in foreign tax liability occurs in a later year.

**Currency fluctuation.** Accrued but unpaid taxes must be translated into U.S. dollars at the prevailing exchange rate on the last day of the year. Foreign taxes paid must be translated into U.S. dollars at the prevailing exchange rate on the date you pay the tax. See *Translating foreign currency into U.S. dollars,* later under *Foreign Currency and Exchange Rates.*

You must make an adjustment to accrued foreign taxes if you find that the amount accrued differs from the amount later paid because of fluctuations in the dollar value of the foreign currency between the date of accrual and the date of payment. But see *When redetermination of tax is not required,* below.

**Notice to the Internal Revenue Service of change in tax.** You must file Form 1040X, *Amended U.S. Individual Income Tax Return,* and Form 1116 for the year to which a foreign tax relates if in a later year you:

1) Must pay additional foreign taxes,
2) Receive a foreign tax refund, or
3) Have a change to the foreign tax accrued because of exchange rate fluctuations.

The IRS will redetermine your U.S. tax liability for the year or years affected. If you pay less tax than you originally claimed credit for, there is no limit on the time the IRS has to redetermine and assess the correct U.S. tax due. If you pay more tax than you originally claimed a credit for, see *Time Limit on Refund Claims,* later.

***When redetermination of tax not required.*** A redetermination of your U.S. tax is not required if the change is due solely to an exchange rate fluctuation and the change in foreign tax liability for the tax year is less than the ***smaller*** of:

1) $10,000, or
2) 2% of the total dollar amount of the foreign tax initially accrued for that foreign country.

In this case, you must adjust your U.S. tax in the tax year in which the accrued foreign taxes are paid.

***Failure-to-notify penalty.*** If you fail to notify the Service of a foreign tax change and cannot show reasonable cause for the failure, you may have to pay a penalty.

For each month, or part of a month, that the failure continues, you pay a penalty of 5% of the tax due resulting from a redetermination of your U.S. tax. This penalty cannot be more than 25% of the tax due.

**Foreign tax refund.** If you receive a foreign tax refund without interest from the foreign government, ***you will not have to pay interest*** on the amount of tax due resulting from the adjustment to your U.S. tax for the time before the date of the refund.

However, if you receive a foreign tax refund with interest, ***you must pay interest*** to the Internal Revenue Service up to the amount of the interest paid to you by the foreign government. The interest you must pay cannot be more than the interest you would have had to pay on taxes that were unpaid for any other reason for the same period.

***Foreign tax imposed on foreign refund.*** If you receive a foreign tax refund that is taxed by the foreign country, you cannot take a separate credit or deduction for this additional foreign tax. However, when you refigure the credit taken for the original tax, reduce the refund by the foreign tax paid on it.

***Example.*** You paid a foreign income tax of $3,000 in 1995, and received a foreign tax refund of $500 in 1997 on which a foreign tax of $100 was imposed. Because you can reduce your refund by the foreign tax imposed on it, you must make an adjustment of only $400 to the credit you took against your 1995 U.S. income tax.

## Time Limit on Refund Claims

You have 10 years to file a claim for refund of U.S. tax if you find that you paid or accrued a larger foreign tax than you claimed a credit for. The 10-year period begins the day after the regular due date for filing the return for the

year in which the taxes were actually paid or accrued.

You have 10 years to file your claim regardless of whether you claim the credit on taxes paid or taxes accrued. The 10-year period applies to claims for refund or credit based on:

1) Fixing math errors in figuring qualified foreign taxes,
2) Reporting qualified foreign taxes not originally reported on the return, or
3) Any other change in the size of the credit (including one caused by correcting the foreign tax credit limit).

The special 10-year period also applies to making or changing your choice of whether to claim a deduction or credit for foreign taxes. See *Making or Changing Your Choice,* discussed earlier under *Choice To Take Credit or Deduction.*

# Who Can Take the Credit?

If you have paid foreign income tax and are subject to U.S. tax on foreign source income, you may be able to take a foreign tax credit.

## U.S. Citizens

If you are a U.S. citizen, you are taxed by the United States on your worldwide income wherever you live. You are normally entitled to take a credit for foreign taxes you pay or accrue.

**Citizen of U.S. possession.** If you are a citizen of a U.S. possession (except Puerto Rico), not otherwise a citizen of the United States, and are not a resident of the United States, you cannot take a foreign tax credit.

**Excluded income.** You cannot take a credit for foreign income taxes you pay or accrue on income that you exclude from gross income under the foreign earned income or foreign housing exclusion. See the discussion of *Taxes on excluded income,* later, under *Reduction in Total Foreign Taxes Available for Credit.* These exclusions are discussed in detail in Publication 54.

**Resident of American Samoa.** If you are a bona fide resident of American Samoa and exclude income from sources in American Samoa, Guam, or the Northern Mariana Islands, you cannot take a credit for the taxes you pay or accrue on the excluded income. For more information on this exclusion, see Publication 570.

## Resident Aliens

If you are a resident alien of the United States, you can take a credit for foreign taxes subject to the same general rules as U.S. citizens. If you are a bona fide resident of Puerto Rico for the entire tax year, you also come under the same rules.

Usually, you can take a credit ***only*** for those foreign taxes imposed on your foreign source income. You must have actually or constructively received the income while you had resident alien status.

If you exclude income under the foreign earned income exclusion or the foreign housing exclusion, you cannot take a foreign tax credit for foreign income taxes paid or accrued on the excluded income. See the discussion of *Taxes on excluded income,* later, under *Reduction in Total Foreign Taxes Available for Credit.* For information on alien status, see Publication 519.

## Nonresident Aliens

As a nonresident alien, you can claim a credit for taxes paid or accrued to a foreign country or possession of the United States ***only*** on foreign source or possession source income that is effectively connected with a trade or business in the United States. For information on alien status and effectively connected income, see Publication 519.

## Who Paid or Accrued the Foreign Tax?

Generally, you can claim the credit only if ***you*** paid or accrued the foreign tax. However, the paragraphs that follow describe some instances in which you can claim the credit even if you did not directly pay or accrue the tax yourself.

**Joint return.** If you file a joint return, you can claim the credit based on the total of any foreign income tax paid or accrued by you and your spouse.

**Partner or S corporation shareholder.** If you are a member of a partnership, or a shareholder in an S corporation, you can claim the credit based on your proportionate share of the foreign income taxes paid or accrued by the partnership or the S corporation. These amounts will be shown on the Schedule K–1 you receive from the partnership or S corporation. However, if you are a shareholder in an S corporation that in turn owns stock in a foreign corporation, you cannot claim a credit for your share of foreign taxes paid by the foreign corporation.

**Beneficiary.** If you are a beneficiary of an estate or trust, you may be able to claim the credit based on your proportionate share of foreign income taxes paid or accrued by the estate or trust. This amount will be shown on the Schedule K–1 you receive from the estate or trust. However, you must show that the tax was imposed on income of the estate and not on income received by the decedent.

**Investment company shareholder.** If you are a shareholder of a regulated investment company (mutual fund) or a foreign investment company, you may be able to claim the credit based on your share of foreign income taxes paid by the company if it chooses to pass the credit on to its shareholders. You should receive from the mutual fund a Form 1099–DIV, or similar statement, showing the foreign country or U.S. possession, your share of the income from that country, and your share of the foreign taxes paid to that country. If you do not receive this information, you will need to contact the company.

**Controlled foreign corporation shareholder.** If you are at least a 10% shareholder of a controlled foreign corporation and choose to be taxed at corporate rates on the amount you must include in gross income from that corporation, you can claim the credit based on your share of foreign taxes paid or accrued by the controlled foreign corporation. If you make this election, you must claim the credits by filing Form 1118, *Foreign Tax Credit—Corporations.*

***Controlled foreign corporation.*** A controlled foreign corporation is a foreign corporation in which U.S. shareholders own more than 50% of the voting power or value of the stock. You are considered a U.S. shareholder if you own 10% or more of the total voting power of all classes of the foreign corporation's stock.

# What Foreign Taxes Qualify for the Credit?

Generally, only income, war profits, and excess profits taxes (income taxes) paid or accrued during the tax year to a foreign country (defined later) or a U.S. possession qualify for the foreign tax credit. However, under certain conditions a tax paid or accrued to a foreign country or U.S. possession in lieu of a tax on income, war profits, or excess profits will qualify. (See *Taxes in Lieu of Income Taxes,* later.)

Whether an amount imposed by a foreign country (foreign charge or levy) qualifies for credit depends on the characteristics of the charge involved.

As a general rule, to qualify for the credit, the foreign tax must have been imposed on you and you must have paid or accrued the foreign tax. You cannot shift the right to claim the credit by contract or other means unless specifically provided by foreign law. A qualified tax that is deducted from wages is considered to be imposed upon the recipient of the wages.

**Amount of foreign tax that qualifies.** The amount of qualified foreign tax that you can use each year for credit purposes or as a deduction is not necessarily the amount of tax withheld by the foreign country. The amount of qualified foreign tax, for credit or deduction purposes, is only the amount of foreign income tax that is the legal and actual tax liability that you paid or accrued during the year.

***Foreign tax refund.*** You cannot take a foreign tax credit or deduction for income taxes paid to a foreign country to the extent it is reasonably certain the amount would be refunded, credited, rebated, abated, or forgiven if you made a claim.

For example, the United States has tax treaties or conventions with many countries allowing U.S. citizens and residents reductions in the rates of tax of those foreign countries. However, some treaty countries require U.S. citizens and residents to pay the tax figured without regard to the lower treaty rates and then claim a refund for the amount by which the tax actually paid is more than the amount of tax figured using the lower treaty rate. For credit or deduction purposes, the taxpayer's qualified foreign tax is the amount figured using the lower treaty rate and not the amount actually paid, since the taxpayer can claim a refund for the excess tax paid.

***Subsidy received.*** If a foreign country returns your foreign tax payments to you in the form of a subsidy, you cannot claim these payments as taxes qualified for the foreign tax credit. A subsidy can be provided by any means but must be determined, directly or

indirectly, in relation to the amount of tax, or to the base used to figure the tax.

The term "subsidy" includes any type of benefit. Some ways of providing a subsidy are refunds, credits, deductions, payments or discharges of obligations. The credit is also not allowed if the subsidy is given to a person related to you, or persons who participated in a transaction, or a related transaction, with you.

***Shareholder receiving refund for corporate tax in integrated system.*** Under some foreign tax laws and treaties, a shareholder is considered to have paid part of the tax that is imposed on the corporation. You may be able to claim a refund of these taxes from the foreign government. You must include the refund (including any amount withheld) in your income in the year received. Any tax withheld from the refund is a qualified foreign tax.

***Example.*** You are a shareholder of a U.K. corporation. You receive a $100 refund of the tax paid to the United Kingdom by the corporation on the earnings distributed to you as a dividend. The U.K. government imposes a 15% withholding tax ($15) on the refund you received. You receive a check for $85. You include $100 in your income. The $15 of tax withheld is a qualified foreign tax.

**Foreign country.** A foreign country includes any foreign state or political subdivision thereof. Income, war profits, and excess profits taxes paid or accrued to a foreign city or province qualify for the U.S. foreign tax credit.

A foreign country also includes ***the continental shelf*** of a foreign country if the country has exclusive rights under international law over the exploration and exploitation of natural resources there, and exercises taxing jurisdiction over that exploration and exploitation. This rule for continental shelf areas is limited to activities involving natural resources.

**U.S. possessions.** For foreign tax credit purposes, all qualified taxes paid to possessions of the United States are considered foreign taxes. For this purpose, U.S. possessions include Puerto Rico, Guam, the Northern Mariana Islands, and American Samoa.

When the term "foreign country" is used in this publication, it includes U.S. possessions unless otherwise stated.

**Penalties and interest.** Amounts paid to a foreign government to satisfy a liability for interest, fines, penalties, or any similar obligation are not taxes and do not qualify for credit.

## Tax Must Be Based on Income

To qualify for credit, the foreign levy must be an income tax (or a tax in lieu of income tax). Simply because the levy is called an income tax by the foreign taxing authority does not make it an income tax for this purpose.

**Income tax.** A foreign levy is an income tax only if it meets both of these tests:

1) It is a tax; that is, you have to pay it and you get no specific economic benefit (discussed below) from paying it.
2) The predominant character of the tax is that of an income tax in the U.S. sense.

A foreign levy may meet these requirements even if the foreign tax law differs from U.S. tax law. The foreign law may include in income items that the United States does not include, or it may allow certain exclusions or deductions that are not allowed under the U.S. income tax law.

**Specific economic benefit.** Generally, you get a specific economic benefit if you receive, or are considered to receive, an economic benefit from the foreign country imposing the levy, ***and***

1) If there is a generally imposed income tax, the economic benefit is not available on substantially the same terms to all persons subject to the income tax, or
2) If there is no generally imposed income tax, the economic benefit is not made available on substantially the same terms to the population of the foreign country in general.

However, see the exception discussed later under *Pension, unemployment, and disability fund payments.*

***Economic benefits.*** Economic benefits include:

- Goods,
- Services,
- Fees or other payments,
- Rights to use, acquire, or extract resources, patents, or other property the foreign country owes or controls, and
- Discharges of contractual obligations.

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Generally, the right or privilege merely to engage in business is not an economic benefit.

You are considered to receive an economic benefit if you have a business transaction with a person who receives a specific economic benefit from the foreign country and, under the terms and conditions of the transaction, you receive directly or indirectly some part of the benefit.

***Dual-capacity taxpayers.*** If you are subject to a foreign country's levy and you also receive a specific economic benefit from that foreign country, you are a "dual-capacity taxpayer." As a dual-capacity taxpayer, you cannot claim a credit for any part of the foreign levy, unless you establish that the amount paid under a distinct element of the foreign levy is a tax, rather than a compulsory payment for a direct or indirect specific economic benefit.

For more information on how to establish amounts paid under separate elements of a levy, write to:

Internal Revenue Service
Assistant Commissioner (International)
Attention: CP:IN:D:CS
950 L'Enfant Plaza South, S.W.
Washington, D.C. 20024

***Pension, unemployment, and disability fund payments.*** A foreign tax imposed on an individual to pay for retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for similar purposes, is not payment for a specific economic benefit if the amount of the tax does not depend on the age, life expectancy, or similar characteristics of that individual.

No deduction or credit is allowed, however, for ***social security taxes*** paid or accrued to a foreign country with which the United States has a social security agreement. For more information about these agreements, see Publication 54 or Publication 519.

**Soak-up taxes.** A foreign tax is not predominantly an income tax and does not qualify for credit to the extent it is a soak-up tax. A tax is a soak-up tax to the extent that liability for it depends on the availability of a credit for it against income tax imposed by another country. This rule applies only if and to the extent that the foreign tax would not be imposed if the credit were not available.

**Taxes based on income.** Foreign taxes on wages, dividends, interest, and royalties generally qualify for the credit. Furthermore, foreign taxes on income can qualify even though they are not imposed under an income tax law.

**Taxes not based on income.** Foreign taxes based on gross receipts, rather than on realized net income, do not qualify ***unless*** they are imposed in lieu of an income tax, as discussed next. Taxes based on assets, such as property taxes, do not qualify for the credit.

## Taxes in Lieu of Income Taxes

A tax paid or accrued to a foreign country qualifies for the credit if it is imposed in lieu of an income tax otherwise generally imposed. A foreign levy is a tax in lieu of an income tax only if:

1) It is not payment for a specific economic benefit as discussed earlier, and
2) It meets the substitution requirements; that is, the tax is imposed in place of, and not in addition to, an income tax otherwise generally imposed. See also the earlier discussion of soak-up taxes.

Since a tax in lieu of an income tax does not have to be based on realized net income, a foreign tax imposed on gross income, gross receipts or sales, or the number of units produced or exported can qualify for the credit.

## Reduction in Total Foreign Taxes Available for Credit

You must reduce your total foreign taxes that are available for the credit under the following circumstances.

**Taxes on excluded income.** You must reduce your foreign taxes available for the credit by the amount of those taxes paid or accrued on income that is excluded from U.S. income under the foreign earned income exclusion or the foreign housing exclusion. See Publication 54 for more information on the foreign earned income and housing exclusions.

***Wages completely excluded.*** If your wages are completely excluded, you cannot take a credit for any of the foreign taxes paid or accrued on these wages.

***Wages partly excluded.*** If only part of your wages is excluded, you cannot take a credit for the foreign income taxes allocable to the excluded part. You find the amount allocable to your excluded wages by multiplying the foreign tax paid or accrued on foreign earned income received or accrued during the tax year by a ***fraction***.

The ***numerator*** of the fraction is your excluded foreign earned income for the tax year minus otherwise deductible expenses directly related and properly apportioned to that income (not including the foreign housing deduction).

The ***denominator*** is your total foreign earned income received or accrued during the tax year minus all deductible expenses allocable to that income (including the foreign housing deduction). If the foreign law taxes foreign earned income and some other income (for example, earned income from U.S. sources or a type of income not subject to U.S. tax), and the taxes on the other income cannot be segregated, the denominator of the fraction is the total amount of income subject to the foreign tax minus deductible expenses allocable to that income.

***Example.*** You are a U.S. citizen and a cash basis taxpayer, employed by Company X and living in Country A. Your records show the following:

| | |
|---|---|
| Foreign earned income received | $120,000 |
| Unreimbursed business travel expenses | 20,000 |
| Income tax paid to Country A | 30,000 |
| Exclusion of foreign earned income and housing allowance | 77,225 |

Because you can exclude part of your wages, you cannot claim a credit for part of the foreign taxes. To find that part, do the following.

First, find the amount of business expenses allocable to excluded wages and therefore not deductible. To do this, multiply the otherwise deductible expenses by a fraction. That fraction is the excluded wages over your foreign earned income.

$$\$20,000 \times \frac{\$77,225}{\$120,000} = \$12,871$$

Next, find the numerator of the fraction by which you will multiply the foreign taxes paid. To do this, subtract business expenses allocable to excluded wages ($12,871) from excluded wages ($77,225). The result is $64,354.

Then, find the denominator of the fraction by subtracting all your deductible expenses from all your foreign earned income ($120,000 − $20,000 = $100,000).

Finally, multiply the foreign tax you paid by the resulting fraction.

$$\$30,000 \times \frac{\$64,354}{\$100,000} = \$19,306$$

The amount of Country A tax you cannot take a credit for is $19,306.

**Taxes on foreign mineral income.** You must reduce any taxes paid or accrued to a foreign country or possession on mineral income from that country or possession if you were allowed a deduction for percentage depletion for any part of the mineral income.

**Taxes from international boycott operations.** In general, if you participate in or cooperate with an international boycott, your foreign taxes resulting from the boycott activity will reduce the total taxes available for credit. For more information, see the discussion later under *International Boycott.*

**Taxes of persons controlling foreign corporations.** If you are an officer, director or 5% or more shareholder of a foreign corporation, you may be required to file an annual information return on **Form 5471,** *Information Return of U.S. Persons With Respect To Certain Foreign Corporations.*

***Penalty for not filing.*** If you fail to file the return by the due date, you must reduce by 10% all foreign taxes that may be used for the foreign tax credit. You then subtract from this 10% reduction any dollar penalty for failure to furnish this information. Generally, the dollar penalty is $1,000 for each failure. Additional penalties apply if the failure continues for 90 days or more.

# Foreign Taxes for Which You Cannot Take a Credit

You cannot claim a foreign tax credit for foreign income taxes paid or accrued under the following circumstances. However, you can claim a deduction for these taxes. See *Choice To Take Credit or Deduction,* earlier.

## Taxes Imposed By Certain Foreign Countries

You cannot claim a foreign tax credit for income taxes paid or accrued to any country if the income giving rise to the tax is for a period (the sanction period) during which:

1) The Secretary of State has designated the country as one that repeatedly provides support for acts of international terrorism,
2) The United States has severed or does not conduct diplomatic relations with the country, or
3) The United States does not recognize the country's government, unless that government is eligible to purchase defense articles or services under the Arms Export Control Act.

*Table 1* lists countries that meet this description for 1997.

Table 1. **Countries That Do Not Qualify for a Foreign Tax Credit in 1997**

| | |
|---|---|
| Cuba | North Korea |
| Iran | Sudan |
| Iraq | Syria |
| Libya | |

Income that is paid through one or more entities is treated as coming from a foreign country listed in *Table 1* if the original source of the income is from one of the listed countries.

**Limit on credit.** In figuring the foreign tax credit limit, discussed later, income for the sanction period of a country listed in *Table 1* is treated as a separate category of foreign income. This will prevent the foreign taxes for the sanction period of these countries from being used as a credit against the U.S. tax.

***Example.*** You lived and worked in Libya until August, when you were transferred to Italy. You paid taxes to each country on the income earned in that country. You cannot claim a foreign tax credit for the foreign taxes paid on the income earned in Libya. When figuring your foreign tax credit limit, you must treat the income earned in Libya as a separate category of foreign income. You cannot take a credit for taxes paid on the income earned in Libya, but that income is taxable in the United States.

**Figuring the credit when a sanction ends.** *Table 2* lists the countries for which sanctions have been lifted. For any of these countries, you can claim a foreign tax credit for the taxes paid or accrued to that country on the income for the period that begins after the end of the sanctioned period.

***Example.*** The sanctions against Country X were lifted on July 31. On August 19, you receive a distribution from a mutual fund of Country X income. The fund paid Country X income tax for you on the distribution. Because the distribution was made after the sanction was lifted, you may include the foreign tax paid on the distribution to compute your foreign tax credit.

***Amounts for the nonsanctioned period.*** If during your tax year a sanction period ends and you are not able to determine the actual income and taxes for the nonsanctioned period, you can allocate amounts to that period. Multiply the income or taxes for the year by the following fraction to determine the amounts allocated to the nonsanctioned period.

$$\frac{\text{Number of nonsanctioned days in year}}{\text{Number of days in year}}$$

***Example.*** You are a calendar year filer and received $20,000 of income from Country X in 1997 on which you paid tax of $4,500. Sanctions against Country X were lifted on July 11, 1997. You are unable to determine how much of the income or tax is for the nonsanctioned period. Because your tax year starts on January 1, and the Country X sanction was lifted on July 11, 1997, 173 days of your tax year are in the nonsanctioned period. You would compute the income for the nonsanctioned period as follows:

$$\frac{173 \text{ days}}{365 \text{ days}} \times \$20,000 = \$9,479$$

You would compute the tax for the nonsanctioned period as follows:

$$\frac{173 \text{ days}}{365 \text{ days}} \times \$4,500 = \$2,133$$

To figure your foreign tax credit, you would use $9,479 as the income from Country X and $2,133 as the tax.

***Further information.*** The rules for figuring the foreign tax credit after a country's sanction period ends are more fully explained in Revenue Ruling 92–62, 1992–2 Cumulative Bulletin, page 193. This ruling can be found in many libraries and IRS offices.

Table 2. **Countries Removed From the Sanctioned List**

| Country | Sanction Period | |
|---|---|---|
| | Starting Date | Ending Date |
| Afghanistan | January 1, 1987 | August 4, 1994 |
| Albania | January 1, 1987 | March 15, 1991 |
| Angola | January 1, 1987 | June 18, 1993 |
| Cambodia | January 1, 1987 | August 4, 1994 |
| South Africa | January 1, 1988 | July 10, 1991 |
| Vietnam | January 1, 1987 | July 21, 1995 |
| People's Democratic Republic of Yemen | January 1, 1987 | May 22, 1990 |

### Taxes Imposed on Certain Dividends

You cannot claim a foreign tax credit for withholding tax on dividends paid or accrued after September 4, 1997, if the dividends are:

1) On stock you held for less than 16 days during the holding period described below, or
2) For a period or periods totaling more than 366 days on preferred stock you held for less than 46 days during the holding period described below.

Regardless of your holding period, you cannot claim the credit to the extent you have an obligation under a short sale or otherwise, to make payments related to the dividend for positions in substantially similar or related property.

**Withholding tax.** For this purpose, withholding tax includes any tax determined on a gross basis. It does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

**Holding period.** To claim the credit for taxes on dividends, you must satisfy the holding period. You must hold the stock for at least 16 days within the 30-day period that begins 15 days before the ex-dividend date (the date you are entitled to the stock dividend). For a preferred stock dividend, if the dividend is for a period or periods totaling more than 366 days, you must hold the preferred stock for at least 46 days within the 90-day period that begins 45 days before you are entitled to the preferred stock dividend. If the dividend is not for more than 366 days, the general 16 day rule, described above applies to the preferred stock. When figuring the holding period, do not count the day you acquired the stock or any days in which you are protected from risk of loss (but do count the day you sold the stock).

***Example 1.*** You bought common stock from a foreign corporation on November 3. You sold the stock on November 19. You received a dividend on this stock, because you owned it on the ex-dividend date of November 5. To claim the credit, you must have held the stock for at least 16 days within the 30-day period that began on October 21 (15 days before the ex-dividend date). Since you held the stock for 16 days, from November 4 until November 19, you are entitled to the credit.

***Example 2.*** The facts are the same as in example 1 except that you sold the stock on November 14. You held the stock for only 11 days. You are not entitled to the credit.

**Exception.** If you are a securities dealer, actively conducting business in a foreign country, you may be able to claim a foreign tax credit for qualified taxes paid on dividends regardless of your holding period. See section 901(k)(4) of the Internal Revenue Code for information.

# How To Figure the Credit

As already indicated, you can claim a foreign tax credit only for foreign taxes on income, war profits, or excess profits, or taxes in lieu of those taxes. In addition, there is a limit on the amount of the credit that you can claim. You figure this limit and your credit on Form 1116. Your credit is the amount of foreign tax you paid or accrued or, if smaller, the limit.

If you have foreign taxes available for credit but you cannot use them because of the limit, you may be able to carry them back to the 2 previous tax years and forward to the next 5 tax years.

Also, certain tax treaties have special rules that you must consider when figuring your foreign tax credit. See *Tax Treaties,* later.

## Limit on the Credit

Your foreign tax credit cannot be more than your total U.S. tax multiplied by a fraction. The numerator (top part) of the fraction is your taxable income from sources outside the United States. The denominator (bottom part) is your total taxable income from all domestic and foreign sources.

To determine the limit, you must separate your foreign source income into categories, as discussed under *Separate Limit Income*. The limit treats all foreign income and expenses in each separate category as a single unit and limits the credit to the U.S. income tax on the taxable income in that category from all sources outside the United States.

In determining your taxable income from sources outside the United States, income from the countries listed in *Table 1,* earlier, is treated as a separate category. You cannot claim a credit for the taxes on that income. However, that income is taxable in the United States. Therefore, you must include it in total taxable income from all domestic and foreign sources.

Complete Part III of Form 1116 to figure the limit on your credit. The maximum amount of your credit will be shown on line 20.

## Separate Limit Income

You must figure the limit on a separate Form 1116 for each of the following categories of income:

1) Passive income,
2) High withholding tax interest,
3) Financial services income,
4) Shipping income,
5) Certain dividends from a domestic international sales corporation (DISC) or former DISC,
6) Certain distributions from a foreign sales corporation (FSC) or former FSC,
7) Any lump-sum distributions from employer benefit plans for which the special averaging treatment is used to determine your tax, and
8) All other income not included in the above categories (***general limitation income***).

In figuring your separate limits, you must combine the income (and losses) in each category from all foreign sources, and then apply the limit.

**Income from controlled foreign corporations.** As a U.S. shareholder, certain income that you receive or accrue from a controlled foreign corporation (CFC) is treated as separate limit income. You are considered a U.S. shareholder in a CFC if you own 10% or more of the total voting power of all classes of the corporation's stock.

Subpart F inclusions, interest, rents, and royalties from a CFC are generally treated as separate limit income to the extent that they are attributable to the separate limit income of the CFC. A dividend paid or accrued out of the earnings and profits of a CFC is treated as separate limit income in the same proportion that the part of earnings and profits attributable to income in the separate category bears to the total earnings and profits of the CFC.

**Partnership distributive share.** In general, a partner's distributive share of partnership income is treated as separate limit income to the extent it is from the separate limit income of the partnership. However, if the partner owns less than a 10% interest in the partnership, the income is generally treated as passive income.

## Passive Income

Passive income generally includes dividends, interest, rents, royalties, and annuities. It also includes gains from the sale of non-income-producing investment property or property that generates passive income. Gains from commodities transactions are included, except for hedging and active business gains or losses of producers, processors, merchants, or handlers of commodities. Passive income also includes amounts you must include as foreign personal holding company income under section 551(a) or 951(a) of the Internal Revenue Codes and amounts includible under section 1293 of the Internal

Revenue Code (relating to certain passive foreign investment companies).

If you receive foreign source distributions from a ***mutual fund*** that elects to pass through to you the foreign tax credit, the income is generally considered passive. The mutual fund will need to provide you with this information.

**What is not passive income.** Passive income does not include gains from the sale of inventory property or property held mainly for sale to customers in the ordinary course of your trade or business. Passive income also does not include export financing interest, high-taxed income, active business rents and royalties from unrelated persons, or any income that is defined in another separate limit category.

***Export financing interest.*** This is interest derived from financing the sale or other disposition of property for use outside the United States if:

1) The property is manufactured or produced in the United States, and
2) 50% or less of the value of the property is due to imports to the United States.

***High-taxed income.*** This is passive income subject to foreign taxes that are higher than the highest U.S. tax rate that can be imposed on the income. The high-taxed income and the taxes imposed on it are moved from the passive income category into the general limitation income category.

## High Withholding Tax Interest

High withholding tax interest is interest (except export financing interest) that is subject to a foreign withholding tax or other tax determined on a gross basis of at least 5%. If interest is not high withholding tax interest because it is export financing interest, it is usually general limitation income. However, if it is received by a financial services entity, it is financial services income.

## Financial Services Income

Financial services income generally is income received or accrued by a financial services entity. This is an entity predominately engaged in the active conduct of a banking, financing, insurance, or similar business. If you qualify as a financial services entity, financial services income includes income from the active conduct of such business, passive income, certain incidental income, and export financing interest which is subject to a foreign withholding or gross-basis tax of at least 5%. Financial services income does not include any export financing interest or high withholding tax interest (except, as noted above, when the export financing interest is subject to a high withholding tax and is received by a financial services entity).

Effective on August 5, 1997, financial services income includes high-taxed income, discussed earlier.

## Shipping Income

This is income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce or income derived from space or ocean activities. It also includes income from the sale or other disposition of these aircraft or vessels. Shipping income that is also financial services income is treated as financial services income.

## DISC Dividends

This dividend income generally consists of dividends from an interest charge domestic international sales corporation (DISC) or former DISC that are treated as foreign source income.

## FSC Distributions

These are:

1) Distributions from a foreign sales corporation (FSC) or former FSC out of earnings and profits attributable to foreign trade income, or
2) Interest and carrying charges incurred by an FSC or former FSC from a transaction that results in foreign trade income.

## Lump-Sum Distribution

If you receive a foreign-source lump-sum distribution (LSD) from a retirement plan, and you figure the tax on it using the special averaging treatment for LSDs, you must make a special computation.

*The special averaging treatment for LSDs is elected by filing Form 4972,* Tax on Lump-Sum Distributions.

Follow the Form 1116 instructions and complete the worksheet in those instructions to determine your foreign tax credit on the LSD.

## General Limitation Income

This is income from sources outside the United States that does not fall into one of the other separate limit categories. It generally includes active business income as well as wages, salaries, and overseas allowances of an individual as an employee.

# Allocation of Foreign Taxes

If you have paid or accrued foreign income tax for a tax year on income in more than one separate limit income category, but the tax is not specifically related to any one category, you must allocate the tax to each category of income.

You do this by multiplying the foreign income tax related to more than one category by a fraction. The numerator of the fraction is the net income in a separate category. The denominator is the total net foreign income.

You figure net income by deducting from the gross income in each category and from the total foreign income any expenses, losses, and other deductions definitely related to them under the laws of the foreign country or U.S. possession. If the expenses, losses, and other deductions are not definitely related to a category of income under foreign law, they are apportioned under the principles of the foreign law. If the foreign law does not relate the expenses to a particular category of income and does not provide for apportionment, use the principles covered in the U.S. Internal Revenue Code.

***Example.*** You paid foreign income taxes of $3,200 to Country A on wages of $80,000 and interest income of $3,000. These were the only items of income on your foreign return. You also have deductions of $4,400 that, under foreign law, are not definitely related to either the wages or interest income.

Because the foreign tax is not specifically for either item of income, you must allocate the tax between the wages and the interest under the tax laws of Country A. For purposes of this example, assume that the laws of Country A do this in a manner similar to the U.S. Internal Revenue Code. First figure the net income in each category by allocating those expenses that are not definitely related to either category of income. You figure the expenses allocable to wages (general limitation income) as follows:

$$\frac{\$80{,}000 \text{ (wages)}}{\$83{,}000 \text{ (total income)}} \times \$4{,}400 = \$4{,}241$$

The net wages are $75,759 ($80,000 – $4,241).

You figure the expenses allocable to interest (passive income) as follows:

$$\frac{\$3{,}000 \text{ (interest)}}{\$83{,}000 \text{ (total income)}} \times \$4{,}400 = \$159$$

The net interest is $2,841 ($3,000 – $159).

Then, to figure the foreign tax on the wages, you multiply the total foreign income tax by the following fraction:

$$\frac{\$75{,}759 \text{ (net wages)}}{\$78{,}600 \text{ (total net income)}} \times \$3{,}200 = \$3{,}084$$

You figure the foreign tax on the interest income as follows:

$$\frac{\$2{,}841 \text{ (net interest)}}{\$78{,}600 \text{ (total net income)}} \times \$3{,}200 = \$116$$

# Foreign Taxes From a Partnership

If you are a partner in a partnership that has foreign income and the partnership paid or accrued foreign income tax, you will figure your credit using certain information from the Schedule K–1 you received from the partnership. To figure your credit, you will need to refer to lines 17a through 17g on the Schedule K–1. Line 17e is the foreign tax that was paid or accrued on your behalf by the partnership.

**S corporation.** If you own stock in an S corporation and receive a Schedule K–1 (Form 1120S), you will find this information about foreign taxes on lines 15a through 15g.

# Figuring the Limit

For each category of income, you must figure:

1) Your taxable income from sources outside the United States, and
2) Your total taxable income from all sources.

You must do this before you can determine the limit on your credit.

**Taxable income.** Your taxable income is gross income less any deductions that apply.

For this computation, do not include in your gross income any earned income that is exempt from tax under the foreign earned income exclusion or the foreign housing exclusion. These exclusions from income are discussed in detail in Publication 54.

Table 3. **Source of Income**

| Item of Income | Factor Determining Source |
|---|---|
| Salaries, wages, other compensation | Where services performed |
| Business income: | |
| Personal services | Where services performed |
| Sale of inventory — purchased | Where sold |
| Sale of inventory — produced | Allocation |
| Interest | Residence of payer |
| Dividends | Whether a U.S. or foreign corporation[1] |
| Rents | Location of property |
| Royalties: | |
| Natural resources | Location of property |
| Patents, copyrights, etc. | Where property is used |
| Sale of real property | Location of property |
| Sale of personal property | Seller's tax home (but see the discussion under *Capital Gains and Losses,* later, for exceptions) |
| Pensions | Where services were performed that earned the pension |
| Sale of natural resources | Allocation |

[1] Exceptions include:
a) Dividends paid by a U.S. Corporation are foreign source if the corporation elects the Puerto Rico economic activity credit or possessions tax credit.
b) Part of a dividend paid by a foreign corporation is U.S. source if at least 25% of the corporation's gross income is effectively connected with a U.S. trade or business for the 3 tax years before the year in which the dividends are paid.

***Self-employed.*** If you are self-employed, the type of business or profession you are in determines what you must include in gross income. If you are in a manufacturing, selling, or mining business, gross income is gross profit (gross receipts less cost of goods sold). If you are in a business of providing services, then gross income is gross receipts.

## Determining the Source of Income

Before you can figure your taxable income in each category from sources outside the United States, you must first determine whether your gross income in each category is from U.S. sources or foreign sources. Some of the general rules for figuring the source of income are outlined in *Table 3.*

## Determining Taxable Income From Sources Outside the United States

To figure your taxable income in each category from sources outside the United States, you first ***allocate*** to specific classes (kinds) of gross income the expenses, losses, and other deductions (including the deduction for foreign housing costs) that are ***definitely related*** to that income.

**Definitely related.** A deduction is definitely related to a specific class of gross income if it is incurred either:

1) As a result of, or incident to, an activity from which that income is derived, or
2) In connection with property from which that income is derived.

**Classes of gross income.** You must determine which of the following classes of gross income your deductions are definitely related to:

1) Compensation for services, including wages, salaries, fees, and commissions,
2) Gross income from business,
3) Gains from dealings in property,
4) Interest,
5) Rents,
6) Royalties,
7) Dividends,
8) Alimony and separate maintenance,
9) Annuities,
10) Pensions,
11) Income from life insurance and endowment contracts,
12) Income from cancelled debts,
13) Your share of partnership gross income,
14) Income in respect of a decedent, and
15) Income from an estate or trust.

***Exempt income.*** When you allocate deductions that are definitely related to one or more classes of gross income, you take exempt income into account for the allocation. However, do not take exempt income into account to apportion deductions that are not definitely related to a separate limit category.

***Interest expense and state income taxes.*** You must allocate and apportion your interest expense and state income taxes under the special rules discussed later under *Interest expense* and *State income taxes.*

***Class of gross income that includes more than one separate limit category.*** If the class of gross income to which a deduction definitely relates includes either:

1) More than one separate limit category, or
2) At least one separate limit category and U.S. source income,

you must ***apportion*** the definitely related deductions within that class of gross income.

To apportion, you can use any method that reflects a reasonable relationship between the deduction and the income in each separate limit category. One acceptable method for many individuals is based on a comparison of the gross income in a class of income to the gross income in a separate limit income category.

Use the following formula to figure the amount of the definitely related deduction apportioned to the income in the separate limit category:

$$\frac{\text{Gross income in separate limit category}}{\text{Total gross income in the class}} \times \text{deduction}$$

Do not take exempt income into account when you apportion the deduction. However, income excluded under the foreign earned income or foreign housing exclusion is ***not considered exempt.*** You must, therefore, apportion deductions to that income.

**Interest expense.** Generally, you apportion your interest expense on the basis of your assets. However, certain special rules apply. If you have gross foreign source income (including income that is excluded under the foreign earned income exclusion ) of $5,000 or less, your interest expense can be apportioned entirely to domestic source income.

***Business interest.*** Apportion interest incurred in a trade or business using the asset method based on your business assets.

Under the asset method, you apportion the interest expense to your separate limit categories based on the value of the assets that produced the income. You can value assets at fair market value or the tax book value.

***Investment interest.*** Apportion this interest on the basis of your investment assets.

***Passive activity interest.*** Apportion interest incurred in a passive activity on the basis of your passive activity assets.

***Home mortgage interest.*** This is your deductible home mortgage interest from Schedule A (Form 1040). Apportion it under a gross income method, taking into account all income (including business, passive activity, and investment income), but excluding income that is exempt under the foreign earned income exclusion. The gross income method is based on a comparison of the gross income in a separate limit category with total gross income.

The Instructions for Form 1116 have a worksheet for apportioning your deductible home mortgage interest expense.

For this purpose, however, any qualified residence that is rented is considered a business asset for the period in which it is rented. You therefore apportion this interest under the rules for passive activity or trade or business interest.

***Example.*** You are engaged in a business that you operate as a sole proprietorship. Your business generates only U.S. source income. Your investment portfolio consists of several less than 10% stock investments. You have stocks with an adjusted basis of $100,000. Some of your stocks (with an adjusted basis of $40,000) generate U.S. source income; your other stocks (with an adjusted basis of $60,000) generate foreign passive income. You own your main home, which is subject to a mortgage of $120,000. Interest on this loan is home mortgage interest. You also have a bank loan in the amount of

$40,000. The proceeds were divided equally between your business and your investment portfolio. Your gross income from your business is $50,000. Your investment portfolio generated $4,000 in U.S. source income and $6,000 in foreign source passive income. All of your debts bear interest at the annual rate of 10%.

The interest expense for your business is $2,000. It is apportioned on the basis of the business assets. All of your business assets generate U.S. source income; therefore, they are U.S. assets. The $2,000 in interest expense on the business loan is allocable to U.S. source income.

The interest expense for your investments is also $2,000. It is apportioned on the basis of investment assets. Your assets consist of stock (adjusted basis, $40,000) generating U.S. source income and stock (adjusted basis, $60,000) generating foreign source passive income. For purposes of figuring the limit on the foreign tax credit, 40% ($40,000/$100,000) or $800 (40% of $2,000) of your investment interest is apportioned to U.S. source income and 60% ($60,000/$100,000) or $1,200 (60% of $2,000) is apportioned to foreign passive income.

Your home mortgage interest expense is $12,000. It is apportioned on the basis of all your gross income. Your gross income consists of $60,000, $54,000 of which is U.S. source income and $6,000 of which is foreign source passive income. Thus, $1,200 ($6,000/$60,000 × $12,000) of the home mortgage interest is apportioned to foreign source passive income.

**State income taxes.** State income taxes (and certain taxes measured by taxable income) are definitely related and allocable to the gross income on which the taxes are imposed. If you pay this kind of state tax and it is imposed in part on foreign source income, the part of your state tax imposed on the foreign source income is definitely related and allocable to foreign source income.

***Foreign income not exempt from state tax.*** If the state does not specifically exempt foreign income from tax, the following are true:

1) If the total income taxed by the state is ***greater than*** the amount of U.S. source income for federal tax purposes, then the state tax is allocable to both U.S. source and foreign source income.

2) If the total income taxed by the state is ***less than or equal to*** the U.S. source income for federal tax purposes, none of the state tax is allocable to foreign source income.

***Foreign income exempt from state tax.*** If state law specifically exempts foreign income from tax, the state taxes are definitely allocable to the U.S. source income.

***Example.*** Your total income for federal tax purposes, before deducting state tax, is $100,000. Of this amount, $25,000 is foreign source income and $75,000 is U.S. source income. Your total income for state tax purposes is $90,000, on which you pay state income tax of $6,000. The state does not specifically exempt foreign source income from tax. The total state income of $90,000 is greater than the U.S. source income for federal tax purposes. Therefore, the $6,000 is definitely related and allocable to gross income that includes foreign source income.

Assuming that $15,000 ($90,000 − $75,000) is the foreign source income taxed by the state, $1,000 of state income tax is allocated to foreign source income, figured as follows:

$$\frac{\$15,000}{\$90,000} \times \$6,000 = \$1,000$$

**Deductions not definitely related.** You must apportion to your foreign income in each separate limit category ***a fraction*** of your other expenses that are not definitely related to a specific class of gross income. If you itemize, these deductions are medical expenses, charitable contributions, and real estate taxes for your home. If you do not itemize, this is your standard deduction. In addition to those amounts, you should take into account any other deductions that are not definitely related to a specific class of income, including amounts shown on Form 1040, lines 23–30a.

The ***numerator*** of the fraction is your gross foreign income in the separate limit category, and the ***denominator*** is your total gross income from all sources. For this purpose, gross income includes income that is excluded under the foreign earned income provisions.

**Itemized deduction limit.** For 1997, you may have to reduce your itemized deductions if your adjusted gross income is more than $121,200 ($60,600 if married filing separately). This reduction does not apply to medical and dental expenses, casualty and theft losses, gambling losses, and investment interest.

You figure the reduction by using the Itemized Deduction Worksheet in the instructions for Schedule A (Form 1040). Line 3 of the worksheet shows the total itemized deductions subject to the reduction. Line 9 shows the amount of the reduction.

To determine your taxable income from sources outside the United States, you must first divide the reduction (line 9 of the worksheet) by the deductions subject to the reduction (line 3 of the worksheet). This is your reduction percentage. Then, multiply the deduction shown on Schedule A (Form 1040) by your reduction percentage. Subtract the result from the deduction shown on Schedule A to determine the amount you can allocate to income from sources outside the United States.

***Example.*** You are single and have an adjusted gross income of $150,000. This is the amount on line 5 of the worksheet. Your itemized deductions other than medical and dental expenses, casualty and theft losses, gambling losses, and investment interest total $20,000. This is the amount on line 3 of the worksheet. Reduce your adjusted gross income (line 5) by $121,200. Enter the result ($28,800) on line 7. The amount on line 8 is $864 ($28,800 × 3%). This amount is also entered on line 9.

You have a charitable contribution deduction of $12,000 shown on Schedule A (Form 1040) that is subject to the reduction. Your reduction percentage is 4.3% ($864/$20,000). You must reduce your $12,000 deduction by $516 (4.3% × $12,000). The reduced deduction, $11,484 ($12,000 − $516), is used to determine your taxable income from sources outside the United States.

**Treatment of personal exemptions.** Do not take the deduction for personal exemptions, including exemptions for dependents, in figuring ***taxable income from sources outside the United States.***

**Taxable income from all sources.** You also figure your total taxable income from all sources without regard to personal exemptions, including exemptions for dependents. You get this figure from line 36, Form 1040.

**U.S. tax liability.** You figure your U.S. tax liability on your taxable income, figured by taking into account the deduction for personal exemptions and exemptions for dependents. You use the amount on line 39, Form 1040, ***less*** any amounts on lines 40, 41, 42, and any mortgage interest credit and District of Columbia first-time homebuyer credit on line 44 of Form 1040.

## Example of Figuring the Limit

Chris Smith is single, under 65, and has been a bona fide resident of Country A for 5 years. Chris earned a salary of $85,000 in Country A. He also had interest income of $5,000 from investments in that country on which he paid an investment counseling fee of $700. Chris paid income tax to Country A on these amounts. In addition, he received $5,000 dividend income from sources in the United States. Chris contributed $500 to his church and other charitable organizations in the United States. He paid $1,500 real estate taxes on his residence in Country A, and deductible interest of $2,500 on his mortgage in Country A.

Chris' income subject to U.S. tax is the total received from all sources. However, from the $85,000 salary received in Country A, he excludes $70,000 under the foreign earned income exclusion. His adjusted gross income is $25,000. Chris' salary is in the general limitation income category. His interest income is in the passive income category. Therefore, he needs to figure two limits. The limits on Chris' salary and interest income are $1,529 and $548, respectively, as shown in ***Table 4***.

# Capital Gains and Losses

If you show a capital gain on both lines 16 and 17 of Schedule D (Form 1040), you must adjust the denominator of your limiting fraction. Complete the *Worksheet for Line 17,* found in the Form 1116 instructions, to figure your adjusted denominator.

If you have any foreign source capital gain or loss, you must adjust the denominator of your limiting fraction. See *Adjustment for Foreign Source Capital Gains and Losses* later.

**Foreign source capital gain.** Your taxable income from foreign sources in a separate limit category (the numerator of the limiting fraction) includes gains from the sale or exchange of capital assets up to the amount of ***foreign source capital gain net income.*** Your taxable income from all sources (the denominator of the fraction) includes gains from the sale or exchange of capital assets up to the amount of ***capital gain net income.***

## Table 4. **Chris Smith Example**

Chris computes his Form 1040 U.S. tax liability as follows.

| | | | |
|---|---|---|---|
| **A.** | **Income Subject to U.S. Tax** | | |
| | 1) Salary (Country A) | | $85,000 |
| | 2) Less: Foreign earned income exclusion | | 70,000 |
| | 3) Salary includible in U.S. federal tax return | | $15,000 |
| | 4) Interest (Country A) | | 5,000 |
| | 5) Dividends (United States) | | 5,000 |
| | 6) Adjusted gross income | | $25,000 |
| **B.** | **Less: Itemized Deductions** | | |
| | 1) Contributions (United States) | $ 500 | |
| | 2) Taxes on residence (Country A) | 1,500 | |
| | 3) Home mortgage interest (Country A) | 2,500 | |
| | 4) Investment counselling fee (Country A) ($700 - 500, 2% of AGI) | 200 | |
| | 5) Total itemized deductions | | 4,700 |
| **C.** | **Taxable Income Before Personal Exemption** | | $20,300 |
| **D.** | **Less: Personal Exemption** | | 2,650 |
| **E.** | **Taxable Income** | | $17,650 |
| **F.** | **U.S. Tax Liability from Tax Table under Single Column** | | $2,651 |

Chris computes his Form 1116 taxable general limitation income from Country A as follows.

| | | | | |
|---|---|---|---|---|
| **G.** | **Computation of Taxable Income from Country A (General Limitation Income)** | | | |
| | 1) General limitation income from Country A includible in U.S. federal income tax return (Line A(3)) | | | $15,000 |
| | 2) Home mortgage interest apportioned to general limitation income (Line B(3)) $2,500 × ($15,000 / $25,000) | | 1,500 | |
| | 3) Total itemized deductions (Line B(5)) | $4,700 | | |
| | 4) Less: Home mortgage interest, plus itemized deductions definitely related to specific income items (Lines B(3) and (4)) | 2,700 | | |
| | 5) Itemized deductions to be apportioned | $2,000 | | |
| | 6) Ratable part of $2,000 applicable to general limitation income $2,000 × ($85,000 (Lines A(2) and G(1)) / $95,000 (Lines A(2) and A(6))) | | 1,789 | |
| | 7) Total deductions that apply to general limitation income | | | 3,289 |
| | 8) Taxable income in general limitation income category | | | $11,711 |

Chris computes his Form 1116 taxable passive income from Country A as follows. (A separate Form 1116 is needed for each category of income.)

| | | | | |
|---|---|---|---|---|
| **H.** | **Computation of Taxable Income from Country A (Passive Income)** | | | |
| | 1) Passive income from Country A includible in U.S. federal income tax return (Line A(4)) | | | $5,000 |
| | 2) Expenses definitely related to passive income (Line B(4)) | | $200 | |
| | 3) Home mortgage interest apportioned to passive income (Line B(3)) $2,500 × ($ 5,000 / $25,000) | | 500 | |
| | 4) Total itemized deductions (Line B(5)) | $4,700 | | |
| | 5) Less: Home mortgage interest, plus itemized deductions definitely related to specific income items (Lines B(3) and (4)) | 2,700 | | |
| | 6) Itemized deductions to be apportioned | $2,000 | | |
| | 7) Ratable part of $2,000 applicable to income category $2,000 × ($5,000 (Line A(4)) / $95,000 (Lines A(2) and A(6))) | | 105 | |
| | 8) Total deductions that apply to passive income | | | 805 |
| | 9) Taxable income in passive income category | | | $4,195 |

Chris computes his credit limit for each category of income. (See discussion of this calculation earlier under *Limit on the Credit*.)

| | | |
|---|---|---|
| **I.** | **Computation of Taxable Income from All Sources for Purposes of the Foreign Tax Credit** | |
| | Taxable income from all sources (Line C) | $20,300 |
| **J.** | **Computation of the Limit on Foreign Tax Credit Allowable (General Limitation Income)** | |
| | ($11,711 (Line G(8)) / $20,300 (Line I)) × $2,651 (Line F) | $ 1,529 |
| **K.** | **Computation of the Limit on Foreign Tax Credit Allowable (Passive Income)** | |
| | ($4,195 (Line H(9)) / $20,300 (Line I)) × $2,651 (Line F) | $ 548 |

***Foreign source capital gain net income.*** Foreign source capital gain net income for a separate limit category is the lesser of:

1) Capital gain net income from foreign sources in the separate limit category, or
2) Capital gain net income from all sources in that category.

***Capital gain net income.*** This is the excess of your gains from sales or exchanges of capital assets over your losses from sales or exchanges of capital assets. This includes net section 1231 gain.

***Capital asset.*** Generally, everything you own and use for personal purposes or investment is a capital asset. Some examples are: stocks or bonds held in your personal account, a home owned and occupied by you and your family, household furnishings, a car used for pleasure or commuting, coin or stamp collections, gems and jewelry, and gold, silver, or any other metal.

***Net section 1231 gain.*** Section 1231 property includes property used in a trade or business and held more than one year. It also includes any capital asset held in connection with a trade or business or a transaction entered into for profit that is subjected to an involuntary conversion, if held for more than one year. You combine all gains and losses from the sales and dispositions of section 1231 property for the tax year. If your section 1231 gains exceed your section 1231 losses, you have a net section 1231 gain. For more information on these gains, see Publication 544, *Sales and Other Dispositions of Assets.*

***Example.*** You are a U.S. citizen and live in Country X. You had a $10,000 long-term capital gain and a $2,000 long-term capital loss from sales of foreign corporate stock through Country X's stock exchange. This is income in the passive category. You also had a $6,000 long-term capital loss from U.S. sources. Your foreign source capital gain net income is $2,000, the lesser of (1) or (2):

**1) Capital gain net income from foreign sources:**

| | |
|---|---|
| Long-term capital gain—Country X | $10,000 |
| Long-term capital loss—Country X | (2,000) |
| Capital gain net income from foreign sources (passive income category) | $8,000 |

**2) Capital gain net income from all sources:**

| | |
|---|---|
| Long-term capital gain—Country X | $10,000 |
| Long-term capital loss—Country X | (2,000) |
| Long-term capital loss—U.S. | (6,000) |
| Capital gain net income from all sources | $2,000 |

When figuring the limit in your passive income category, the amount to include in the numerator of the limiting fraction is $2,000. The amount to include in the denominator is also $2,000, capital gain net income from all sources. However, these amounts will have to be adjusted. See *Adjustment for Foreign Source Capital Gains and Losses* later.

**Foreign source capital loss.** Your taxable income from foreign sources in a separate limit category (the numerator of the limiting fraction) is reduced by any net capital loss from foreign sources in that category, to the extent taken into account in figuring your capital gain net income. For this purpose, your net capital loss is the total of your losses from the sale or exchange of capital assets and any capital loss carryover less your cap-

ital loss deduction limit for the tax year. Generally your capital loss deduction limit is $3,000 ($1,500 if married filing separately).

When figuring net capital loss, include gains and losses that are not from the sale or exchange of capital assets but that are treated as capital gains and losses, such as net section 1231 gains.

**Sales or exchanges of certain personal property.** Generally, if personal property is sold by a U.S. resident, the income from the sale is treated as U.S. sourced. If sold by a nonresident, the income is treated as foreign sourced.

***U.S. resident.*** The term "U.S. resident," for this purpose, means a U.S. citizen or resident alien who does not have a tax home in a foreign country. The term also includes a nonresident alien who has a tax home in the United States. Generally, your tax home is the general area of your main place of business, employment, or post of duty, regardless of where you maintain your family home. Your tax home is the place where you are permanently or indefinitely engaged to work as an employee or self-employed individual. If you do not have a regular or main place of business because of the nature of your work, then your tax home is the place where you regularly live. If you do not fit either of these categories, you are considered an itinerant and your tax home is wherever you work.

***Nonresident.*** A nonresident is any person other than a U.S. resident.

U.S. citizens and resident aliens will not be treated as nonresidents for a sale of personal property ***unless*** an income tax of at least 10% of the gain on the sale is paid to a foreign country.

***Inventory.*** Income from the sale of inventory that you purchased is sourced where the property is sold. Generally, this is where title to the property passes to the buyer.

Income from the sale of inventory that you produced in the United States and sold outside the United States (or vice versa) is sourced based on an allocation. For information on making the allocation, see section 1.863–3 of the Income Tax Regulations.

***Intangibles.*** Income from the sale of intangible property (such as a patent, copyright, trademark, or goodwill) that is contingent on the productivity, use, or disposition of the property is sourced in the country where the property is used. Payments for goodwill are sourced in the country where the goodwill was generated.

***Depreciable property.*** The gain from the sale of depreciable personal property, up to the amount of the previously allowable depreciation, is sourced in the same way as the original deductions were sourced. Thus, to the extent the previous deductions for depreciation were allocable to U.S. source income, the gain is U.S. source. To the extent the depreciation deductions were allocable to foreign sources, the gain is foreign source income. Gain in excess of the depreciation deductions is sourced the same as inventory.

If personal property is ***used predominantly in the United States,*** treat the gain from the sale, up to the amount of the allowable depreciation deductions, entirely as U.S. source income.

If the property is ***used predominantly outside the United States,*** treat the gain, up to the amount of the depreciation deductions, entirely as foreign source income.

Depreciation includes amortization and any other allowable deduction that treats a capital expenditure as a deductible expense.

***Sales through foreign office or fixed place of business.*** Income earned by U.S. residents from the sale of personal property through an office or other fixed place of business outside the United States is generally treated as foreign source if:

1) The income from the sale is from the business operations located outside the United States, and
2) At least 10% of the income is paid as tax to the foreign country.

If less than 10% is paid as tax, the income is U.S. source.

This rule does ***not*** apply to income sourced under the rules for inventory property, depreciable personal property, intangible property (when payments in consideration for the sale are contingent on the productivity, use, or disposition of the property), or goodwill.

## Adjustment for Foreign Source Capital Gains and Losses

If you had a foreign source capital gain or loss, you must adjust the numerator of the limiting fraction. The Form 1116 instructions contain worksheets for figuring the adjustments.

*If you show a foreign or domestic source capital gain on both lines 16 and 17 of Schedule D (Form 1040), you must adjust the denominator of your limiting fraction. Complete the* Worksheet for Line 17 *found in the Form 1116 instructions to figure your adjusted denominator.*

**Foreign Schedule D.** If you had a foreign source capital gain or loss, you must complete a separate Schedule D using only your foreign source capital gains and losses. On this "foreign Schedule D", complete Parts I, II, and III.

If Part III, line 17, is a gain, complete Part IV (through line 50) of that Schedule D. Also complete *Worksheet A (Capital Gains)* in the instructions for Form 1116.

If Part III, line 17, is a loss, you can use *Worksheet B (Capital Losses)* in the instructions for Form 1116 to make the adjustment.

*Use your foreign Schedule D only to compute the adjusted amounts. Do* **not** *file it with your return.*

**More than one category.** If you have foreign source capital gains and losses that are from more than one separate limit income category, complete the "foreign Schedule D" through line 17. Then, depending on whether you have a gain or a loss on line 17, use whichever of the following procedures applies.

***Gain.*** If line 17 of your foreign Schedule D is a gain, take the following steps.

1) Complete a separate foreign Schedule D through line 17 for each separate income category, using only your gains and losses for that category.
2) For each category, follow the procedure discussed under *Foreign Schedule D*, depending on whether line 17 of the separate Schedule D is a gain or loss.
3) Subtract the total of all your adjusted capital losses (line 16 , Worksheet B, if used) from the total of all your adjusted capital gains (line 12, Worksheet A).
4) Compare the amount from step 3 to the amount on line 12 of the *Worksheet for Line 17* in the Form 1116 instructions. (The foreign capital gain net income taken into account for purposes of the foreign tax credit cannot exceed your worldwide capital gain net income.)

   If the amount on line 12 of the *Worksheet for Line 17* is equal to or greater than the amount from step 3, no further adjustment is necessary. For each category include the amount determined in step 2.

   If the amount on line 12 of the *Worksheet for Line 17* is less than the amount from step 3, you must allocate the difference to those categories that have gains. You reduce the gain for each category based on what percent of the total adjusted foreign capital gain is represented by the adjusted gain in that particular category.

***Example.*** You have a total adjusted foreign capital gain (from step 3 ) of $25,000. All categories have gains, $5,000 is from the general limitation category. The amount on line 12 of the *Worksheet for Line 17* is $22,580. Since the amount is less than the amount from step 3, you must allocate the difference, $2,420 ($25,000 − $22,580) to each of the categories. You must reduce the gain in the general limitation category by $484 ($5,000/$25,000 × $2,420). On the Form 1116 that you complete for the general limitation category, you would include $4,516 ($5,000 − $484) as your capital gain on line 1.

***Loss.*** If line 17 of your foreign Schedule D is a loss, you must adjust the amount of your foreign loss based on the gain it offsets. You can use Worksheet B to make this required adjustment. Your adjusted net capital loss appears on line 16 of Worksheet B.

1) Add up the losses from all separate limit income categories that have losses. This is your aggregate foreign loss.
2) Divide the loss from each category by the aggregate foreign loss.
3) For each category, multiply your adjusted net loss (amount from line 16 of Worksheet B, if used) by the amount in step 2. This is your adjusted net loss amount for that category that you include on line 5 of Form 1116 for that separate limit category.

***Example.*** If you have a passive category loss of $2,000 and a general limitation category loss of $3,000, your aggregate foreign loss is $5,000. Assume your net foreign capital loss (the amount from line 17 of your foreign Schedule D) is $4,000 and that after applying and adjustment factor of .5555, your adjusted net capital loss is $2,222. For the passive category, the amount to include on line 5 of Form 1116 is $889 ($2,000 ÷ $5,000] × $2,222).

## Allocation of Foreign Losses

If you have a foreign loss when figuring your taxable income in a separate limit income category, and you have income in one or more of the other separate categories, you must first reduce the income in these other categories by the loss before reducing income from U.S. sources.

***Example.*** You have $10,000 of income in the passive income category and incur a loss of $5,000 in the general limitation income category. You use the $5,000 loss to offset $5,000 of the income in the passive category.

**How to allocate.** You must allocate foreign losses among the separate limit income categories in the same proportion as each category's income bears to total foreign income.

***Example.*** You have a $2,000 loss in the general limitation income category, $3,000 of passive income, and $2,000 in distributions from an FSC. You must allocate the foreign loss to the income in the other separate categories. Sixty percent ($3,000/$5,000) of the $2,000 loss (or $1,200) reduces passive income and forty percent ($2,000/$5,000) or $800 reduces FSC distributions.

***Loss more than foreign income.*** If you have a loss remaining after reducing the income in other separate limit categories, use this excess to reduce U.S. source income. When you use a foreign loss to offset U.S. source income, you must recapture the loss as explained later under *Recapture of Foreign Losses.*

**Recharacterization of subsequent income in a loss category.** If you use a loss in one separate limit category (category A) to reduce the amount of income in another category or categories (category B and/or category C) and, in a later year you have income in category A, you must, in that later year, recharacterize some or all of the income from category A as income from category B and/or category C.

*Do not recharacterize the tax.*

***Example.*** Using the same facts as in the previous example, in the next year you have $4,000 of passive income, $1,000 in FSC distributions, and $5,000 of general limitation income. Since $1,200 of the general limitation loss was used to reduce your passive income in the previous year, $1,200 of the current year's general limitation income of $5,000 must be recharacterized as passive income. This makes the current year's total of passive income $5,200 ($4,000 + $1,200). Similarly, $800 of the general limitation income must be recharacterized as FSC distributions, making the current year's total of FSC distributions $1,800 ($1,000 + $800). The total income in the general limitation category is then $3,000.

**U.S. losses.** Allocate any net loss from sources in the United States among the different categories of foreign income ***after:***

1) Allocating all foreign losses as described above,
2) Recapturing any prior year overall foreign loss as described below, and
3) Recharacterizing foreign source income as described above.

## Recapture of Foreign Losses

If you have only losses in your separate limit categories, or if you have a loss remaining after allocating your foreign losses to other separate categories, you have an overall foreign loss. If you use this loss to offset U.S. source income (resulting in a reduction of your U.S. tax liability), you must recapture your loss in each succeeding year in which you have taxable income from foreign sources.

You make the recapture by treating part of your taxable income from foreign sources in a recapture year as U.S. source income. In addition, if you dispose of property used in your foreign trade or business, you may be considered to have had a gain on the disposition (sale, gift, etc.) because of the recapture-of-foreign-losses provision. The amount you treat as U.S. source income reduces the numerator of the limiting fraction (foreign source income), and therefore reduces the foreign tax credit limit.

You must establish separate accounts for each type of foreign loss that you sustain. The balances in these accounts are the overall foreign loss subject to recapture. Reduce these balances at the end of each tax year by the loss that you recaptured. You must attach a statement to your Form 1116 to report the balances (if any) in your overall foreign loss accounts.

**Overall foreign loss.** An overall foreign loss is the amount by which your gross income from foreign sources for a tax year is exceeded by the sum of your deductions that are directly related or that are allocated to the income. You must allocate to the income a ratable part of any expenses, losses, or other deductions, such as itemized deductions, or the standard deduction if you do not itemize, which are not directly related to an item or class of gross income. You must recapture the overall loss regardless of whether you chose to claim the foreign tax credit for the loss year.

***Example.*** You are single and have gross dividend income of $10,000 from U.S. sources. You also have a greater than 10% interest in a foreign partnership in which you materially participate. The partnership has a loss for the year, and your distributive share of the loss is $15,000. Your share of the partnership's gross income is $100,000, and your share of its expenses is $115,000. Your only foreign source income is your share of partnership income which is in the general limitation income category. You are a bona fide resident of a foreign country and you elect to exclude your foreign earned income. You exclude the maximum $70,000. You also have itemized deductions of $4,700 that are not directly related to any item of income.

In figuring your overall foreign loss in the general limitation category for the year, you must allocate a ratable part of the $4,700 in itemized deductions to the foreign source income. You figure the ratable part of the $4,700 that is for foreign source income, based on gross income, as follows:

$$\frac{\$100{,}000 \text{ (Foreign gross income)}}{\$110{,}000 \text{ (Total gross income)}} \times \$4{,}700 = \$4{,}273$$

Therefore, your ***overall foreign loss*** for the year is $8,773, figured as follows:

| | | |
|---|---|---|
| Foreign gross income | | $100,000 |
| Less: Foreign earned income exclusion | $70,000 | |
| Allowable directly related expenses ($30,000/100,000 × $115,000) | 34,500 | |
| Ratable part of itemized deductions | 4,273 | 108,773 |
| Overall foreign loss | | $8,773 |

***Losses not considered.*** You do not consider the following in figuring an overall foreign loss in a given year:

1) Net operating loss deduction,
2) Foreign expropriation loss not compensated by insurance or otherwise, and
3) Casualty or theft loss not compensated by insurance or other arrangement.

**Losses excepted from overall foreign loss recapture rules.** There is one type of foreign source loss that is excepted from the recapture rules. This is a loss on the sale, exchange, or other disposition of bonds, notes, or other evidences of indebtedness issued before May 14, 1976, by a foreign government or instrumentality for the acquisition of:

1) Property located in that country, or
2) Stock or indebtedness of a corporation created or organized in or under the laws of that foreign country.

**Recapture provision.** If you have an overall foreign loss for any tax year and use the loss to offset U.S. source income, part of your taxable income from foreign sources for each succeeding year is treated as U.S. source taxable income. The part that is treated as U.S. source income is the **least** of:

1) The balance in the applicable overall foreign loss account (to the extent not treated as U.S. source income in a prior tax year),
2) 50% (or a larger percentage that you can choose) of your taxable income from foreign sources for the succeeding tax year, or
3) The foreign source taxable income in the former loss category after the allocation of foreign losses (discussed earlier).

***Example.*** During 1996 and 1997, you are single and a 20% general partner in a partnership that derives its income from Country X. You also receive dividend income from U.S. sources during those years.

For 1996, the partnership had a loss and your share was $20,000, consisting of $80,000 gross income less $100,000 expenses. Your net loss from the partnership is $2,500, after deducting the foreign earned income exclusion and directly related allowable expenses. This is income in the general limitation category. Your U.S. dividend income was $20,000. Your itemized deductions totaled $5,000 and were not definitely related to any item of income. In figuring your taxable income for 1996, you deducted your share of the partnership loss from Country X from your U.S. source income.

During 1997, the partnership had net income from Country X. Your share of the net income was $40,000, consisting of $100,000 gross income less $60,000 expenses. Your net income from the partnership is $12,000, after deducting the foreign earned income

exclusion and the directly related allowable expenses. This is income in the general limitation category. You also received dividend income of $20,000 from U.S. sources. Your itemized deductions were $6,000, which are not directly related to any item of income. You paid income taxes of $4,000 to Country X on your share of the partnership income.

When figuring your foreign tax credit for 1997, you must find the foreign source taxable income that you must treat as U.S. source income because of the foreign loss recapture provisions.

You figure the foreign taxable income that you must recapture as follows:

**A. Determination of 1996 Overall Foreign Loss**

| | | |
|---|---|---|
| 1) Partnership loss from Country X | | $2,500 |
| 2) Add: Part of itemized deductions allocable to gross income from Country X— | | |
| $\frac{\$80{,}000}{\$100{,}000} \times \$5{,}000 = \$4{,}000$ | | |
| 3) Overall foreign loss for 1996 | | $6,500 |

**B. Amount of Recapture for 1997**

| | | |
|---|---|---|
| 1) General limitation category foreign loss to extent not previously recaptured | | $6,500 |
| 2) Foreign source taxable income | $12,000 | |
| Less: Itemized deductions allocable to foreign source taxable income ($100,000 / $120,000 × $6,000) | 5,000 | $7,000 |
| 3) 50% of taxable income subject to recapture | | $3,500 |
| 4) Taxable income in general limitation category after allocation of foreign losses—General limitation taxable income | $12,000 | |
| Less: Itemized deductions allocable to that income ($100,000 / $120,000 × $6,000) | 5,000 | |
| General limitation taxable income less allocated foreign losses — ($7,000 − 0) | $7,000 | |
| 5) Recapture for 1997 (least of (1), (3), or (4)) | | $3,500 |

The amount of the recapture is shown on line 15, Form 1116.

***Recapturing more overall foreign loss than required.*** If you want to make an election or change a prior election to recapture a greater part of the balance of an overall foreign loss account than is required (as discussed earlier), you must attach a statement to your Form 1116 making the election. If you change a prior year's election, you should file an amended tax return.

The statement you attach to Form 1116 must show:

1) The percentage and amount of your foreign taxable income that you are treating as U.S. source income, and
2) The balance (both before and after the recapture) in the overall foreign loss account that you are recapturing.

***Deduction for foreign taxes.*** You can recapture part (or all, if applicable) of an overall foreign loss in tax years in which you deduct, rather than credit, your foreign taxes. You recapture the lesser of:

1) The balance in the applicable overall foreign loss account, or
2) The foreign source taxable income of the same separate limit type that resulted in the overall foreign loss minus the foreign taxes imposed on that income.

**Special rules for losses before 1987.** If you had an overall foreign loss account at the end of your last tax year beginning before 1987, there are special rules for recapturing the balance in subsequent years. You recapture the balance from the ***separate limit income category*** in effect after 1986 that is comparable to the income category for which the loss account was established. For example, if you have a balance in your overall foreign loss account in the former nonbusiness interest income category, you will recapture this loss from the current passive income category.

Recapture overall foreign losses in the former general limitation income category (all other) from your current general limitation, financial services, and shipping income categories.

If the total of these categories subject to the recapture is more than the overall foreign loss to be recaptured, figure the amount of each type of separate limit income to treat as U.S. source income by multiplying the overall foreign loss subject to recapture by a ***fraction***.

The ***numerator*** of the fraction is the income in each separate category from which the loss can be recaptured. The ***denominator*** is the total income of all the separate categories from which the loss can be recaptured. However, if you can show that the loss is from one or more separate limit categories in effect after 1986, then you can recapture the loss from those separate categories only. Make this recapture after you have allocated your foreign losses and before you have recharacterized later income, as discussed earlier.

***When to recapture.*** Recapture an overall foreign loss incurred in a tax year beginning before 1987 before an overall foreign loss incurred in tax years after 1986.

**Dispositions.** If, before you have fully recaptured an overall foreign loss, you dispose of trade or business property used predominantly outside the United States, the disposition is subject to the recapture rules. You are considered to have received and recognized foreign taxable income in the year you dispose of the property.

The foreign source income that you are considered to have received and recognized on the property and that you must treat as U.S. source income is 100% of the lesser of:

1) The fair market value of the property minus your adjusted basis, or
2) The remaining amount of the overall foreign loss not treated as U.S. source income in the current year or any prior tax year.

***Predominant use outside U.S.*** You determine whether property was used predominantly (more than 50% of the time) outside the United States by counting its use during the 3-year period ending on the date of disposition. If you used the property fewer than 3 years, count the use during the period it was used in a trade or business.

***Disposition defined.*** A disposition includes a sale, exchange, distribution, or gift of property, whether or not gain or loss is normally recognized on the transfer. The character of the income recognized solely because of the disposition rules is the same as if you had sold or exchanged the property.

However, a disposition ***does not include*** a disposition of property that is not a material factor in producing income.

***Basis adjustment.*** If gain is recognized on a disposition solely because of an overall foreign loss account balance at the time of the disposition, the recipient of the property can increase its basis by the amount of gain deemed recognized. If the property was transferred by gift, its basis in the hands of the donor immediately prior to the gift is increased by the amount of gain deemed recognized.

## Tax Treaties

The tax treaties to which the United States is a party are designed, in part, to prevent double taxation of the same income by the United States and the treaty country. Certain treaties have special rules you must consider when figuring your foreign tax credit if you are a U.S. citizen residing in the treaty country. These provisions generally allow an additional credit for part of the tax imposed by the treaty partner on U.S. source income. It is separate from, and in addition to, your foreign tax credit for foreign taxes paid or accrued on foreign source income. The treaties that provide for this special credit are those with ***Australia, Barbados, Canada, Czech Republic, Finland, France, Germany, India, Israel, Italy, Kazakhstan, Mexico, the Netherlands, New Zealand, Portugal, Slovak Republic, Spain, Sweden, and Tunisia.*** There is a worksheet at the end of this publication to help you figure the special credit. (But do not use this worksheet to figure the additional credit under the treaties with Australia and New Zealand.)

For more information, write to:

Internal Revenue Service
Assistant Commissioner (International)
Attention: CP:IN:D:CS
950 L'Enfant Plaza South, S.W.
Washington, DC 20024

You can also contact the United States Revenue Service Representatives at the U.S. Embassies in Bonn, London, Mexico City, Paris, Rome, Santiago, Singapore, Sydney, and Tokyo, as appropriate, for assistance.

**Report required.** You may have to report certain information with your return if you claim a foreign tax credit under a treaty provision. To report the necessary information, use **Form 8833,** *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).*

***Penalty for not reporting.*** If you do not report this information, you may have to pay a penalty of $1,000.

# Carryback and Carryover

If, because of the limit on the credit, you cannot use the full amount of qualified foreign taxes paid or accrued in the tax year, you are allowed a 2-year carryback and then a 5-year carryover of the unused foreign taxes.

This means that you can treat the unused foreign tax of a tax year as though the tax were paid or accrued in your 2 preceding and 5 succeeding tax years up to the amount of any excess limit in those years. A period of less than 12 months for which you make a return is considered a tax year.

The ***unused foreign tax*** in each category is the amount of qualified taxes paid or accrued minus the limit for that category. The ***excess limit*** in each category is the amount by which the limit is more than the qualified taxes paid or accrued for that category.

Figure your carrybacks or carryovers separately for each separate limit income category.

The mechanics of the carryback and carryover are illustrated by the following examples.

***Example 1.*** All your foreign income is in the general limitation income category. The limit on your credit and the qualified taxes paid to Country X are as follows:

| | Your limit | Tax paid | Unused foreign tax (+) or excess limit (–) |
|---|---|---|---|
| 1995 | $100 | $50 | –50 |
| 1996 | $200 | $100 | –100 |
| 1997 | $300 | $500 | +200 |

In 1997, you had unused foreign tax of $200 to carry to other years. You are considered to have paid this unused foreign tax first in 1995 (the second preceding tax year) up to the excess limit in that year of $50, and then in 1996 (the first preceding tax year) up to that year's excess limit of $100. You can then carry forward the remaining $50 of unused tax.

***Example 2.*** All your foreign income is in the passive income category. In 1993, you had an unused foreign tax of $200. Since you had no foreign income in 1991 and 1992, you cannot claim a credit for the unused foreign taxes in those years. You can, however, carry forward the unused tax to 1994, 1995, 1996, 1997, and 1998. The limit on your credit and the qualified foreign taxes paid on passive income are as follows:

| | Your limit | Tax paid | Unused foreign tax (+) or excess limit (–) |
|---|---|---|---|
| 1993 | $200 | $400 | +200 |
| 1994 | $200 | $300 | +100 |
| 1995 | $100 | $300 | +200 |
| 1996 | $300 | $150 | –150 |
| 1997 | $400 | $300 | –100 |
| 1998 | $100 | $150 | +50 |

You are not considered to have paid the $200 of unused foreign tax from 1993 in 1994 or 1995 since you have no excess limit in either of those years. Therefore, you carry the tax forward and are considered to have paid it in 1996, up to the excess limit of $150. The carryover reduces your excess limit in that year to zero. The remaining unused foreign tax of $50 can be carried to 1997. At this point, you have fully absorbed the unused foreign tax from 1993 and can carry it no further. You can also carry forward the unused foreign tax from 1994 and 1995.

**Effect of bankruptcy or insolvency.** If your debts are canceled because of bankruptcy or insolvency, you may have to reduce your unused foreign tax carryovers to or from the tax year of the debt cancellation by 33⅓ ¢ for each $1 of canceled debt that you exclude from your gross income. Your bankruptcy estate may have to make this reduction if it has acquired your unused foreign tax carryovers. Also, you may not be allowed to carry back any unused foreign tax to a year before the year in which the bankruptcy case began. For more information, see *Reduction of Tax Attributes* in Publication 908, *Bankruptcy Tax Guide.*

## Time Limit on Tax Assessment

When you carry back an unused foreign tax, IRS is given additional time to assess any tax resulting from the carryback. An assessment can be made up to the end of one year after the expiration of the statutory period for an assessment relating to the year in which the carryback originated.

## Claim for Refund

If you have an unused foreign tax that you are carrying back to the first or the second preceding tax year, you should file Form 1040X, *Amended U.S. Individual Income Tax Return,* for each earlier tax year to which you are carrying the unused foreign tax, and attach a revised Form 1116.

## Taxes All Credited or All Deducted

In a given year, you must either claim a credit for all foreign taxes that qualify for the credit or claim a deduction for all of them. This rule is applied with the carryback and carryover procedure, as follows:

1) You cannot claim a credit carryback or carryover from a year in which you deducted qualified foreign taxes,
2) You cannot deduct unused foreign taxes in any year to which you carry them, even if you deduct qualified foreign taxes actually paid in that year, and
3) You cannot claim a credit for unused foreign taxes in a year to which you carry them unless you also claim a credit for foreign taxes actually paid or accrued in that year.

***Unused taxes carried to deduction year.*** If you carry unused foreign taxes to a year in which you chose to deduct qualified foreign taxes, you must compute a foreign tax credit limit for the deduction year as if you had chosen to credit foreign taxes for that year. To the extent the credit computation results in an excess limit (as defined earlier) for the deduction year, you must treat the unused foreign taxes carried to the deduction year as paid or accrued in that year. You cannot actually deduct or claim a credit for the unused foreign taxes carried to the deduction year. But, this treatment reduces the amount of unused foreign taxes that you can carry to another year.

Because you cannot deduct or claim a credit for unused foreign taxes treated as paid or accrued in a deduction year, you will get no tax benefit for those taxes (the amount absorbed) unless you file a timely refund claim or an amended return to reverse your choice from deducting the taxes to claiming the credit. You have ten years from the due date of the return for the deduction year to make this change. See *Making or Changing Your Choice* discussed earlier under *Choice to Take Credit or Deduction.*

***Example.*** In 1997, you paid foreign taxes of $300 to Country X on income in the passive income category. You have a foreign tax credit carryover of $200 from the same category from 1996. For 1997, you figure your foreign tax credit limit to be $400.

If you choose to claim a credit for your foreign taxes in 1997, you would be allowed a credit of $400, consisting of $300 paid in 1997 and $100 of the $200 carried over from 1996. You will have a credit carryover to 1998 of $100, which is your unused 1996 foreign tax credit carryover.

If you choose to deduct your foreign taxes in 1997, your deduction will be limited to $300, which is the amount of taxes paid in 1997. You are not allowed a deduction for any part of the carryover from 1996. However, you must treat $100 of the credit carryover as used in 1997, because you have an unused credit limit of $100 ($400 limit minus $300 of foreign taxes paid in 1996). This reduces your carryover to later years.

If you claimed the deduction for 1997 and later decided you wanted to receive a benefit for that $100 part of the 1996 carryover, you could reverse the choice of a deduction for 1997. You would have to claim a credit for those taxes by filing an amended return for 1997 within the time allowed.

## Married Couples

For a tax year in which you and your spouse file a joint return, you must figure the unused foreign tax or excess limit in each separate limit category on the basis of your combined income, deductions, taxes, and credits.

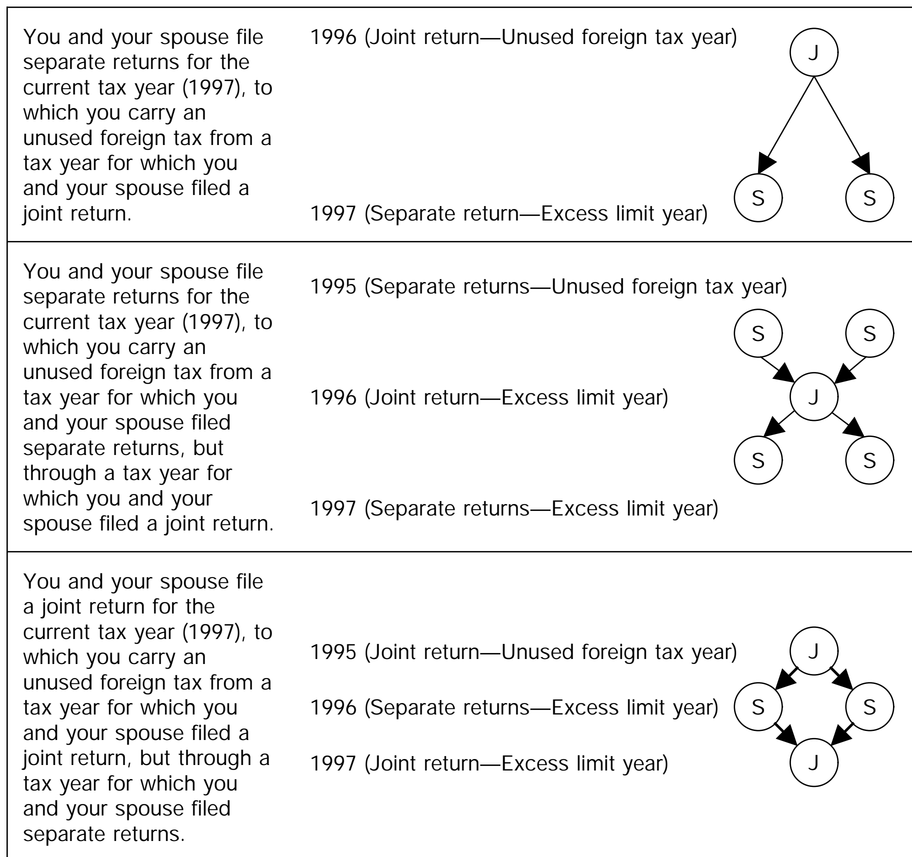
For a tax year in which you and your spouse file separate returns, you figure the unused foreign tax or excess limit by using only your own separate income, deductions, taxes, and credits. However, if you file a joint return for any other year involved in figuring a carryback or carryover of unused foreign tax to the current tax year, you will need to make an allocation, as explained under *Allocations Between Husband and Wife,* later.

**Continuous use of joint return.** If you and your spouse file a joint return for the current tax year, and file joint returns for ***each*** of the other tax years involved in figuring the carryback or carryover of unused foreign tax to the current tax year, you figure the joint carryback or carryover to the current tax year using the joint unused foreign tax and the joint excess limits.

**Joint and separate returns in different years.** If you and your spouse file a joint return for the current tax year, but file separate returns for all the other tax years involved in figuring the carryback or carryover of the unused foreign tax to the current tax year, your separate carrybacks or carryovers will be a joint carryback or carryover to the current tax year.

In other cases in which you and your spouse file joint returns for some years and separate returns for other years, you must make the allocation described in *Allocations Between Husband and Wife,* next.

Figure A. **Allocation Between Husband and Wife**




J—Joint return filed
S—Separate return filed

## Allocations Between Husband and Wife

You may have to allocate an unused foreign tax or excess limit for a tax year in which you and your spouse filed a joint return. This allocation is needed in the following three situations:

1) You and your spouse file separate returns for the current tax year, to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return.
2) You and your spouse file separate returns for the current tax year, to which you carry an unused foreign tax from a tax year for which you and your spouse filed separate returns, but through a tax year for which you and your spouse filed a joint return.
3) You and your spouse file a joint return for the current tax year, to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return, but through a tax year for which you and your spouse filed separate returns.

These three situations are illustrated in ***Figure A***. In each of the situations, 1997 is the current year.

**Method of allocation.** For a tax year in which you must allocate the unused foreign tax or the excess limit for your separate income categories between you and your spouse, you must take the following steps:

1) Figure a percentage for each separate income category by dividing the taxable income of each spouse from sources outside the United States in that category by the joint taxable income from sources outside the United States in that category. Then, apply each percentage to its category's joint foreign tax credit limit to find the part of the limit allocated to each spouse.
2) Figure the part of the unused foreign tax, or of the excess limit, for each separate income category allocable to each spouse. You do this by comparing the allocated limit (figured in (1)), with the foreign taxes paid or accrued by each spouse on income in that category. If the foreign taxes you paid or accrued for that category are more than your part of its limit, you have an unused foreign tax. If, however, your part of that limit is more than the foreign taxes you paid or accrued, you have an excess limit for that category.

**Allocation of the carryback and carryover.** The mechanics of the carryback and carryover, when allocations between husband and wife are needed, are illustrated by the following example.

***Example.*** A Husband (H) and Wife (W) filed joint returns for 1993, 1995, and 1996 and separate returns for 1994 and 1997. Neither H nor W had any unused foreign tax or excess limit for any year before 1993. For the tax years involved, the income, unused foreign tax, excess limits, and carrybacks and carryovers are in the general limitation income category and are shown in *Table 5*.

W's allocated part of the unused foreign tax from 1993 ($30) is partly absorbed by her separate excess limit of $20 for 1994, and then fully absorbed by her allocated part of the joint excess limit for 1995 ($20). H's allocated part of the unused foreign tax from 1993 ($50) is fully absorbed by his allocated part of the joint excess limit ($65) for 1995.

H's separate unused foreign tax from 1994 ($25) is partly absorbed (up to $15) by his remaining excess limit in 1995, and then fully absorbed by W's remaining part of the joint excess limit for 1995 ($10). Each spouse's excess limit on a joint return (for 1995 in this case) is reduced in three ways. First, it is reduced by each one's carryover from earlier years (W has a carryover of unused foreign tax of $10 from 1993). Second, it is reduced by any carryover or carryback from the year of origin of the unused foreign tax under consideration (in this example W had no carryover of unused foreign tax from 1994 but rather an excess limit). Third, it is reduced by the unabsorbed carryover or carryback of the other spouse from the year of origin of the unused foreign tax (H's remaining $10 of unused foreign tax carryover from 1994).

Table 5. **Carryback/Carryover**

| Tax Year | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|
| **Return** | **Joint** | **Separate** | **Joint** | **Joint** | **Separate** |
| H's unused foreign tax to be carried back or over, or excess limit* (enclosed in parentheses) . . . | $50 | $25 | ($65) | $104 | ($50) |
| W's unused foreign tax to be carried back or over, or excess limit* (enclosed in parentheses) . . . | $30 | ($20) | ($20) | $69 | ($10) |
| Carryover absorbed: | | | | | |
| W's from 1993 . . . . . . . . | — | 20W | 10W | — | — |
| H's from 1993 . . . . . . . . | — | — | 50H | — | — |
| H's from 1994 . . . . . . . . | — | — | 15H | — | — |
| " . . . . . . . . | — | — | 10W | — | — |
| W's from 1996 . . . . . . . . | — | — | — | — | 10W |
| H's from 1996 . . . . . . . . | — | — | — | — | 50H |
| W = Absorbed by W's excess limit | | | | | |
| H = Absorbed by H's excess limit | | | | | |

* General limitation income category only

W's allocated part of the unused foreign tax of $69 from 1996 is partly absorbed by her excess limit in 1997 ($10), and the remaining $59 will be a carryover to the general limitation income category for 1998 and the following 3 years unless absorbed sooner. H's allocated part of the unused foreign tax of $104 from 1996 is partly absorbed by his excess limit in 1997 ($50), and the remaining $54 will be a carryover to 1998 and the following 3 years unless absorbed sooner.

### Joint Return Filed in a Deduction Year

When you file a joint return in a deduction year, and carry unused foreign tax through that year from the prior year in which you and your spouse filed separate returns, the amount absorbed in the deduction year is the unused foreign tax of each spouse deemed paid or accrued in the deduction year up to the amount of that spouse's excess limit in that year. You cannot reduce either spouse's excess limit in the deduction year by the other's unused foreign taxes in that year.

# International Boycott

If you participate in or cooperate with an international boycott during the tax year, you have to reduce either your foreign tax credit otherwise allowable or your foreign taxes available for credit. Do this for each separate income category.

Other benefits related to an interest charge domestic international sales corporation (IC-DISC), a controlled foreign corporation (CFC), and a foreign sales corporation (FSC) may be denied.

These rules generally do not apply to employees with wages who are working and living in a boycotting country, or to retirees with pensions who are living in these countries.

***List of boycotting countries.*** A list of the countries which may require participation in or cooperation with an international boycott is published by the Department of the Treasury each calendar quarter. As of the revision date of this publication, the following countries are listed:

Table 6. **Boycotting Countries**

| | |
|---|---|
| Bahrain | Qatar |
| Iraq | Saudi Arabia |
| Kuwait | Syria |
| Lebanon | United Arab Emirates |
| Libya | Republic of Yemen |
| Oman | |

For information concerning changes to the list, write to:

Internal Revenue Service
Assistant Commissioner (International)
Attn: CP:IN:D:CS
950 L'Enfant Plaza South, S.W.
Washington, D.C. 20024.

## Determinations of Whether Boycott Rules Apply

You may request a determination from the Internal Revenue Service as to whether a particular operation constitutes participation in or cooperation with an international boycott. The procedures for obtaining a determination from the Service are outlined in Revenue Procedure 77–9, 1977–1 C.B. 542. You can buy the *Cumulative Bulletin* from the Government Printing Office. Copies are also available in most IRS offices and you are welcome to read them there.

**Public inspection.** A determination is treated as a written determination and is open to public inspection. In addition, any background file related to the determination is open to public inspection. However, your identity and certain other information will remain confidential.

## Reporting Requirements

If you are a ***U.S. person*** (defined later), you must file a report if you:

1) Have operations,
2) Are a member of a controlled group, a member of which has operations,
3) Are a U.S. shareholder who owns 10% or more of the voting power of all voting stock of a foreign corporation that has operations, but only if you own the stock of the foreign corporation directly or through foreign entities,
4) Are a partner in a partnership that has operations, or
5) Are treated as the owner of a trust that has operations

in or related to a boycotting country (or with the government, a company, or national of a boycotting country).

***A U.S. person*** is a citizen or resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust which does not exclude from income its foreign source income that is not effectively connected with the conduct of a trade or business within the United States.

**Form required.** If you have to file a report, you must use **Form 5713,** *International Boycott Report,* and attach all supporting schedules.

You must file the form in duplicate when your tax return is due, including extensions. Send one copy to the Internal Revenue Service Center, Philadelphia, PA 19255. Attach the other copy to your income tax return that you file with your usual Internal Revenue Service Center.

**Penalty for failure to file.** If you willfully fail to make a report, in addition to other penalties, you may be fined not more than $25,000 or imprisoned for no more than one year, or both.

**Confidentiality of reports.** Your reports submitted as part of the tax return are confidential.

# How To Claim the Credit

You must file Form 1116 to claim a credit for foreign taxes. You must also translate your foreign income and taxes into U.S. dollars.

## Form 1116

If you claim the foreign tax credit, you must file a Form 1116 with your U.S. income tax return, Form 1040.

You must file a separate Form 1116 for each of the following categories of income for which you claim a foreign tax credit:

1) Passive income,
2) High withholding tax interest,
3) Financial services income,
4) Shipping income,
5) Dividends from a DISC or former DISC,
6) Certain distributions from an FSC or former FSC,
7) Lump-sum distributions, and
8) General limitation income—all other income from sources outside the United States.

A Form 1116 consists of four parts as explained here:

1) *Part I—Figuring Taxable Income or Loss From Sources Outside the United States for Category Checked Above.* Enter the gross amounts of your foreign or possession source income in the separate limit category for which you are completing the form. From these, subtract the deductions that are definitely related to the separate limit income, and a ratable share of the deductions not definitely related to that income. If, in a separate limit category, you received income from more than one foreign country or U.S. possession, complete a separate column for each. **Note:** If you receive only passive income and your foreign tax paid or accrued is $200 or less ($400 if married filing jointly), you may not have to list each country separately. See the instructions for Form 1116 for more information.
2) *Part II—Foreign Taxes Paid or Accrued.* This part shows the foreign taxes you paid or accrued on the income in the separate limit category in foreign currency and U.S. dollars. If you paid (or accrued) foreign tax to more than one foreign country or U.S. possession, complete a separate line for each.
3) *Part III—Figuring the Credit.* You use this part to figure the foreign tax credit that is allowable.
4) *Part IV—Summary of Credits From Separate Parts III.* You use this part on one Form 1116 to summarize the foreign tax credits figured on separate Forms 1116.

## Records To Keep

You should keep a receipt for each foreign tax payment. If you claim a credit for taxes accrued, you should also keep the foreign tax return on which you based the accrued tax.

Although you do not have to attach proof of the foreign taxes paid or accrued to your Form 1116, you should keep this proof in case you are later asked to verify the taxes shown on your Form 1116.

The receipt or return you keep as proof should be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. If the receipt or return is in a foreign language, you also should provide a certified translation of it. Revenue Ruling 67–308, 1967–2 C.B. 254, discusses in detail the requirements of the certified translation. You can buy the *Cumulative Bulletin* from the Government Printing Office. Copies of the *Cumulative Bulletins* are also available in most IRS offices and you are welcome to read them there.

## Alternative Minimum Tax

In addition to your regular income tax, you may be liable for the alternative minimum tax. The foreign tax credit is allowed to a limited extent against this tax. See the instructions for Form 6251, *Alternative Minimum Tax—Individuals,* for a discussion of the alternative minimum tax and the foreign tax credit applied against it.

## Foreign Currency and Exchange Rates

U.S. income tax is imposed on income expressed in U.S. dollars, while the foreign tax is imposed on income expressed in foreign currency. Therefore, the tax credit is affected when the foreign currency depreciates or appreciates in value in terms of U.S. dollars.

**Rate of exchange for foreign income.** When reporting foreign income on your U.S. income tax return, you must report income and expenses in your functional currency.

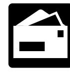
The U.S. dollar is the functional currency for all taxpayers except some qualified business units. A qualified business unit is a separate and clearly identified unit of a trade or business that maintains separate books and records. Therefore, unless you are self-employed, your functional currency is the U.S. dollar.

Even if you are self-employed and have a qualified business unit, your functional currency is the U.S. dollar if ***any*** of the following apply:

1) You conduct the business in dollars.
2) The principal place of business is located in the United States.
3) You choose to or must use the dollar as your functional currency.
4) The business books and records are not kept in the currency of the economic environment in which a significant part of the business activities is conducted.

***Translating foreign currency into U.S. dollars.*** You translate the value of foreign currency into U.S. dollars at the rates of exchange prevailing at the time you actually or constructively received the income or paid the expenses. You should use the rate that most nearly reflects the value of foreign currency—the official rate, the open market rate, or any other appropriate rate. You must be able to justify the rate you use. You can generally get exchange rates from banks and U.S. Embassies.

***Self-employed.*** If you are self-employed in a foreign country, you may have to report income and expenses for that business in foreign currency.



For more information, write to:

Internal Revenue Service
Assistant Commissioner (International)
Attention: CP:IN:D:CS
950 L'Enfant Plaza South, S.W.
Washington, DC 20024

**Rate of exchange for foreign taxes paid.** If you claim the credit for foreign taxes on the ***cash basis,*** use the rate of exchange in effect on the date you paid the foreign taxes to the foreign country. If your tax was withheld in foreign currency, you use the rate of exchange in effect for the date on which the tax is withheld. If you make foreign estimated tax payments, you use the rate of exchange in effect for the date on which you made the estimated tax payment.

If you claim the credit for foreign taxes on an ***accrual basis,*** you should use the rate of exchange in effect on the last day of your tax year in converting the foreign money into U.S. dollars. This is a provisional or interim credit. If a different rate of exchange is in effect when you actually pay the tax, you must make an adjustment to reflect that rate. See *Foreign Tax Redeterminations* under *Credit for Taxes Paid or Accrued* earlier.

# Simple Example — Filled-In Form 1116

Betsy Wilson is a U.S. citizen who owns 200 shares of XYZ company, a German corporation. She received a dividend of $620 from XYZ, which withheld and paid tax of $93 to Germany on her dividend. Betsy will need to complete a Form 1116 to claim the $93 as a credit. Betsy, who is single and under 65, works as a night auditor in Pittsburgh and earns $21,000.

To complete Form 1116, Betsy fills in her name, social security number, and checks the box for passive income. In Part I of the form she writes the name of the foreign country in column A and shows on line 1 the amount of income ($620) and type of income (dividends) she received from XYZ company. Next, since Betsy does not itemize her deductions, she puts her standard deduction ($4,150) on line 3a and completes 3b and 3c. Her gross foreign source income (line 3d) is $620 and gross income from all sources (line 3e) is $21,620. She completes this section and enters $119 on line 6. Line 7 is $501, the difference between lines 1 and 6.

In Part II Betsy completes the form through line 8. This is the amount of tax XYZ withheld and paid to Germany.

In Part III Betsy figures her credit as shown on the completed form. The computation shows that she may take part of the amount paid to Germany as a credit against her U.S. income tax. Because this is the only Form 1116 that Betsy must complete, she does not need to fill in lines 22 through 29 of Part IV. The balance of the foreign tax paid to Germany is available for a carryback and/or carryover.

# Comprehensive Example — Filled-In Form 1116

Robert Smith, a U.S. citizen, is a salesman who lived and worked in Country X for all of 1997, except for one week he spent in the United States on business. He is single and under 65. He is a cash-basis taxpayer who uses the calendar year as his tax year.

During the year, Robert received income from sources within Country X and the United States.

**Income from United States.** Robert received wages of $2,400 for services performed during the one week in the United States. He also received dividend income of $3,000 from sources within the United States.

**Income from Country X.** Robert received the following income from Country X during the year and paid tax on the income to Country X on December 31. The conversion rate throughout the year was 2 pesos to each U.S. dollar (2:1).

| Income | Tax |
|---|---|
| $100,000 wages (200,000 pesos) | $27,400 (54,800 pesos) |
| $4,000 dividend income (8,000 pesos) | $600 (1,200 pesos) |
| $1,000 interest income (2,000 pesos) | $50 (100 pesos) |

***Foreign earned income.*** Robert is a bona fide resident of Country X and figures his allowable exclusion of foreign earned income on Form 2555, *Foreign Earned Income* (not illustrated). He excludes $70,000 of the wages earned in Country X.

***Business expenses.*** Robert paid $3,400 of unreimbursed business expenses, of which $1,000 were definitely related to the wages earned in the U.S. and $2,400 were definitely related to wages earned in Country X.

Robert must prorate the business expenses related to the wages earned in Country X between the wages he includes on his U.S. tax return and the amount he excludes as foreign earned income. He cannot deduct the part of the expenses related to the income that he excludes. He figures his allowable expenses as follows:

$$\frac{\$30,000}{\$100,000} \times \$2,400 = \$720$$

He claims his expenses of $1,720 ($720 + $1,000 from U.S. business trip) as an itemized deduction on Schedule A (Form 1040), subject to the 2% of adjusted gross income limit. The balance, $1,680 ($3,400 – $1,720), is related to the excluded income and not deductible.

Form **1116**

Department of the Treasury
Internal Revenue Service

# Foreign Tax Credit

**(Individual, Estate, Trust, or Nonresident Alien Individual)**

**▶ Attach to Form 1040, 1040NR, 1041, or 990-T.**

**▶ See separate instructions.**

OMB No. 1545-0121

**1997**

Attachment Sequence No. **19**

Name: Betsy Wilson

**Identifying number** as shown on page 1 of your tax return: 111-00-1111

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below. Complete this form for credit for taxes on:

- **a** [X] Passive income
- **b** [ ] High withholding tax interest
- **c** [ ] Financial services income
- **d** [ ] Shipping income
- **e** [ ] Dividends from a DISC or former DISC
- **f** [ ] Certain distributions from a foreign sales corporation (FSC) or former FSC
- **g** [ ] Lump-sum distributions (see page 3 of the instructions before completing form)
- **h** [ ] General limitation income—all other income from sources outside the United States (including income from sources within U.S. possessions)

**i** Resident of (name of country) ▶ United States

**Note:** *If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to* ***more than one*** *foreign country or U.S. possession, use a separate column and line for each country or possession. However, see the exception under* ***How To Complete Form 1116*** *on page 1 of the instructions.*

## Part I Figuring Taxable Income or Loss From Sources Outside the United States for Category Checked Above

| | Foreign Country or U.S. Possession | | | | Total |
|---|---|---|---|---|---|
| | A | B | C | | (Add cols. A, B, and C.) |
| **j** **Enter the name of the foreign country or U.S. possession** ▶ | Germany | | | | |
| **1** Gross income from sources within country shown above and of the type checked above. See page 5 of the instructions: Dividends | 620 | | | 1 | 620 |
| **Deductions and losses** (*Caution: See pages 6 and 7 of the instructions*): | | | | | |
| **2** Expenses **definitely related** to the income on line 1 (attach statement) | | | | | |
| **3** Pro rata share of other deductions **not definitely related:** | | | | | |
| **a** Certain itemized deductions or standard deduction. See instructions | 4,150 | | | | |
| **b** Other deductions (attach statement) | -0- | | | | |
| **c** Add lines 3a and 3b | 4,150 | | | | |
| **d** Gross foreign source income. See instructions | 620 | | | | |
| **e** Gross income from all sources. See instructions | 21,620 | | | | |
| **f** Divide line 3d by line 3e. Do not enter more than "1" | .0287 | | | | |
| **g** Multiply line 3c by line 3f | 119 | | | | |
| **4** Pro rata share of interest expense. See instructions: | | | | | |
| **a** Home mortgage interest. (Use worksheet on page 7 of the instructions) | | | | | |
| **b** Other interest expense | | | | | |
| **5** Losses from foreign sources | | | | | |
| **6** Add lines 2, 3g, 4a, 4b, and 5 | 119 | | | 6 | 119 |
| **7** Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ▶ | | | | 7 | 501 |

## Part II Foreign Taxes Paid or Accrued (See page 7 of the instructions.)

Credit is claimed for taxes (you must check one): (k) [X] Paid (l) [ ] Accrued

| Country | (m) Date paid or accrued | In foreign currency: Taxes withheld at source on: (n) Dividends | (o) Rents and royalties | (p) Interest | (q) Other foreign taxes paid or accrued | In U.S. dollars: Taxes withheld at source on: (r) Dividends | (s) Rents and royalties | (t) Interest | (u) Other foreign taxes paid or accrued | (v) Total foreign taxes paid or accrued (add cols. (r) through (u)) |
|---|---|---|---|---|---|---|---|---|---|---|
| A | 12-31-97 | 145 | | | | 93 | | | | 93 |
| B | | | | | | | | | | |
| C | | | | | | | | | | |

**8** Add lines A through C, column (v). Enter the total here and on line 9, page 2 ▶ **8** 93

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 11440U Form **1116** (1997)

## Part III Figuring the Credit

| Line | Description | | Amount | | Amount |
|---|---|---|---|---|---|
| 9 | Enter amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I | 9 | 93 | | |
| 10 | Carryback or carryover (attach detailed computation) | 10 | -0- | | |
| 11 | Add lines 9 and 10 | 11 | 93 | | |
| 12 | Reduction in foreign taxes. See page 7 of the instructions | 12 | -0- | | |
| 13 | Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit | | | 13 | 93 |
| 14 | Enter amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I. See page 8 of the instructions | 14 | 501 | | |
| 15 | Adjustments to line 14. See page 8 of the instructions | 15 | -0- | | |
| 16 | Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21.) | 16 | 501 | | |
| 17 | **Individuals:** Enter amount from Form 1040, line 36. If you are a nonresident alien, enter amount from Form 1040NR, line 35. **Estates and trusts:** Enter your taxable income without the deduction for your exemption | 17 | 17,470 | | |
| | **Caution:** *If you figured your tax using the special rates on capital gains, see page 9 of the instructions.* | | | | |
| 18 | Divide line 16 by line 17. If line 16 is more than line 17, enter the figure "1" | | | 18 | .0287 |
| 19 | **Individuals:** Enter amount from Form 1040, line 39, **less** any amounts on Form 1040, lines 40, 41, 42, and any mortgage interest credit (from Form 8396) and District of Columbia first-time homebuyer credit (from Form 8859) on line 44. If you are a nonresident alien, enter amount from Form 1040NR, line 38, less any amount on Form 1040NR, lines 39, 40, and any mortgage interest credit (from Form 8396) and District of Columbia first-time homebuyer credit (from Form 8859) on line 42. **Estates and trusts:** Enter amount from Form 1041, Schedule G, line 1c, or Form 990-T, lines 36 and 37 | | | 19 | 2,224 |
| 20 | Multiply line 19 by line 18 (maximum amount of credit) | | | 20 | 64 |
| 21 | Enter the amount from line 13 or line 20, whichever is **smaller.** If this is the only Form 1116 you are completing, skip lines 22 through 29 and enter this amount on line 30. Otherwise, complete the appropriate line in Part IV. See page 9 of the instructions ▶ | | | 21 | 64 |

## Part IV Summary of Credits From Separate Parts III (See page 9 of the instructions.)

| Line | Description | | Amount | | Amount |
|---|---|---|---|---|---|
| 22 | Credit for taxes on passive income | 22 | | | |
| 23 | Credit for taxes on high withholding tax interest | 23 | | | |
| 24 | Credit for taxes on financial services income | 24 | | | |
| 25 | Credit for taxes on shipping income | 25 | | | |
| 26 | Credit for taxes on dividends from a DISC or former DISC | 26 | | | |
| 27 | Credit for taxes on certain distributions from a FSC or former FSC | 27 | | | |
| 28 | Credit for taxes on lump-sum distributions | 28 | | | |
| 29 | Credit for taxes on general limitation income (all other income from sources outside the United States) | 29 | | | |
| 30 | Add lines 22 through 29 | | | 30 | 64 |
| 31 | Reduction of credit for international boycott operations. See instructions for line 12 on page 8 | | | 31 | |
| 32 | Subtract line 31 from line 30. This is your foreign tax credit. Enter here and on Form 1040, line 43; Form 1040NR, line 41; Form 1041, Schedule G, line 2a; or Form 990-T, line 39a ▶ | | | 32 | 64 |

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**Itemized deductions.** Robert was entitled to the following itemized deductions.

| | |
|---|---|
| Interest on home mortgage | $2,900 |
| Real estate tax | 940 |
| Charitable contribution | 460 |
| Employee expenses [$1,720 – $808 ($40,400 × 2%)] | 912 |
| Total | $5,212 |

## Forms 1116

Robert must use two Forms 1116 to figure his allowable foreign tax credit. On one Form 1116, he will mark the block—*General limitation income—all other income from sources outside the United States,* and figure his foreign tax credit on the wages of $100,000. On the other Form 1116, he will mark the block—*Passive income,* and figure his foreign tax credit on his interest income of $1,000 and dividend income of $4,000.

Under the later discussions for each part on the Form 1116, Robert's computations are explained for ***each*** Form 1116 that must be completed. Both Forms 1116 are illustrated at the end of this publication.

## Computation of Taxable Income

Before making any entries on Form 1116, Robert must figure his taxable income on Form 1040.

His taxable income is $32,538, figured as follows:

| **Gross Income** | |
|---|---|
| Wages (Country X) | $100,000 |
| Less: Foreign earned income exclusion | 70,000 |
| | $30,000 |
| Wages (U.S.) | 2,400 |
| Interest income (Country X) | 1,000 |
| Dividend income (U.S.) | 3,000 |
| Dividend income (Country X) | 4,000 |
| Total (Adjusted gross income) | $40,400 |
| **Less: Total Itemized Deductions** | 5,212 |
| Taxable income before the personal exemption | $35,188 |
| **Less: Personal Exemption** | 2,650 |
| **Taxable Income** | $32,538 |

On each Form 1116, Robert enters $35,188 (his taxable income ***before*** the personal exemption) on line 17 of Part III.

## Part I—Figuring Taxable Income or Loss From Sources Outside the United States for Category Checked Above

In figuring the limit on both Forms 1116, Robert must separately determine his taxable income from Country X (line 7 of Form 1116).

To figure his taxable income, Robert first reduces gross income from sources within Country X by expenses and other deductions that are definitely related to the income, and next by a ratable share of all other deductions that are not definitely related to specific income sources. Robert figures the ratable share of deductions not definitely related by using the ratio of gross income from sources within Country X to gross income from all sources. Since Robert itemizes his deductions, he does not consider the standard deduction in his allocation.

**Form 1116—General limitation income.** On this Form 1116, Robert figures his taxable income from Country X for income in the general limitation income category only. He does not include his passive income of interest and dividends.

Robert enters the wages earned in Country X of $30,000 (after subtracting the foreign earned income exclusion) on line 1.

The unreimbursed employee business expenses related to these foreign source wages included in income are $720, as shown earlier. Robert must allocate the 2% of adjusted gross income limit ($808) between these employee business expenses and the employee business expenses related to his U.S. source income ($1,000). He figures this as follows:

$$\frac{\$720}{\$1,720} \times \$808 = \$338$$

The denominator ($1,720) is the total allowable unreimbursed business expenses ($1,000 + $720). The amount of deductible expenses definitely related to $30,000 of taxable foreign wages is $382 ($720 − $338). He enters $382 on line 2. He attaches this explanation to his Form 1116 that he files with his tax return.

Robert enters $1,400 on line 3a. This is the sum of his real estate tax ($940) and charitable contributions ($460), which are itemized deductions not definitely related to income from any source. Robert must prorate these itemized deductions by using the ratio of gross income from Country X in the general limitation category (line 3d) to his gross income from all sources (line 3e). For this purpose, gross income from Country X and gross income from all sources includes the $70,000 of wages that qualify for the foreign earned income exclusion. He figures the ratable part of deductions, $1,268, as follows and enters it on line 3g.

$$\frac{\$100,000}{\$110,400} \times \$1,400 = \$1,268$$

Robert apportions his qualified home mortgage interest, $2,900, to general limitation income as follows:

$$\frac{\$30,000}{\$40,400} \times \$2,900 = \$2,153$$

For this purpose, gross income does not include the wages that qualified for the foreign earned income exclusion. Robert enters this amount, $2,153, on line 4a.

Robert adds the amounts on lines 2, 3g, and 4a and subtracts that total ($3,803) from the amount on line 1 to arrive at foreign source taxable income of $26,197 in this category. Robert enters this amount on line 7.

**Form 1116—Passive income.** On this Form 1116, Robert determines the taxable income from Country X for passive interest and dividend income. He enters the $1,000 interest income and the $4,000 dividend income from Country X on line 1.

Robert figures the part of his itemized deductions allocable to passive income as follows and enters the amount on line 3g.

$$\frac{\$5,000}{\$110,400} \times \$1,400 = \$63$$

Robert apportions the qualified home mortgage interest to passive income as follows:

$$\frac{\$5,000}{\$40,400} \times \$2,900 = \$359$$

He enters this amount, $359, on line 4a.

Robert adds the amounts on lines 3g and 4a and subtracts that total ($422) from the amount on line 1 to arrive at foreign source taxable income of $4,578 in this category. Robert enters this amount on line 7.

## Part II—Foreign Taxes Paid or Accrued

Robert uses Part II, Form 1116, to report the foreign tax paid or accrued on income from foreign sources.

**Form 1116—General limitation income.** On this Form 1116, Robert enters the amount of foreign taxes paid, in foreign currency and in U.S. dollars, on the wages from Country X.

**Form 1116—Passive income.** On this Form 1116, Robert enters the amount of foreign taxes paid, in foreign currency and in U.S. dollars, on the interest and dividend income.

## Part III—Figuring the Credit

Robert figures the amount of foreign tax credit in Part III on each Form 1116.

**Form 1116—General limitation income.** On this Form 1116, Robert figures the amount of foreign tax credit allowable for the foreign taxes paid on his wages from Country X. He has a carryover of $200 for unused foreign taxes paid in 1996 and enters that amount on line 10. He attaches a schedule showing how he figured his $200 carryover to 1997 after carrying back the unused $350 tax paid in 1996 to the 2 preceding tax years. (This schedule is shown in *Table 7.*) The unused foreign tax in 1996 and the excess limits in 1994 and 1995 are in the general limitation income category. The unused foreign tax of $200 is carried over to the general limitation income category in 1997.

On line 12, Robert must reduce the total foreign taxes paid by the amount related to the wages he excludes as foreign earned income. To do this, he multiplies the $27,400 foreign tax he paid on his foreign wages by a fraction. The numerator of the fraction is his foreign earned income exclusion ($70,000) minus a proportionate part of his definitely related business expenses ($1,680). The denominator of the fraction is his total foreign wages ($100,000) minus his total definitely related business expenses ($2,400).

$$\$27,400 \times \frac{(\$70,000 - \$1,680)}{(\$100,000 - \$2,400)} = \$19,180$$

He enters the result, $19,180, on line 12. His total foreign taxes available for credit are $8,420 ($200 + $27,400 − $19,180).

By completing the rest of Part III, Robert finds that his limit is $4,395.

The foreign tax credit on the general limitation income is the lesser of the foreign tax

Table 7. **Robert's Schedule Showing Computation of His Carryover**

| | 1994 | 1995 | 1996 |
|---|---|---|---|
| Maximum credit allowable under limit | $450 | $700 | $1,200 |
| Foreign tax paid in tax year | 400 | 600 | 1,550 |
| Unused foreign tax ( + ) to be carried over or excess of limit ( - ) over tax | - $50 | - $100 | + $350 |
| Tax credit carried back from 1996 | 50 | 100 | |
| Net excess tax to be carried over to 1997 | 0 | 0 | + $350 |
| Less: Carrybacks to 1994 and 1995 | | | 150 |
| Amount carried over to 1997 | | | $200 |

available for credit, $8,420, or the limit, $4,395.

**Form 1116—Passive income.** Robert now figures the foreign tax credit allowable for the foreign taxes he paid on his interest and dividend income from Country X.

By completing Part III of Form 1116, he finds that the limit on his credit is $768.

The foreign tax credit is the lesser of the foreign tax paid, $650, or the limit, $768.

## Part IV—Summary of Credits From Separate Parts III

Robert summarizes his foreign tax credits for the two types of income on Part IV of ***one*** Form 1116. He uses the Part IV of Form 1116—***General limitation income.***

Robert did not participate in or cooperate with an international boycott during the tax year. The allowable foreign tax credit is, therefore, $5,045 ($650 + $4,395), shown on line 32. He also enters this amount on line 41 of Form 1040.

## Unused Foreign Taxes

Robert now determines if he has any unused foreign taxes that can be used as a carryback or carryover to other tax years.

**General limitation income.** Robert has 1997 unused foreign taxes of $4,025 ($8,420 – $4,395) available as a carryover to 1998 and later years. (The foreign taxes related to his foreign earned income exclusion are not available for carryover.) He cannot carry back any part of the 1997 unused taxes to 1995 or 1996 as shown in *Table 7.*

**Passive income.** Since the tax Robert paid on his interest and dividend income is less than the amount for which he could have claimed a credit in 1997 under the limit for this separate income category, he has no unused tax and therefore no carryback or carryover to other tax years.

# How To Get More Information

You can get help from the IRS in several ways.

**Free publications and forms.** To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need. If you are located outside the United States, contact the nearest U.S. embassy.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

**Tax questions.** You can call the IRS with your tax questions. If you are within the United States, check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

If you are located outside the United States, write to:

Internal Revenue Service<br>Assistant Commissioner (International)<br>Attn: CP:IN:D:CS<br>950 L'Enfant Plaza South, S.W.<br>Washington, DC 20024

**TTY/TDD equipment.** If you are in the United States and have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.

**Evaluating the quality of our telephone services.** To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our "800 number" telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

Form **1116**

Department of the Treasury
Internal Revenue Service

# Foreign Tax Credit

**(Individual, Estate, Trust, or Nonresident Alien Individual)**

**▶ Attach to Form 1040, 1040NR, 1041, or 990-T.**

**▶ See separate instructions.**

OMB No. 1545-0121

1997

Attachment Sequence No. 19

Name: Robert Smith

**Identifying number** as shown on page 1 of your tax return: 000-00-0000

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below. Complete this form for credit for taxes on:

- a ☐ Passive income
- b ☐ High withholding tax interest
- c ☐ Financial services income
- d ☐ Shipping income
- e ☐ Dividends from a DISC or former DISC
- f ☐ Certain distributions from a foreign sales corporation (FSC) or former FSC
- g ☐ Lump-sum distributions (see page 3 of the instructions before completing form)
- h ☒ General limitation income—all other income from sources outside the United States (including income from sources within U.S. possessions)

i Resident of (name of country) ▶ Country X

**Note:** *If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to* ***more than one*** *foreign country or U.S. possession, use a separate column and line for each country or possession. However, see the exception under* ***How To Complete Form 1116*** *on page 1 of the instructions.*

## Part I Figuring Taxable Income or Loss From Sources Outside the United States for Category Checked Above

| | Foreign Country or U.S. Possession A | B | C | | Total (Add cols. A, B, and C.) |
|---|---|---|---|---|---|
| j **Enter the name of the foreign country or U.S. possession** ▶ | Country X | | | | |
| 1 Gross income from sources within country shown above and of the type checked above. See page 5 of the instructions: Wages | 30,000 | | | 1 | 30,000 |
| **Deductions and losses** (***Caution:*** *See pages 6 and 7 of the instructions*): | | | | | |
| 2 Expenses **definitely related** to the income on line 1 (attach statement) | 382 | | | | |
| 3 Pro rata share of other deductions **not definitely related:** | | | | | |
| a Certain itemized deductions or standard deduction. See instructions | 1,400 | | | | |
| b Other deductions (attach statement) | | | | | |
| c Add lines 3a and 3b | 1,400 | | | | |
| d Gross foreign source income. See instructions | 100,000 | | | | |
| e Gross income from all sources. See instructions | 110,400 | | | | |
| f Divide line 3d by line 3e. Do not enter more than "1" | .9058 | | | | |
| g Multiply line 3c by line 3f | 1,268 | | | | |
| 4 Pro rata share of interest expense. See instructions: | | | | | |
| a Home mortgage interest. (Use worksheet on page 7 of the instructions) | 2,153 | | | | |
| b Other interest expense | | | | | |
| 5 Losses from foreign sources | | | | | |
| 6 Add lines 2, 3g, 4a, 4b, and 5 | 3,803 | | | 6 | 3,803 |
| 7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ▶ | | | | 7 | 26,197 |

## Part II Foreign Taxes Paid or Accrued (See page 7 of the instructions.)

Credit is claimed for taxes (you must check one): (k) ☒ Paid (l) ☐ Accrued

| Country | (m) Date paid or accrued | Foreign currency: Taxes withheld at source on: (n) Dividends | (o) Rents and royalties | (p) Interest | (q) Other foreign taxes paid or accrued | U.S. dollars: Taxes withheld at source on: (r) Dividends | (s) Rents and royalties | (t) Interest | (u) Other foreign taxes paid or accrued | (v) Total foreign taxes paid or accrued (add cols. (r) through (u)) |
|---|---|---|---|---|---|---|---|---|---|---|
| A | 12-31-97 | | | | 54,800 | | | | 27,400 | 27,400 |
| B | | | | | | | | | | |
| C | | | | | | | | | | |

8 Add lines A through C, column (v). Enter the total here and on line 9, page 2 ▶ 8 27,400

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 11440U Form **1116** (1997)

## Part III Figuring the Credit

| Line | Description | Line | Amount | Line | Amount |
|---|---|---|---|---|---|
| 9 | Enter amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I | 9 | 27,400 | | |
| 10 | Carryback or carryover (attach detailed computation) | 10 | 200 | | |
| 11 | Add lines 9 and 10 | 11 | 27,600 | | |
| 12 | Reduction in foreign taxes. See page 7 of the instructions | 12 | 19,180 | | |
| 13 | Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit | | | 13 | 8,420 |
| 14 | Enter amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I. See page 8 of the instructions | 14 | 26,197 | | |
| 15 | Adjustments to line 14. See page 8 of the instructions | 15 | -0- | | |
| 16 | Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21.) | 16 | 26,197 | | |
| 17 | **Individuals:** Enter amount from Form 1040, line 36. If you are a nonresident alien, enter amount from Form 1040NR, line 35. **Estates and trusts:** Enter your taxable income without the deduction for your exemption | 17 | 35,188 | | |
| | **Caution:** *If you figured your tax using the special rates on capital gains, see page 9 of the instructions.* | | | | |
| 18 | Divide line 16 by line 17. If line 16 is more than line 17, enter the figure "1" | | | 18 | .7445 |
| 19 | **Individuals:** Enter amount from Form 1040, line 39, **less** any amounts on Form 1040, lines 40, 41, 42, and any mortgage interest credit (from Form 8396) and District of Columbia first-time homebuyer credit (from Form 8859) on line 44. If you are a nonresident alien, enter amount from Form 1040NR, line 38, less any amount on Form 1040NR, lines 39, 40, and any mortgage interest credit (from Form 8396) and District of Columbia first-time homebuyer credit (from Form 8859) on line 42. **Estates and trusts:** Enter amount from Form 1041, Schedule G, line 1c, or Form 990-T, lines 36 and 37 | | | 19 | 5,903 |
| 20 | Multiply line 19 by line 18 (maximum amount of credit) | | | 20 | 4,395 |
| 21 | Enter the amount from line 13 or line 20, whichever is **smaller.** If this is the only Form 1116 you are completing, skip lines 22 through 29 and enter this amount on line 30. Otherwise, complete the appropriate line in Part IV. See page 9 of the instructions ▶ | | | 21 | 4,395 |

## Part IV Summary of Credits From Separate Parts III (See page 9 of the instructions.)

| Line | Description | Line | Amount | Line | Amount |
|---|---|---|---|---|---|
| 22 | Credit for taxes on passive income | 22 | 650 | | |
| 23 | Credit for taxes on high withholding tax interest | 23 | | | |
| 24 | Credit for taxes on financial services income | 24 | | | |
| 25 | Credit for taxes on shipping income | 25 | | | |
| 26 | Credit for taxes on dividends from a DISC or former DISC | 26 | | | |
| 27 | Credit for taxes on certain distributions from a FSC or former FSC | 27 | | | |
| 28 | Credit for taxes on lump-sum distributions | 28 | | | |
| 29 | Credit for taxes on general limitation income (all other income from sources outside the United States) | 29 | 4,395 | | |
| 30 | Add lines 22 through 29 | | | 30 | 5,045 |
| 31 | Reduction of credit for international boycott operations. See instructions for line 12 on page 8 | | | 31 | |
| 32 | Subtract line 31 from line 30. This is your foreign tax credit. Enter here and on Form 1040, line 43; Form 1040NR, line 41; Form 1041, Schedule G, line 2a; or Form 990-T, line 39a ▶ | | | 32 | 5,045 |

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Form **1116**

Department of the Treasury
Internal Revenue Service

# Foreign Tax Credit

**(Individual, Estate, Trust, or Nonresident Alien Individual)**

**► Attach to Form 1040, 1040NR, 1041, or 990-T.**

**► See separate instructions.**

OMB No. 1545-0121

1997

Attachment Sequence No. 19

Name: Robert Smith

**Identifying number** as shown on page 1 of your tax return: 000-00-0000

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below. Complete this form for credit for taxes on:

- a [X] Passive income
- b [ ] High withholding tax interest
- c [ ] Financial services income
- d [ ] Shipping income
- e [ ] Dividends from a DISC or former DISC
- f [ ] Certain distributions from a foreign sales corporation (FSC) or former FSC
- g [ ] Lump-sum distributions (see page 3 of the instructions before completing form)
- h [ ] General limitation income—all other income from sources outside the United States (including income from sources within U.S. possessions)

i Resident of (name of country) ► Country X

**Note:** *If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to* ***more than one*** *foreign country or U.S. possession, use a separate column and line for each country or possession. However, see the exception under* ***How To Complete Form 1116*** *on page 1 of the instructions.*

## Part I Figuring Taxable Income or Loss From Sources Outside the United States for Category Checked Above

| | Foreign Country or U.S. Possession A | B | C | | Total (Add cols. A, B, and C.) |
|---|---|---|---|---|---|
| **j Enter the name of the foreign country or U.S. possession** ► | Country X | | | | |
| 1 Gross income from sources within country shown above and of the type checked above. See page 5 of the instructions: Dividend, Interest | 5,000 | | | 1 | 5,000 |
| **Deductions and losses** (*Caution: See pages 6 and 7 of the instructions*): | | | | | |
| 2 Expenses **definitely related** to the income on line 1 (attach statement) | | | | | |
| 3 Pro rata share of other deductions **not definitely related:** | | | | | |
| a Certain itemized deductions or standard deduction. See instructions | 1,400 | | | | |
| b Other deductions (attach statement) | | | | | |
| c Add lines 3a and 3b | 1,400 | | | | |
| d Gross foreign source income. See instructions | 5,000 | | | | |
| e Gross income from all sources. See instructions | 110,400 | | | | |
| f Divide line 3d by line 3e. Do not enter more than "1" | .0453 | | | | |
| g Multiply line 3c by line 3f | 63 | | | | |
| 4 Pro rata share of interest expense. See instructions: | | | | | |
| a Home mortgage interest. (Use worksheet on page 7 of the instructions) | 359 | | | | |
| b Other interest expense | | | | | |
| 5 Losses from foreign sources | | | | | |
| 6 Add lines 2, 3g, 4a, 4b, and 5 | 422 | | | 6 | 422 |
| 7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ► | | | | 7 | 4,578 |

## Part II Foreign Taxes Paid or Accrued (See page 7 of the instructions.)

Credit is claimed for taxes (you must check one): (k) [X] Paid (l) [ ] Accrued

| Country | (m) Date paid or accrued | In foreign currency — Taxes withheld at source on: (n) Dividends | (o) Rents and royalties | (p) Interest | (q) Other foreign taxes paid or accrued | In U.S. dollars — Taxes withheld at source on: (r) Dividends | (s) Rents and royalties | (t) Interest | (u) Other foreign taxes paid or accrued | (v) Total foreign taxes paid or accrued (add cols. (r) through (u)) |
|---|---|---|---|---|---|---|---|---|---|---|
| A | 12-31-97 | 1,200 | | 100 | | 600 | | 50 | | 650 |
| B | | | | | | | | | | |
| C | | | | | | | | | | |

8 Add lines A through C, column (v). Enter the total here and on line 9, page 2 ► 8 650

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 11440U Form **1116** (1997)

## Part III Figuring the Credit

| Line | Description | Box | Amount | Box | Amount |
|---|---|---|---|---|---|
| 9 | Enter amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I | 9 | 650 | | |
| 10 | Carryback or carryover (attach detailed computation) | 10 | -0- | | |
| 11 | Add lines 9 and 10 | 11 | 650 | | |
| 12 | Reduction in foreign taxes. See page 7 of the instructions | 12 | -0- | | |
| 13 | Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit | | | 13 | 650 |
| 14 | Enter amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I. See page 8 of the instructions | 14 | 4,578 | | |
| 15 | Adjustments to line 14. See page 8 of the instructions | 15 | -0- | | |
| 16 | Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21.) | 16 | 4,578 | | |
| 17 | **Individuals:** Enter amount from Form 1040, line 36. If you are a nonresident alien, enter amount from Form 1040NR, line 35. **Estates and trusts:** Enter your taxable income without the deduction for your exemption | 17 | 35,188 | | |
| | **Caution:** *If you figured your tax using the special rates on capital gains, see page 9 of the instructions.* | | | | |
| 18 | Divide line 16 by line 17. If line 16 is more than line 17, enter the figure "1" | | | 18 | .1301 |
| 19 | **Individuals:** Enter amount from Form 1040, line 39, **less** any amounts on Form 1040, lines 40, 41, 42, and any mortgage interest credit (from Form 8396) and District of Columbia first-time homebuyer credit (from Form 8859) on line 44. If you are a nonresident alien, enter amount from Form 1040NR, line 38, less any amount on Form 1040NR, lines 39, 40, and any mortgage interest credit (from Form 8396) and District of Columbia first-time homebuyer credit (from Form 8859) on line 42. **Estates and trusts:** Enter amount from Form 1041, Schedule G, line 1c, or Form 990-T, lines 36 and 37 | | | 19 | 5,903 |
| 20 | Multiply line 19 by line 18 (maximum amount of credit) | | | 20 | 768 |
| 21 | Enter the amount from line 13 or line 20, whichever is **smaller.** If this is the only Form 1116 you are completing, skip lines 22 through 29 and enter this amount on line 30. Otherwise, complete the appropriate line in Part IV. See page 9 of the instructions ▶ | | | 21 | 650 |

## Part IV Summary of Credits From Separate Parts III (See page 9 of the instructions.)

| Line | Description | Box | Amount | Box | Amount |
|---|---|---|---|---|---|
| 22 | Credit for taxes on passive income | 22 | | | |
| 23 | Credit for taxes on high withholding tax interest | 23 | | | |
| 24 | Credit for taxes on financial services income | 24 | | | |
| 25 | Credit for taxes on shipping income | 25 | | | |
| 26 | Credit for taxes on dividends from a DISC or former DISC | 26 | | | |
| 27 | Credit for taxes on certain distributions from a FSC or former FSC | 27 | | | |
| 28 | Credit for taxes on lump-sum distributions | 28 | | | |
| 29 | Credit for taxes on general limitation income (all other income from sources outside the United States) | 29 | | | |
| 30 | Add lines 22 through 29 | | | 30 | |
| 31 | Reduction of credit for international boycott operations. See instructions for line 12 on page 8 | | | 31 | |
| 32 | Subtract line 31 from line 30. This is your foreign tax credit. Enter here and on Form 1040, line 43; Form 1040NR, line 41; Form 1041, Schedule G, line 2a; or Form 990-T, line 39a ▶ | | | 32 | |

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## Worksheet. **Additional Foreign Tax Credit on U.S. Income***

| | COL. A | COL. B |
|---|---|---|
| **I. U.S. tax on U.S. source income** | | |
| (U.S. source rules) | | |
| **1.** Dividends | ______ | ______ |
| **2.** Interest | ______ | ______ |
| **3.** Royalties | ______ | ______ |
| **4.** Capital gain | ______ | ______ |
| **5. a.** Gross earned income | ______ | |
| **b.** Allocable employee business expenses | ______ | |
| **c.** Net compensation | | ______ |
| **6. a.** Gross rent, real property | ______ | |
| **b.** Direct expenses | ______ | |
| **c.** Net rent | | ______ |
| **7.** Other ______ | ______ | ______ |
| **8.** Total | ______ | ______ |
| **9.** Enter tax from Form 1040 (see instructions) | | ______ |
| **10.** Enter AGI from line 32, Form 1040 | | ______ |
| **11.** Divide line 9 by line 10 | | ______ |
| **12.** Multiply line 11 by line 8 (estimated U.S. tax on U.S. income) | | ______ |
| **II. Tax at source allowable under treaty** | | |
| **A.** Items fully taxable by U.S. | | |
| **13. a.** Identify ______ | ______ | |
| **b.** Multiply by line 11 | | ______ |
| **B.** Items partly taxable by U.S. | | |
| **14. a.** Identify ______ | ______ | |
| **b.** Treaty rate | ______ | |
| **c.** Allowable tax at source (Multiply line 14a by 14b) | | ______ |
| **15. a.** Identify | ______ | |
| **b.** Treaty rate | ______ | |
| **c.** Allowable tax at source (Multiply line 15a by 15b) | | ______ |
| **16.** Total (Add lines 13b, 14c, and 15c) | | ______ |
| **C.** Identify each item of U.S. source income from Col. A, Step I, on which U.S. may not, under treaty, tax residents of the other country who are not U.S. citizens ______ | ______ | |
| ______ | ______ | |
| ______ | ______ | |
| **III. Additional credit** | | |
| **17.** Residence country tax on U.S. source income before foreign tax credit | | ______ |
| **18.** Foreign tax credit allowed by residence country for U.S. income tax paid | | ______ |
| **19.** Maximum credit. Subtract the greater of line 16 or line 18 from line 12. | | ______ |
| **20. a.** Enter the amount from line 17 | ______ | |
| **b.** Enter the greater of line 16 or line 18 | ______ | |
| **c.** Subtract line 20b from line 20a | | ______ |
| **21.** Additional credit. Enter the smaller of line 19 or line 20c. Add this amount to line 32 of Part IV of Form 1116. | | ______ |

* See the discussion on *Tax Treaties* for information on when you should use this worksheet.

## Worksheet Instructions. **Additional Foreign Tax Credit on U.S. Income**

**STEP I**

Figure the estimated tax on U.S. income using U.S. source rules.

**Lines 1–7—**Enter the gross amount for each type of income in Column A, and the net amount, if appropriate, in Column B.

**Line 8—**Enter the total.

**Line 9—**Enter amount from Form 1040, line 39, less any amounts on Form 1040, lines 40, 41, 42, and any mortgage interest credit and District of Columbia first-time homebuyer credit on line 44.

**Line 11—**Express this rate as a decimal.

**Line 12—**Multiply the rate on line 11 by your U.S. source income to figure your estimated U.S. tax on U.S. source income.

**STEP II**

Determine the amount of tax that the United States is allowed to collect at source under the treaty on income of residents of the other country who are not U.S. citizens.

**PART A—**Income fully taxable by the United States. Identify the type and amount of income.

**Line 13—**Use the average tax rate on the AGI, figured above in Step I.

**PART B—**Income for which treaty limits U.S. tax at source.

**Lines 14–15—**Identify each type and amount of income. Use the specified treaty rate.

**PART C—**Identify the items not taxable at source by the United States under the treaty.

**STEP III**

Figure the amount of the additional credit for foreign taxes paid or accrued on U.S. source income. The additional credit is limited to the difference between the estimated U.S. tax (STEP I) and the greater of the allowable U.S. tax at source (STEP II) or the foreign tax credit allowed by the residence country (line 18).

**Line 17—**Enter the amount of the residence country tax on your U.S. source income before reduction for foreign tax credits. If possible, use that fraction of the pre-credit residence country tax which U.S. source taxable income bears to total taxable income. Otherwise, report that fraction of the pre-credit foreign tax which gross U.S. income bears to total gross income for foreign tax purposes.

**Line 18—**Enter the amount of the foreign tax credit allowed by the residence country for U.S. income tax paid.

**Line 19—**Figure the maximum credit allowed by subtracting the greater of the tax at source allowable under treaty (line 16) or the foreign tax credit allowed by the residence country (line 18) from the U.S. source income.

**Line 21—**This amount may be claimed as a foreign tax credit on Form 1116. Complete Form 1116 according to the instructions. Add the special credit to line 32, Part IV, of Form 1116 and report that total on your Form 1040. File this worksheet with your Form 1040 as an attachment to Form 1116.

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## Tax Publications for Individual Taxpayers

**General Guides**

- **1** Your Rights as a Taxpayer
- **17** Your Federal Income Tax (For Individuals)
- **225** Farmer's Tax Guide
- **334** Tax Guide for Small Business
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- **553** Highlights of 1997 Tax Changes
- **595** Tax Highlights for Commercial Fishermen
- **910** Guide to Free Tax Services

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- **3** Armed Forces' Tax Guide
- **378** Fuel Tax Credits and Refunds
- **463** Travel, Entertainment, Gift, and Car Expenses
- **501** Exemptions, Standard Deduction, and Filing Information
- **502** Medical and Dental Expenses
- **503** Child and Dependent Care Expenses
- **504** Divorced or Separated Individuals
- **505** Tax Withholding and Estimated Tax
- **508** Educational Expenses
- **514** Foreign Tax Credit for Individuals
- **516** U.S. Government Civilian Employees Stationed Abroad
- **517** Social Security and Other Information for Members of the Clergy and Religious Workers
- **519** U.S. Tax Guide for Aliens
- **520** Scholarships and Fellowships
- **521** Moving Expenses
- **523** Selling Your Home
- **524** Credit for the Elderly or the Disabled
- **525** Taxable and Nontaxable Income
- **526** Charitable Contributions
- **527** Residential Rental Property
- **529** Miscellaneous Deductions
- **530** Tax Information for First-Time Homeowners
- **531** Reporting Tip Income
- **533** Self-Employment Tax
- **534** Depreciating Property Placed in Service Before 1987
- **537** Installment Sales
- **541** Partnerships
- **544** Sales and Other Dispositions of Assets
- **547** Casualties, Disasters, and Thefts (Business and Nonbusiness)
- **550** Investment Income and Expenses
- **551** Basis of Assets
- **552** Recordkeeping for Individuals
- **554** Older Americans' Tax Guide
- **555** Federal Tax Information on Community Property
- **556** Examination of Returns, Appeal Rights, and Claims for Refund
- **559** Survivors, Executors, and Administrators
- **561** Determining the Value of Donated Property
- **564** Mutual Fund Distributions
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- **594** Understanding the Collection Process
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- **929** Tax Rules for Children and Dependents
- **936** Home Mortgage Interest Deduction
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- **967** IRS Will Figure Your Tax
- **968** Tax Benefits for Adoption
- **1542** Per Diem Rates
- **1544** Reporting Cash Payments of Over $10,000
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**Spanish Language Publications**

- **1SP** Derechos del Contribuyente
- **579SP** Cómo Preparar la Declaración de Impuesto Federal
- **594SP** Comprendiendo el Proceso de Cobro
- **596SP** Crédito por Ingreso del Trabajo
- **850** English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- **1544SP** Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

## Commonly Used Tax Forms

- **1040** U.S. Individual Income Tax Return
  - **Sch A** Itemized Deductions
  - **Sch B** Interest and Dividend Income
  - **Sch C** Profit or Loss From Business
  - **Sch C-EZ** Net Profit From Business
  - **Sch D** Capital Gains and Losses
  - **Sch E** Supplemental Income and Loss
  - **Sch EIC** Earned Income Credit
  - **Sch F** Profit or Loss From Farming
  - **Sch H** Household Employment Taxes
  - **Sch R** Credit for the Elderly or the Disabled
  - **Sch SE** Self-Employment Tax
- **1040EZ** Income Tax Return for Single and Joint Filers With No Dependents
- **1040A** U.S. Individual Income Tax Return
  - **Sch 1** Interest and Dividend Income for Form 1040A Filers
  - **Sch 2** Child and Dependent Care Expenses for Form 1040A Filers
  - **Sch 3** Credit for the Elderly or the Disabled for Form 1040A Filers
- **1040-ES** Estimated Tax for Individuals
- **1040X** Amended U.S. Individual Income Tax Return
- **2106** Employee Business Expenses
- **2106-EZ** Unreimbursed Employee Business Expenses
- **2119** Sale of Your Home
- **2210** Underpayment of Estimated Tax by Individuals, Estates and Trusts
- **2441** Child and Dependent Care Expenses
- **2848** Power of Attorney and Declaration of Representative
- **3903** Moving Expenses
- **4562** Depreciation and Amortization
- **4868** Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
- **4952** Investment Interest Expense Deduction
- **5329** Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
- **6251** Alternative Minimum Tax–Individuals
- **8283** Noncash Charitable Contributions
- **8582** Passive Activity Loss Limitations
- **8606** Nondeductible IRAs (Contributions, Distributions, and Basis)
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- **595** Tax Highlights for Commercial Fishermen
- **910** Guide to Free Tax Services

**Employer's Guides**

- **15** Employer's Tax Guide (Circular E)
- **15-A** Employer's Supplemental Tax Guide
- **51** Agricultural Employer's Tax Guide (Circular A)
- **80** Federal Tax Guide For Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)
- **179** Guía Contributiva Federal Para Patronos Puertorriqueños (Circular PR)
- **926** Household Employer's Tax Guide

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- **1544SP** Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

## Commonly Used Tax Forms

- **W-2** Wage and Tax Statement
- **W-4** Employee's Withholding Allowance Certificate
- **940** Employer's Annual Federal Unemployment (FUTA) Tax Return
- **940EZ** Employer's Annual Federal Unemployment (FUTA) Tax Return
- **1040** U.S. Individual Income Tax Return
  - **Sch A** Itemized Deductions
  - **Sch B** Interest and Dividend Income
  - **Sch C** Profit or Loss From Business
  - **Sch C-EZ** Net Profit From Business
  - **Sch D** Capital Gains and Losses
  - **Sch E** Supplemental Income and Loss
  - **Sch F** Profit or Loss From Farming
  - **Sch H** Household Employment Taxes
  - **Sch R** Credit for the Elderly or the Disabled
  - **Sch SE** Self-Employment Tax
- **1040-ES** Estimated Tax for Individuals
- **1040X** Amended U.S. Individual Income Tax Return
- **1065** U.S. Partnership Return of Income
  - **Sch D** Capital Gains and Losses
  - **Sch K-1** Partner's Share of Income, Credits, Deductions, etc.
- **1120** U.S. Corporation Income Tax Return
- **1120-A** U.S. Corporation Short-Form Income Tax Return
- **1120S** U.S. Income Tax Return for an S Corporation
  - **Sch D** Capital Gains and Losses and Built-In Gains
  - **Sch K-1** Shareholder's Share of Income, Credits, Deductions, etc.
- **2106** Employee Business Expenses
- **2106-EZ** Unreimbursed Employee Business Expenses
- **2210** Underpayment of Estimated Tax by Individuals, Estates, and Trusts
- **2441** Child and Dependent Care Expenses
- **2848** Power of Attorney and Declaration of Representative
- **3800** General Business Credit
- **3903** Moving Expenses
- **4562** Depreciation and Amortization
- **4797** Sales of Business Property
- **4868** Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
- **5329** Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
- **6252** Installment Sale Income
- **8283** Noncash Charitable Contributions
- **8300** Report of Cash Payments Over $10,000 Received in a Trade or Business
- **8582** Passive Activity Loss Limitations
- **8606** Nondeductible IRAs (Contributions, Distributions, and Basis)
- **8822** Change of Address
- **8829** Expenses for Business Use of Your Home