Department of the Treasury

Internal Revenue Service

Publication 514

Cat. No. 15018A

Foreign Tax Credit for Individuals

For use in preparing

2004 Returns

Get forms and other information faster and easier by:

Internet • www.irs.gov

FAX • 703–368–9694 (from your fax machine)

Contents

What's New for 2004

Holding period for claiming a credit for taxes withheld on dividends. The period in which you must hold the stock at least 16 days has changed to a 31-day period. For preferred stock, the period in which you must hold the stock at least 46 days has changed to a 91-day period. These changes apply to dividends paid after September 4, 1997. For more information, see *Taxes Imposed on Certain Dividends.*

Credit for foreign taxes withheld on income or gain. You cannot claim a credit for foreign taxes withheld on income or gain (other than dividends) from certain property. This rule applies to income or gain paid or accrued after November 21, 2004. For more information, see *Taxes Withheld on Income or Gain (Other Than Dividends)* under *Taxes for Which You Can Only Take an Itemized Deduction*.

Carryback and carryover. Unused foreign taxes arising in tax years beginning after October 22, 2004 can be carried back 1 year and forward 10 years. In addition, the carryforward period has been extended from 5 years to 10 years for unused foreign taxes that could be carried forward under the 5-year rule of prior law to tax years ending after October 22, 2004. See *Carryback and Carryover.*

Disposition of stock in a controlled foreign corporation (CFC). If you dispose of stock in a CFC at a gain after October 22, 2004, the gain may be subject to recapture as U.S. source income. See *Recapture of Foreign Losses.*

Gifts to charity. Do not apportion to your foreign source gross income any deduction for charitable contributions you made after July 27, 2004. You can elect to also apply this rule to charitable contributions made before July 28, 2004, but only for the tax year ending after July 27, 2004. See *Deductions not definitely related* under *Determining Taxable Income From Sources Outside the United States.*

What's New for 2005

Rate of exchange for foreign taxes. If you claim the credit for foreign taxes on an accrual basis, you must generally use the average exchange rate for the tax year to which taxes relate. However, in tax years beginning after 2004, you can elect not to use the average exchange rate for any foreign taxes for which the foreign tax liability is denominated in a currency other than your functional currency. If you make this election, use the exchange rate in effect on the date you paid the taxes. This election is effective for the year you make it and all subsequent years unless you revoke it with IRS consent.

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.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Introduction

If you paid or accrued foreign taxes to a foreign country on foreign source 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:

- How to choose to take the credit or the deduction,
- Who can take the credit,
- What foreign taxes qualify for the credit,
- How to figure the credit, and
- How to carry over unused foreign taxes to other tax years.

Unless you choose not to be subject to the foreign tax credit limit, you claim the credit by filing Form 1116 with your U.S. income tax return. Two examples with filled-in Forms 1116 are provided at the end of this publication.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can write to us at the following address:

Internal Revenue Service
Individual Forms and Publications Branch
SE:W:CAR:MP:T:I
1111 Constitution Ave. NW, IR-6406
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

You can email us at **taxforms@irs.gov*. (The asterisk must be included in the address.) Please put "Publications Comment" on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

Tax questions. If you have a tax question, visit *www.irs.gov* or call 1-800-829-1040. We cannot answer tax questions at either of the addresses listed above.

Ordering forms and publications. Visit *www.irs.gov/formspubs* to download forms and publications, call 1-800-829-3676, or write to one of the three addresses shown under *How To Get Tax Help* in the back of this 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 Tax Help* near the end of this publication for information about getting these publications and this form.

Choosing 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 generally must complete Form 1116 and attach it to your U.S. tax return. However, you may qualify for the exception that allows you to claim the foreign tax credit without using Form 1116. See *How To Figure the Credit,* later. To choose to claim the taxes as an itemized deduction, use Schedule A (Form 1040), Itemized Deductions.

TIP *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.

If you choose to take a credit for qualified foreign taxes, you must take the credit for all of them. 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.

There are exceptions to this general rule, which are described next.

Exceptions for 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 if:

- You paid the tax to a country for which a credit is not allowed because it provides support for acts of international terrorism, or because the United States does not have diplomatic relations with it or recognize its government,
- You paid withholding tax on dividends from foreign corporations whose stock you did not hold for the required period of time,
- You paid withholding tax on income or gain (other than dividends) from property you did not hold for the required period of time,
- You participated in or cooperated with an international boycott, or
- You paid taxes in connection with the purchase or sale of oil or gas.

For more information on these items, see *Taxes for Which You Can Only Take an Itemized Deduction* later under *Foreign Taxes for Which You Cannot Take a Credit.*

Foreign taxes that are not income taxes. Generally, only foreign income taxes qualify for the foreign tax credit. Other taxes, such as foreign real and personal property taxes, do not qualify. But you may be able to deduct these other taxes even if you claim the foreign tax credit for foreign income taxes.

You generally 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 trade or business expenses 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 may be able to 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 regular 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 your returns and paying your U.S. tax liability. In February 2004, you file an amended return for tax year 1993 choosing to take a credit for your 1993 foreign taxes because you now realize that the credit is more advantageous than the deduction for that year. Because the regular due date of your 1993 return was April 15, 1994, this choice is timely (within 10 years).

Because there is a limit on the credit for your 1993 foreign tax, you have unused 1993 foreign taxes. Ordinarily, you first carry back unused foreign taxes arising in 1993 to, 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 chose to deduct your foreign taxes and the 10-year period for changing the choice for 1991 and 1992 has passed, you cannot carry the unused 1993 foreign taxes back to tax years 1991 and 1992.

Because the 10-year periods have not passed for your 1994 through 1998 income tax returns, you can still choose to carry forward any unused 1993 foreign taxes. However, you must reduce the unused 1993 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 1991 and 1992.

CAUTION
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.

Why Choose the Credit?

The foreign tax credit is intended to relieve you of the double tax burden when your foreign source income is taxed by both the United States and the foreign country. 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. The foreign tax credit can only reduce U.S. taxes on foreign source income; it cannot reduce U.S. taxes on U.S. source income.

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:

- 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,
- 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, and
- If you choose to take the foreign tax credit, and the taxes paid or accrued exceed the credit limit for the tax year, you may be able to carry over or carry back the excess to another tax year. (See *Limit on the Credit* under *How To Figure the Credit,* later.)

Example 1. For 2004, you and your spouse have adjusted gross income of $80,000, including $20,000 of dividend income from foreign sources. None of the dividends are qualified dividends. You file a joint return and can claim two $3,100 exemptions. You had to pay $2,000 in foreign income taxes on the dividend income. If you take the foreign taxes as an itemized deduction, your total itemized deductions are $12,000. Your taxable income then is $61,800 and your tax is $8,931.

If you take the credit instead, your itemized deductions are only $10,000. Your taxable income then is $63,800 and your tax before the credit is $9,431. After the credit, however, your tax is only $7,431. Therefore, your tax is $1,500 lower ($8,931– $7,431) by taking the credit.

Example 2. In 2004, 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 $56,000 of income from U.S. sources. You are single, entitled to one $3,100 exemption, and have other itemized deductions of $5,400. If you deduct the foreign tax on your U.S. return, your taxable income is $49,000 ($5,000 + $56,000 – $3,100 – $5,400 – $3,500) and your tax is $8,994.

If you take the credit instead, your taxable income is $52,500 ($5,000 + $56,000 – $3,100 – $5,400) and your tax before the credit is $9,869. You can take a credit of only $809 because of limits discussed later. Your tax after the credit is $9,060 ($9,869 – $809), which is $66 ($9,060 – $8,994) more than if you deduct the foreign tax.

If you choose the credit, you will have unused foreign taxes of $2,691 ($3,500 – $809). 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 or accrue it, depending on your method of accounting. "Tax year" refers to the tax year for which your U.S. return is filed, not the tax year for which your foreign return is filed.

Accrual method of accounting. 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.

Contesting your foreign tax liability. 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 a credit for the amount you pay before a final determination of foreign tax liability is made. Once your liability is 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 may have to adjust the credit, as discussed later under *Foreign Tax Redetermination.*

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.

The IRS can request this bond at any time without regard to the *Time Limit on Tax Assessment,* discussed later under *Carryback and Carryover*.

Cash method of accounting. 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 take credit in the year taxes accrue. 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 take the credit when foreign taxes accrue applies to all foreign taxes qualifying 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 take the credit when foreign taxes accrue and pay them in a later year, you cannot claim a deduction for any part of the previously accrued taxes.

Credit based on taxes paid 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 took the credit based on taxes paid. This year you chose to take the credit based on taxes accrued. During the year you paid foreign income taxes owed for last year. You also accrued foreign income taxes for this year 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.

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.

Translating foreign currency into U.S. dollars. If you receive all or part of your income or pay some or all of your expenses in foreign currency, you must translate the foreign currency into U.S. dollars. How you do this depends on your functional currency. Your functional currency generally is the U.S. dollar unless you are required to use the currency of a foreign country.

You must make all federal income tax determinations 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. 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.

- You conduct the business primarily in dollars.
- The principal place of business is located in the United States.
- You choose to or are required to use the dollar as your functional currency.
- 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.

If your functional currency is the U.S. dollar, you must immediately translate into dollars all items of income, expense, etc., that you receive, pay, or accrue in a foreign currency and that will affect computation of your income tax. If there is more than one exchange rate, use the one that most properly reflects your income. You can generally get exchange rates from banks and U.S. Embassies.

If your functional currency is not the U.S. dollar, make all income tax determinations in your functional currency. At the end of the year, translate the results, such as income or loss, into U.S. dollars to report on your income tax return.

For more information, write to:

Internal Revenue Service
International Section
P.O. Box 920
Bensalem, PA 19020–8518.

Rate of exchange for foreign taxes paid. Use the rate of exchange in effect on the date you paid the foreign taxes to the foreign country unless you meet the exception discussed next. If your tax was withheld in foreign currency, you use the rate of exchange in effect for the date on which the tax was 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.

Exception. If you claim the credit for foreign taxes on an accrual basis, you must generally use the average exchange rate for the tax year to which the taxes relate. This rule applies to accrued taxes relating to tax years beginning after 1997 and only under the following conditions.

1. The foreign taxes are paid on or after the first day of the tax year to which they relate.
2. The foreign taxes are paid not later than 2 years after the close of the tax year to which they relate.

For all other foreign taxes, you should use the exchange rate in effect on the date you paid them.

Foreign Tax Redetermination

A foreign tax redetermination is any change in your foreign tax liability that may affect your U.S. foreign tax credit claimed.

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.

If a foreign tax redetermination occurs, a redetermination of your U.S. tax liability is required in the following situations.

Tax years beginning before 1998. For tax years beginning before 1998, a redetermination of your U.S. tax liability is required if:

- You must pay additional foreign taxes,
- You receive a refund of foreign taxes paid, or
- There is a change in the dollar amount of your foreign tax credit because of differences in the exchange rate at the time the foreign taxes were accrued and the time they were paid.

See *Rate of exchange for foreign taxes paid,* earlier, under *Foreign Currency and Exchange Rates.*

When redetermination of tax is not required. A redetermination 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.

Tax years beginning after 1997. For tax years beginning after 1997, a redetermination of your U.S. tax liability is required if:

1. The accrued taxes when paid differ from the amount you claimed as a credit,
2. The accrued taxes you claimed as a credit in one tax year are not paid within 2 years after the end of that tax year, or
3. The foreign taxes you paid are refunded in whole or in part.

If (2) above applies to you, you will not be allowed a credit for the unpaid taxes until you pay them. When you pay the accrued taxes, you must translate them into U.S. dollars using the exchange rate as of the date they were paid. The foreign tax credit is allowed for the year to which the foreign tax relates. See *Rate of exchange for foreign taxes paid,* earlier, under *Foreign Currency and Exchange Rates.*

Notice to the Internal Revenue Service (IRS) of redetermination. You must file Form 1040X, Amended U.S. Individual Income Tax Return, and a revised Form 1116 for the tax year affected by the redetermination. The IRS will redetermine your U.S. tax liability for the year or years affected.

If you pay less foreign tax than you originally claimed a credit for, you must file Form 1040X and a revised Form 1116 within 180 days after the redetermination occurred. There is no limit on the time the IRS has to redetermine and assess the correct U.S. tax due. If you pay more foreign tax than you originally claimed a credit for, you have 10 years to file a claim for refund of U.S. taxes. See *Time Limit on Refund Claims,* later.

Failure-to-notify penalty. If you fail to notify the IRS of a foreign tax redetermination 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 IRS 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 your foreign tax refund is taxed by the foreign country, you cannot take a separate credit or deduction for this additional foreign tax. However, when you refigure the foreign tax credit taken for the original foreign tax, reduce the amount of the refund by the foreign tax paid on the refund.

Example. You paid a foreign income tax of $3,000 in 2002, and received a foreign tax refund of $500 in 2004 on which a foreign tax of $100 was imposed. When you refigure your credit for 2002, you must reduce the $3,000 you paid by $400.

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 for 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 *Choosing To Take Credit or Deduction.*

Who Can Take the Credit?

U.S. citizens, resident aliens, and nonresident aliens who paid foreign income tax and are subject to U.S. tax on foreign source income 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 not a resident of the United States, you cannot take a foreign tax credit.

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 income you actually or constructively received while you had resident alien status.

For information on alien status, see Publication 519.

Nonresident Aliens

If you are a nonresident alien, you generally cannot take the credit. However, you may be able to take the credit if:

- You were a bona fide resident of Puerto Rico during your entire tax year, or
- You pay or accrue tax to a foreign country or U.S. possession on income from foreign sources that is effectively connected with a trade or business in the United States. But if you must pay tax to a foreign country or U.S. possession on income from U.S. sources only because you are a citizen or a resident of that country or U.S. possession, do not use that tax in figuring the amount of your credit.

For information on alien status and effectively connected income, see Publication 519.

What Foreign Taxes Qualify for the Credit?

Generally, the following four tests must be met for any foreign tax to qualify for the credit.

1. The tax must be imposed on you.
2. You must have paid or accrued the tax.
3. The tax must be the legal and actual foreign tax liability.
4. The tax must be an income tax (or a tax in lieu of an income tax).

CAUTION *Certain foreign taxes do not qualify for the credit even if the four tests are met. See* Foreign Taxes for Which You Cannot Take a Credit, *later.*

Tax Must Be Imposed on You

You can claim a credit only for foreign taxes that are imposed on you by a foreign country or U.S. possession. For example, a tax that is deducted from your wages is considered to be imposed on you. You cannot shift the right to claim the credit by contract or other means.

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

U.S. possessions. For foreign tax credit purposes, all qualified taxes paid to U.S. possessions 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.

You Must Have Paid or Accrued the Tax

Generally, you can claim the credit only if you paid or accrued the foreign tax to a foreign country or U.S. possession. 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 foreign income taxes 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.

Mutual fund shareholder. If you are a shareholder of a mutual fund, you may be able to claim the credit based on your share of foreign income taxes paid by the fund 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 foreign income, and your share of the foreign taxes paid. If you do not receive this information, you will need to contact the fund.

Controlled foreign corporation shareholder. If you are a 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, directly or indirectly, 10% or more of the total voting power of all classes of the foreign corporation's stock. See Internal Revenue Code sections 951(b) and 958(b) for more information.

Tax Must Be the Legal and Actual Foreign Tax Liability

The amount of foreign tax that qualifies is not necessarily the amount of tax withheld by the foreign country. Only the legal and actual foreign tax liability that you paid or accrued during the year qualifies for the credit.

Foreign tax refund. You cannot take a foreign tax credit for income taxes paid to a foreign country if 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 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. The qualified foreign tax is the amount figured using the lower treaty rate and not the amount actually paid, since the excess tax is refundable.

Subsidy received. Tax payments a foreign country returns to you in the form of a subsidy do not qualify for the foreign tax credit. This rule applies even if the subsidy is given to a person related to you, or persons who participated with you in a transaction or a related transaction. 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.

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 French corporation. You receive a $100 refund of the tax paid to France by the corporation on the earnings distributed to you as a dividend. The French 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.

Tax Must Be an Income Tax (or Tax in Lieu of Income Tax)

Generally, only income, war profits, and excess profits taxes (income taxes) qualify for the foreign tax credit. 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 if the tax is in lieu of an income, war profits, or excess profits tax. See *Taxes in Lieu of Income Taxes,* later.

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. A foreign levy is an income tax only if it meets both of the following 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 U.S. law does not include, or it may allow certain exclusions or deductions that U.S. law does not allow.

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 available on substantially the same terms to the population of the foreign country in general.

You are considered to receive a specific 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 all or part of the benefit.

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

Economic benefits. Economic benefits include the following.

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

.

Generally, the right or privilege merely to engage in business is not an economic 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
International Section
P.O. Box 920
Bensalem, PA 19020-8518.

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.

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 not based on income. Foreign taxes based on gross receipts or the number of units produced, 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.

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 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:

- It is not payment for a specific economic benefit as discussed earlier, and
- The tax is imposed in place of, and not in addition to, an income tax otherwise generally imposed.

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.

A soak-up tax (discussed earlier) generally does not qualify as a tax in lieu of an income tax. However, if the foreign country imposes a soak-up tax in lieu of an income tax, the amount that does not qualify for foreign tax credit is the lesser of the following amounts.

- The soak-up tax.

- The foreign tax you paid that is more than the amount you would have paid if you had been subject to the generally imposed income tax.

Foreign Taxes for Which You Cannot Take a Credit

This part discusses the foreign taxes for which you cannot take a credit. These are:

- Taxes on excluded income,
- Taxes for which you can only take an itemized deduction,
- Taxes on foreign oil related income,
- Taxes on foreign mineral income,
- Taxes from international boycott operations,
- Taxes of U.S. persons controlling foreign corporations or partnerships, and
- Taxes on foreign oil and gas extraction income.

Taxes on Excluded Income

You may not take a credit for foreign taxes paid or accrued on income excluded from U.S. gross income.

Foreign Earned Income and Housing Exclusions

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 foreign earned income and housing amounts excluded under the foreign earned income and housing exclusions for the tax year minus otherwise deductible expenses definitely related and properly apportioned to that income. Deductible expenses do not include 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	87,225

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.

$$\$20{,}000 \times \frac{\$87{,}225}{\$120{,}000} = \$14{,}538$$

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 ($14,538) from excluded wages ($87,225). The result is $72,687.

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.

$$\$30{,}000 \times \frac{\$72{,}687}{\$100{,}000} = \$21{,}806$$

The amount of Country A tax you cannot take a credit for is $21,806.

Taxes on Income From Puerto Rico Exempt From U.S. Tax

If you have income from Puerto Rican sources that is not taxable, you must reduce your foreign taxes paid or accrued by the taxes allocable to the exempt income. For information on figuring the reduction, see Publication 570.

Possession Exclusion

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.

Extraterritorial Income Exclusion

You cannot take a credit for taxes you pay on qualifying foreign trade income excluded on Form 8873, Extraterritorial Income Exclusion. However, see Internal Revenue Code section 943(d) for an exception for certain withholding taxes.

Taxes for Which You Can Only Take an Itemized Deduction

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

Taxes Imposed By Sanctioned Countries (Section 901(j) Income)

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:

- The Secretary of State has designated the country as one that repeatedly provides support for acts of international terrorism,
- The United States has severed or does not conduct diplomatic relations with the country, or
- 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.

The following countries meet this description for 2004. Income taxes paid or accrued to these countries in 2004 do not qualify for the credit.

- Cuba.
- Iran.
- Iraq (taxes on income arising before June 28).
- Libya (taxes on income arising before December 10).
- North Korea.
- Sudan.
- Syria.

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

Waiver of denial of the credit. A waiver can be granted to a sanctioned country if the President of the United States determines that granting the waiver is in the national interest of the United States and will expand trade and investment opportunities for U.S. companies in the sanctioned country. The President must report to Congress his intentions to grant the waiver and his reasons for granting the waiver not less than 30 days before the date on which the waiver is granted.

Limit on credit. In figuring the foreign tax credit limit, discussed later, income from a sanctioned country is a separate category of foreign income. You must fill out a separate Form 1116 for this income. This will prevent you from claiming a credit for foreign taxes paid or accrued to the sanctioned country.

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. Because the income earned in Libya is a separate category of foreign income, you must fill out a separate Form 1116 for that 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 1 (below) 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 sanction 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 a sanction period ends during your tax year and you are not able to determine the actual income and taxes for the nonsanctioned period, you can allocate amounts to that period based on the number of days in the period that fall in your tax year. Multiply the income or taxes for the year by the following fraction to determine the amounts allocable 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 2004 on which you paid tax of $4,500. Sanctions against Country X were lifted on July 11, 2004. 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, 2004, 173 days of your tax year are in the nonsanctioned period. You would compute the income for the nonsanctioned period as follows:

$$\frac{173}{366} \times \$20{,}000 = \$9{,}454$$

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

$$\frac{173}{366} \times \$4{,}500 = \$2{,}127$$

To figure your foreign tax credit, you would use $9,454 as the income from Country X and $2,127 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, Cumulative Bulletin 1992-2, page 193. This Cumulative Bulletin can be found in many libraries and IRS offices.

Taxes Imposed on Certain Dividends

You cannot claim a foreign tax credit for withholding tax (defined later) on dividends paid or accrued after September 4, 1997, if either of the following applies to the dividends.

- The dividends are on stock you held for less than 16 days during the 31-day period that begins 15 days before the ex-dividend date (defined later).
- The dividends are for a period or periods totaling more than 366 days on preferred stock you held for less than 46 days during the 91-day period that begins 45 days before the ex-dividend date. If the dividend is not for more than 366 days, rule (1) applies to the preferred stock.

When figuring how long you held the stock, count the day you sold it, but do not count the day you acquired it or any days on which you were protected from risk or loss.

Regardless of how long you held the stock, 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.

Ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the purchaser of a stock is not entitled to receive the next dividend payment.

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 31-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 who actively conducts business in a foreign country, you may be able to claim a foreign tax credit for qualified taxes paid on dividends regardless of how long you held the stock or whether you were obligated to make payments for positions in substantially similar or related property. See section 901(k)(4) of the Internal Revenue Code for more information.

Taxes Withheld on Income or Gain (Other Than Dividends)

For income or gain (other than dividends) paid or accrued after November 21, 2004, on property, you cannot claim a foreign tax credit for withholding tax (defined later):

- If you have not held the property for at least 16 days during the 31-day period that begins 15 days before the date on which the right to receive the payment arises, or
- To the extent you have to make related payments on positions in substantially similar or related property.

When figuring how long you held the property, count the day you sold it, but do not count the day you acquired it or any days on which you were protected from risk or loss.

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.

Exception for dealers. If you are a dealer in property who actively conducts business in a foreign country, you may be able to claim a foreign tax credit for qualified taxes withheld on income or gain from that property regardless of how long you held it or whether you have to make related payments on position in similar or related property. See section 901(I)(2) of the Internal Revenue Code for more information.

Taxes in Connection With the Purchase or Sale of Oil or Gas

You cannot claim a foreign tax credit for taxes paid or accrued to a foreign country in connection with the purchase or sale of oil or gas extracted in that country if you do not have an economic interest in the oil or gas, and the

Table 1. **Countries Removed From the Sanctioned List**

Country	Sanctioned Period: Starting Date	Sanctioned Period: Ending Date
Afghanistan	January 1, 1987	August 4,1994
Angola	January 1, 1987	June 18, 1993
Cambodia	January 1, 1987	August 4,1994
Iraq	February 1, 1991	June 27, 2004
Libya	January 1,1987	December 9, 2004
Vietnam	January 1, 1987	July 21, 1995

purchase price or sales price is different from the fair market value of the oil or gas at the time of purchase or sale.

Taxes on Foreign Oil Related Income

You must reduce foreign taxes paid or accrued on foreign oil related income to the extent that the tax imposed by the foreign country on such income is considered to be materially greater than the tax imposed by that country on income other than foreign oil related income or foreign oil and gas extraction income (discussed later). See Regulations section 1.907(b)-1. The amount of tax not allowed as a credit under this rule is allowed as a business expense deduction.

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

If you participate in or cooperate with an international boycott during the tax year, your foreign taxes resulting from boycott activities will reduce the total taxes available for credit. See the instructions for line 12 in the Form 1116 instructions to figure this reduction.

This rule generally does not apply to employees with wages who are working and living in boycotting countries, 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 date this publication was printed, the following countries are listed.

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

For information concerning changes to the list, write to:

Internal Revenue Service
International Section
P.O. Box 920
Bensalem, PA 19020–8518

Determinations of whether the boycott rule applies. 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 in Cumulative Bulletin 1977-1. 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 and any related background file is open to public inspection. However, your identity and certain other information will remain confidential.

Reporting requirements. You must file a report with the IRS if you or any of the following persons have operations in or related to a boycotting country or with the government, a company, or national of a boycotting country.

- A foreign corporation in which you own 10% or more of the voting power of all voting stock but only if you own the stock of the foreign corporation directly or through foreign entities.
- A partnership in which you are a partner.
- A trust you are treated as owning.

Form 5713 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. Your reports submitted as part of the tax return are confidential.

Penalty for failure to file. If you willfully fail to make a report, in addition to other penalties, you may be fined $25,000 or imprisoned for no more than one year, or both.

Taxes on Foreign Oil and Gas Extraction Income

You must reduce your foreign taxes by a portion of any foreign taxes imposed on foreign oil and gas extraction income. The amount of the reduction is the amount by which your foreign oil and gas extraction taxes exceed the amount of your foreign oil and gas extraction income multiplied by a fraction equal to your pre-credit U.S. tax liability (Form 1040, line 43) divided by your worldwide income. You may be entitled to carry over to other years taxes reduced under this rule. See Internal Revenue Code section 907(f).

Taxes of U.S. Persons Controlling Foreign Corporations and Partnerships

If you had control of a foreign corporation or a foreign partnership for the annual accounting period of that corporation or partnership that ended with or within your tax year, you may have to file an annual information return. If you do not file the required information return, you may have to reduce the foreign taxes that may be used for the foreign tax credit. See *Penalty for not filing Form 5471 or Form 8865,* later.

U.S. persons controlling foreign corporations. If you are a U.S. citizen or resident who had control of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of that corporation, you may have to file an annual information return on Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations. Under this rule, you generally had control of a foreign corporation if at any time during the corporation's tax year you owned:

- Stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or
- More than 50% of the total value of shares of all classes of stock of the foreign corporation.

U.S. persons controlling foreign partnerships. If you are a U.S. citizen or resident who had control of a foreign partnership at any time during the partnership's tax year, you may have to file an annual information return on Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships. Under this rule, you generally had control of the partnership if you owned more than 50% of the capital or profits or interest, or an interest to which 50% of the deductions or losses were allocated.

You also may have to file Form 8865 if at any time during the tax year of the partnership, you owned a 10% or greater interest in the partnership while the partnership was controlled by U.S. persons owning at least a 10% interest. See the Instructions for Form 8865 for more information.

Penalty for not filing Form 5471 or Form 8865. Generally, there is a dollar penalty of $10,000 for each annual accounting period for which you fail to furnish information. Additional penalties apply if the failure continues for more than 90 days after the day on which notice of the failure to furnish the information is mailed.

If you fail to file either Form 5471 or Form 8865 when due, you may also be required to reduce by 10% all foreign taxes that may be used for the foreign tax credit. This 10% reduction shall not exceed the greater of $10,000 or the income of the foreign corporation or foreign partnership for the accounting period for which the failure occurs. This foreign tax credit penalty is also reduced by the amount of the dollar penalty imposed.

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 10 tax years. See *Carryback and Carryover*, later.

CAUTION *Unused foreign taxes arising in tax years beginning after October 22, 2004 can be carried back 1 year.*

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

Exemption from foreign tax credit limit. You will not be subject to this limit and will be able to claim the credit without using Form 1116 if the following requirements are met.

- Your only foreign source gross income for the tax year is passive income. Passive income is defined later under *Separate Limit Income.* However, for purposes of this rule, high taxed income and export financing interest are also passive income. Passive income also includes income that would be passive except that it is also described in another income category.
- Your qualified foreign taxes for the tax year are not more than $300 ($600 if married filing a joint return).
- All of your gross foreign income and the foreign taxes are reported to you on a payee statement (such as a Form 1099-DIV or 1099-INT).
- You elect this procedure for the tax year.

If you make this election, you cannot carry back or carry over any unused foreign tax to or from this tax year.

CAUTION *This election exempts you only from the limit figured on Form 1116 and not from the other requirements described in this publication. For example, the election does not exempt you from the requirements discussed earlier under* What Foreign Taxes Qualify for the Credit.

Limit on the Credit

Your foreign tax credit cannot be more than your total U.S. tax liability (line 43 Form 1040) multiplied by a fraction. The numerator of the fraction is your taxable income from sources outside the United States. The denominator is your total taxable income from U.S. 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.

Separate Limit Income

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

- Passive income.
- High withholding tax interest.
- Financial services income.
- Shipping income.
- Certain dividends from a domestic international sales corporation (DISC) or former DISC.
- Certain distributions from a foreign sales corporation (FSC) or former FSC.
- Any lump sum distributions from employer benefit plans for which the special averaging treatment is used to determine your tax.
- Section 901(j) income.
- Income re-sourced by treaty.
- General limitation income. This is all other income not included in the above categories.

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 voting stock.

Subpart F inclusions, interest, rents, and royalties from a CFC are generally treated as separate limit income if 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. For more information, see section 904(d)(3) of the Internal Revenue Code and section 1.904-5 of the Regulations.

Partnership distributive share. In general, a partner's distributive share of partnership income is treated as separate limit income if 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. For more information, see section 1.904-5(h) of the Regulations.

Passive Income

Except as described earlier under *Income from controlled foreign corporations* and *Partnership distributive share,* passive income generally includes the following.

- Dividends.
- Interest.
- Rents.
- Royalties.
- Annuities.
- Net gain from the sale of non-income-producing investment property or property that generates passive income.
- Net gain from commodities transactions, except for hedging and active business gains or losses of producers, processors, merchants, or handlers of commodities.
- Amounts you must include as foreign personal holding company income under section 551(a) or 951(a) of the Internal Revenue Code.
- Amounts includible in income 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 a written statement showing the amount of foreign taxes it elected to pass through to you.

What is not passive income. Passive income does not include any of the following.

- Gains or losses from the sale of inventory property or property held mainly for sale to customers in the ordinary course of your trade or business.
- Export financing interest.
- High-taxed income.
- Active business rents and royalties from unrelated persons.
- Active business rents and royalties from related persons if they are paid or accrued after September 20, 2004.
- 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:

- The property is manufactured, produced, grown, or extracted in the United States, and
- 50% or less of the value of the property is due to imports into 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. See section 1.904-4(c) of the Regulations for more information.

High Withholding Tax Interest

High withholding tax interest is interest (except export financing interest) that is subject to a foreign or U.S. possession 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 predominantly 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 that business, passive income, high-taxed income, certain incidental income, and export financing interest which is subject to a foreign or U.S. possession withholding tax or gross-basis tax of at least 5%.

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:

- Distributions from a foreign sales corporation (FSC) or former FSC out of earnings and profits attributable to foreign trade income, or
- 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. Follow the Form 1116 instructions and complete the worksheet in those instructions to determine your foreign tax credit on the LSD.

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

Section 901(j) Income

This is income earned from activities conducted in sanctioned countries. Income derived from each sanctioned country is subject to a separate foreign tax credit limitation. Therefore, you must use a separate Form 1116 for income earned from each such country. See *Taxes Imposed By Sanctioned Countries (Section 901(j) Income)* under *Taxes for Which You Can Only Take an Itemized Deduction*, earlier.

Income Re-Sourced By Treaty

If a sourcing rule in an applicable income tax treaty treats any of the income described below as foreign source, and you elect to apply the treaty, the income will be treated as foreign source.

- Certain gains (section 865(h)).
- Certain income from a U.S.-owned foreign corporation (section 904(g)(10)). See Regulations section 1.904-5(m)(7) for an example.

You must compute a separate foreign tax credit limitation for any such income for which you claim benefits under a treaty, using a separate Form 1116 for each amount of re-sourced income from a treaty country.

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 that does not fall into one of the other separate categories. It also includes wages, salaries, and overseas allowances of an individual as an employee.

Allocation of Foreign Taxes

If you paid or accrued foreign income tax for a tax year on income in more than one separate limit income category, allocate the tax to the income category to which the tax specifically relates. If 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 total 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 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. Your total net income is $78,600 ($83,000 – $4,400).

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 or an S Corporation

If foreign taxes were paid or accrued on your behalf by a partnership or an S corporation, you will figure your credit using certain information from the Schedule K-1 you received from the partnership or S corporation. If you received a 2004 Schedule K-1 from a partnership or an S corporation that includes foreign tax information, see your Form 1116 instructions for how to report that information.

Figuring the Limit

Before you can determine the limit on your credit, you must first figure your total taxable income from all sources before the deduction for personal exemptions. This is the amount shown on line 40 of Form 1040. Then for each category of income, you must figure your taxable income from sources outside the United States.

Determining 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 2.

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

This rule does not apply to the sale of inventory, intangible property, or depreciable property, or property sold through a foreign office or fixed place of business. The rules for these types of property are discussed later.

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 who is not a U.S. resident.

U.S. citizens and resident aliens with a foreign tax home will be treated as nonresidents for a sale of personal property only if an income tax of at least 10% of the gain on the sale is paid to a foreign country.

This rule also applies to losses recognized after January 7, 2002, if the foreign country would have imposed a 10% or higher tax had the sale resulted in a gain. You can choose to apply this rule to losses recognized in tax years beginning after 1986. For details about making this choice, see section 1.865-1(f)(2) of the Regulations. For stock losses, see section 1.865-2(e) of the Regulations.

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 Regulations.

Intangibles. Intangibles include patents, copyrights, trademarks, and goodwill. The gain from the sale of amortizable or depreciable intangible property, up to the previously allowable amortization or depreciation deductions, is sourced in the same way as the original deductions were sourced. This is the same as the source rule for gain from the sale of depreciable property. See *Depreciable property,* next, for details on how to apply this rule.

Gain in excess of the amortization or depreciation deduction is sourced in the country where the property is used if the income from the sale is contingent on the productivity, use, or disposition of that property. If the income is not contingent on the productivity, use, or disposition of the property, the income is sourced according to the seller's tax home as discussed earlier. Payments for goodwill are sourced in the country where the goodwill was generated if the payments are not contingent on the productivity, use, or disposition of the property.

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.

A loss recognized after January 7, 2002, is sourced in the same way as the depreciation deductions were sourced. However, if the property was used predominantly outside the United States, the entire loss reduces foreign source income. You can choose to apply this rule to losses recognized in tax years beginning after 1986. For details about making this choice, see section 1.865-1(f)(2) of the Regulations.

Depreciation includes amortization and any other allowable deduction for a capital expense that is treated 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:

- The income from the sale is from the business operations located outside the United States, and
- 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 also applies to losses recognized after January 7, 2002, if the foreign country would have imposed a 10% or higher tax had the sale resulted in a gain. You can choose to apply this rule to losses recognized in tax years beginning after 1986. For details about making this choice, see section 1.865-1(f)(2) of the Regulations. For stock losses, see section 1.865-2(e) of the Regulations.

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.

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:

- As a result of, or incident to, an activity from which that income is derived, or
- 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.

Table 2. **Source of Income**

Item of Income	Factor Determining Source
Salaries, wages, other compensation	Where services performed
Business income: Personal services Sale of inventory—purchased Sale of inventory—produced	 Where services performed Where sold Allocation
Interest	Residence of payer
Dividends	Whether a U.S. or foreign corporation*
Rents	Location of property
Royalties: Natural resources Patent, copyrights, etc.	 Location of property Where property is used
Sale of real property	Location of property
Sale of personal property	Seller's tax home (but see *Sales or exchanges of certain personal property,* later, for exceptions)
Pensions	Where services were performed that earned the pension
Sale of natural resources	Allocation based on fair market value of product at export terminal. For more information, see section 1.863-1(b) of the Regulations.

*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 declared.

- Compensation for services, including wages, salaries, fees, and commissions.
- Gross income from business.
- Gains from dealings in property.
- Interest.
- Rents.
- Royalties.
- Dividends.
- Alimony and separate maintenance.
- Annuities.
- Pensions.
- Income from life insurance and endowment contracts.
- Income from cancelled debts.
- Your share of partnership gross income.
- Income in respect of a decedent.
- 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:

- More than one separate limit category, or
- 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 allocated entirely to U.S. 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. For more information about the asset method, see Temporary Regulations section 1.861-9T(g).

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.

Partnership interest. General partners and limited partners with partnership interests of 10% or more must classify their distributive shares of partnership interest expense under the three categories listed above. They must apportion the interest expense according to the rules for those categories by taking into account their distributive share of partnership gross income or pro rata share of partnership assets. For special rules that may apply, see section 1.861-9T(e) of the Regulations.

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 business interest.

Example. You are operating a business 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 from the bank loan 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. This $2,000 is interest expense 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. $800 ($40,000/ $100,000 × $2,000) of your investment interest is apportioned to U.S. source income and $1,200 ($60,000 / $100,000 × $2,000) is apportioned to foreign source passive income.

Your home mortgage interest expense is $12,000. It is apportioned on the basis of all your gross income. Your gross income is $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 state income tax 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 rules apply.

- 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.
- 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 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 both U.S. and 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 apportioned 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 deductions that are not definitely related to a specific class of gross income. If you itemize, these deductions are medical expenses, general sales taxes, and real estate taxes for your home. They also include charitable contributions you made before July 28, 2004, unless you elect not to apportion any of them to foreign income as explained in the instructions for line 3a in the Form 1116 instructions. If you do not itemize, this is your standard deduction. You should also apportion any other deductions that are not definitely related to a specific class of income, including deductions shown on Form 1040, lines 23-34a.

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 but does not include any other exempt income.

Itemized deduction limit. For 2004, you may have to reduce your itemized deductions on Schedule A (Form 1040) if your adjusted gross income is more than $142,700 ($71,350 if married filing separately). This reduction does not apply to medical and dental expenses, casualty and theft losses (other than losses of employee property), gambling losses, and investment interest.

You figure the reduction by using the Itemized Deductions 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 itemized deductions subject to the reduction (line 3 of the worksheet). This is your reduction percentage (expressed as a decimal rounded to at least four places). Then, multiply each itemized deduction subject to the reduction by your reduction percentage. Subtract the result from the itemized deduction 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 subject to the reduction total $20,000. This is the amount on line 3 of the worksheet. Reduce your adjusted gross income (line 5) by $142,700. Enter the result ($7,300) on line 7. The amount on line 8 is $219 ($7,300 × 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. You made all of them before July 28, 2004, and you did not make the election discussed earlier under *Deductions not definitely related.* Your reduction percentage is 1.095% (219 ÷ $20,000). You must reduce your $12,000 deduction by $131 (1.095% × $12,000). The reduced deduction, $11,869 ($12,000 − $131), 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.

Qualified Dividends

If you have any qualified dividends, you may be required to make adjustments to the amount of those qualified dividends before you take them into account on line 1 or line 17 of Form 1116. See *Foreign Qualified Dividends and Capital Gains (Losses)* in the Form 1116 instructions to determine the adjustments you may be required to make before taking foreign qualified dividends into account on line 1 of Form 1116. See the instructions for Line 17 in the Form 1116 instructions to determine the adjustments you may be required to make before taking U.S. or foreign qualified dividends into account on line 17 of Form 1116.

Capital Gains and Losses

If you have capital gains (including any capital gain distributions) or capital losses, you may have to make certain adjustments to those gains or losses before taking them into account on line 1 (gains), line 5 (losses), or line 17 (taxable income before subtracting exemptions) of Form 1116.

Lines 1 and 5. If you have foreign source capital gains or losses, you may be required to make certain adjustments to those foreign source capital gains or losses before you take them into account on line 1 or line 5 of Form 1116. You may use the instructions in this publication under *Adjustments to Foreign Source Capital Gains and Losses* to determine the adjustments you must make. Use the instructions under *Foreign Qualified Dividends and Capital Gains (Losses)* in the instructions for Form 1116 instead of the instructions in this publication if (1), (2), or (3) applies to you.

1) You do not file a Schedule D (Form 1040) or Schedule D (Form 1041) with your tax return.
2) You have foreign source capital gains or losses in less than 3 separate categories and one of the following applies to you.
   a. You figured your tax using the Qualified Dividends and Capital Gains Tax Worksheet in the instructions for Form 1040 and either line 3 or line 7 of that worksheet is zero or line 17 of that worksheet is equal to or greater than line 18.
   b. You figured your tax using Schedule D (Form 1041) and (1) line 23 is zero, (2) line 15 is zero or a loss, or (3) line 33 is equal to or greater than line 34.
   c. You figured your tax using the Schedule D Tax Worksheet in the instructions for Schedule D (Form 1040) or in the instructions for Form 1041 and (1) line 17 is zero, (2) line 9 is zero or a loss, or (3) line 35 is equal to or greater than line 36.
   d. The amount of your foreign source net capital gain, plus the amount of your foreign source qualified dividends, is less than $20,000 and one of the following applies to you.
      i Line 7 of the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040 or Line 17 of the Schedule D Tax Worksheet in the instructions for Schedule D (Form 1040) is less than or equal to:
         i $178,650 if married filing jointly or qualifying widow(er),
         ii $89,325 if married filing separately,
         iii $146,750 if single, or
         iv $162,700 if head of household.
      ii Line 23 of Schedule D (Form 1041) or line 17 of the Schedule D Tax Worksheet in the Form 1041 instructions is less than or equal to $7,000.

   Note: Your foreign source net capital gain is the excess of your net long-term capital gain from foreign sources over your net short-term capital loss (if any) from foreign sources. Ignore any long-term capital gains you elected to include on Form 4952, line 4g, in determining your foreign source net capital gain. Ignore any qualified dividends you elected to include on Form 4952, line 4g, in determining the amount of your foreign source qualified dividends.
3) You did not complete the Unrecaptured Section 1250 Gain Worksheet in the instructions for Schedule D and you did not complete the 28% Rate Gain Worksheet in the instructions for Schedule D.

If you choose not to use the instructions in this publication or in the instructions to Form 1116, see section 904(b)(2) of the Internal Revenue Code to determine the adjustments you must make.

If you choose to use the instructions in this publication, see *Adjustments to Foreign Source Capital Gains and Losses* below to determine the adjustments you must make.

Line 17 (Form 1116). If you have U.S. or foreign source capital gains, you may be required to adjust the amount you enter on line 17 of Form 1116. Use the instructions for line 17 in the Instructions for Form 1116 to determine whether you are required to make an adjustment and to determine the amount of the adjustment.

Adjustments to Foreign Source Capital Gains and Losses

You may have to make the following adjustments to your foreign source capital gains and losses.

- U.S. capital loss adjustment.
- Capital gain rate differential adjustment.

Before you make these adjustments, you must reduce your net capital gain by the amount of any gain you elected to include in investment income on line 4g of Form 4952, Investment Interest Expense Deduction. Your net capital gain is the excess of your net long-term capital gain for the year over any net short-term capital loss for the year.

U.S. capital loss adjustment. You must adjust the amount of your foreign source capital gains to the extent that your foreign source capital gain exceeds the amount of your worldwide capital gain (the “U.S. capital loss adjustment”).

Your “foreign source capital gain” is the amount of your foreign source capital gains in excess of your foreign source capital losses. If your foreign source capital gains do not exceed your foreign source capital losses, you do not have a foreign source capital gain and you do not need to make the U.S. capital loss adjustment. See *Capital gain rate differential adjust-*

ment later for adjustments you must make to your foreign source capital gains or losses.

Your "worldwide capital gain" is the amount of your worldwide (U.S. and foreign) capital gains in excess of your worldwide (U.S. and foreign) capital losses. If your worldwide capital losses equal or exceed your worldwide capital gains, your "worldwide capital gain" is zero.

Your U.S. capital loss adjustment is the amount of your foreign source capital gain in excess of your worldwide capital gain. (If the amount of your foreign source capital gain does not exceed the amount of your worldwide capital gain, you do not have a U.S. capital loss adjustment.) See *Capital gain rate differential adjustment* later for adjustments you must make to your foreign source capital gains or losses. If you have a U.S. capital loss adjustment, you must reduce your foreign source capital gains by the amount of the U.S. capital loss adjustment. To make this adjustment, you must allocate the total amount of the U.S. capital loss adjustment among your foreign source capital gains using the following steps.

Step 1. You must apportion the U.S. capital loss adjustment among your separate categories that have a net capital gain. A separate category has a net capital gain if the amount of foreign source capital gains in the separate category exceeds the amount of foreign source capital losses in the separate category. You must apportion the U.S. capital loss adjustment pro rata based on the amount of net capital gain in each separate category.

Example 1. Alfie has a $300 foreign source capital gain in the passive category, a $1,000 foreign source capital gain in the general limitation category, a $400 foreign source capital loss in the general limitation category, and a $150 U.S. source capital loss. He figures his net gains and U.S. capital loss adjustment as follows.

Foreign source capital gain = $900
(($1,000 + $300) – $400)

Worldwide capital gain = $750
(($1,000 + $300) – ($400 + $150))

U.S. capital loss adjustment = $150
($900 – $750)

Alfie must then apportion the U.S. capital loss adjustment ($150) between the passive category and the general limitation category based on the amount of net capital gain in each separate category.

$50 apportioned to passive category
($150 × $300/$900)

Alfie reduces his $300 net capital gain in the passive category by $50 and includes the resulting $250 on line 1 of the Form 1116 for the passive category.

$100 apportioned to general limitation category
($150 × $600/$900)

Alfie reduces his $600 of net capital gain in the general limitation category by $100 and includes the resulting $500 on line 1 of the Form 1116 for the general limitation category.

Step 2. If you apportioned any amount of the total U.S. capital loss adjustment to a separate category with a net capital gain in more than one rate group, you must further apportion the U.S. capital loss adjustment among the rate groups in that separate category (separate category rate groups) that have a net capital gain.

The *rate groups* are the 28% rate group, the 25% rate group, the 15% rate group, and the short-term rate group. The 28% rate group, the 25% rate group, and the 15% rate group are "long term" rate groups. *Table 3* explains the rate groups.

You must apportion the U.S. capital loss adjustment pro rata based on the amount of net capital gain in each separate category rate group. Your net capital gain in a separate category rate group is the amount of your foreign source capital gains in that separate category in the rate group in excess of your foreign source capital losses in that separate category in the rate group. If your foreign source capital losses exceed your foreign source capital gains, you have a net capital loss in the separate category rate group.

Example 2. Dennis has a $300 U.S. source long-term capital loss. Dennis also has foreign source capital gains and losses in the following categories.

Income category	28% rate	15% rate	short-term
Passive	$200	($100)	$100
General limitation		$700 ($300)	

He figures his U.S. capital loss adjustment as follows.

Dennis' foreign source capital gain is $600.
(($200 + $700 + $100) – ($100 + $300))

Dennis' worldwide capital gain is $300.
(($200 + $700 + $100) – ($100 + $300 + $300)

Dennis' U.S. capital loss adjustment is $300.
($600 – $300)

Dennis must apportion his $300 U.S. capital loss adjustment between the passive category and the general limitation category based on the amount of net capital gain in each separate category.

Dennis' net capital gain in the passive category is $200.
(($100 + $200) - $100)
Dennis apportions $100 to the passive category.
($300 × $200/$600)

Dennis' net capital gain in the general limitation category is $400.
($700 - $300)
Dennis apportions $200 to the general limitation category.
($300 × $400/$600)

Dennis has net capital gain in more than one rate group in the passive category. Therefore, the $100 apportioned to the passive category must be further apportioned between the short-term rate group and the 28% rate group based on the amount of net capital gain in each rate group.

Dennis apportions $33.33 to the short-term rate group.
($100 × $100/$300)

Dennis apportions $66.67 to the $28% rate group.
($100 × $200/$300)

After the U.S. capital loss adjustment, Dennis has $100 of foreign source 15% capital loss in the passive category, $66.67 of foreign source short-term capital gain in the passive category, $133.33 of foreign source 28% gain in the passive category, and $200 of foreign source 15% capital gain in the general limitation category, as shown in the following table.

Income category	28% rate	15% rate	short-term
Passive	$200.00 -66.67 **$133.33**	($100)	$100.00 – 33.33 **$66.67**
General limitation		$700.00 (300.00) -200.00 **$200.00**	

Capital gain rate differential adjustment. After you have made your U.S. capital loss adjustment, you must make additional adjustments (capital gain rate differential adjustments) to your foreign source capital gains and losses.

You must make adjustments to each separate category rate group that has a net capital gain or loss. See *Step 2* under *U.S. capital loss adjustment*, earlier, for instructions on how to determine whether you have a net capital gain or loss in a separate category rate group.

How to make the adjustment. How you make the capital gain rate differential adjustment depends on whether you have a net capital gain or net capital loss in a separate category rate group.

Table 3. **Rate Groups**

A capital gain or loss is in the...	IF...
28% rate group	it is included on the 28% *Rate Gain Worksheet* in the instructions for Schedule D.
25% rate group	it is included on line 1 through line 13 of the *Unrecaptured Section 1250 Gain Worksheet* in the instructions for Schedule D.
15% rate group	it is a long-term capital gain or loss and is not in the 28% or 25% rate group.
Short-term rate group	it is a short-term capital gain or loss.

Net capital gain in a separate category rate group. If you have a net capital gain in a separate category rate group, you must do the following.

1. First determine the amount of your net capital gain in each separate category rate group that must be adjusted.
2. Then make the capital gain rate differential adjustment. See *Capital gain rate differential adjustment for net capital gains,* later.

How to determine the amount of net capital gain that must be adjusted. You must adjust the net capital gain in each separate category long-term rate group that remains after the U.S. capital loss adjustment. You must adjust the entire amount of that remaining net capital gain if you do not have a net long-term capital loss from U.S. sources or you do not have any short-term capital gains. If you have a net long-term capital loss from U.S. sources and you have any short-term capital gains, you only need to adjust a portion of the remaining net capital gain in each separate category long-term rate group. In that case, the portion you must adjust is limited to the portion of the remaining net capital gain in the separate category long-term rate group in excess of the U.S. long term loss adjustment amount (if any) allocated to that separate category long-term rate group. You have a net long-term capital loss from U.S. sources if your long-term capital losses from U.S. sources exceed your long-term capital gains from U.S. sources.

The U.S. long-term loss adjustment amount is the excess of your net long-term capital loss from U.S. sources over the amount by which you reduced your long-term capital gains from foreign sources under *U.S. capital loss adjustment* above. If only one separate category long-term rate group has a net capital gain after the U.S. capital loss adjustment, your U.S. long-term loss adjustment amount is allocated to that separate category long-term rate group. If more than one separate category long-term rate group has a net capital gain after the U.S. capital loss adjustment, you must allocate the U.S. long-term loss adjustment amount among the separate category long-term rate groups pro rata based on the amount of the remaining net capital gain in each separate category long-term rate group.

Example 3. Mary has a $200 15% capital loss from U.S. sources, a $50 15% capital gain from U.S. sources, and a $200 short-term capital gain from U.S. sources. Mary also has a $300 28% capital gain and a $150 15% capital gain from the passive category.

Mary does not have a U.S. capital loss adjustment because her foreign source capital gain ($450) does not exceed her worldwide capital gain ($500).

Mary's net long-term capital loss from U.S. sources is $150 ($200-$50). Her U.S. long-term loss adjustment amount is $150 ($150 - $0). Mary allocates the $150 between the 28% rate group and the 15% rate group as follows.

Mary allocates $100 ($150 x $300/$450) to the 28% rate group in the passive category. Therefore, $200 ($300 - $100) of her $300 28% capital gain must be adjusted before it is included on line 1. The remaining $100 of 28% capital gain is included on line 1 without adjustment.

Mary allocates $50 ($150 x $150/$450) to the 15% rate group in the passive category. Therefore, only $100 ($150 - $50) of her $150 15% capital gain must be adjusted before it is included on line 1. The remaining $50 of 15% capital gain is included on line 1 without adjustment.

Capital gain rate differential adjustment for net capital gains. Adjust your net capital gain (or the applicable portion of your net capital gain) in each separate category long-term rate group as follows.

- For each separate category that has a net capital gain in the 15% rate group, multiply the applicable amount of the net capital gain by 0.4286.
- For each separate category that has a net capital gain in the 25% rate group, multiply the applicable amount of the net capital gain by 0.7143.
- For each separate category that has a net capital gain in the 28% rate group, multiply the applicable amount of the foreign source net capital gain by 0.8.

Add each result to any net capital gain in the same long-term separate category rate group that you were not required to adjust and include the combined amounts on line 1 of the applicable Form 1116.

No adjustment is required if you have a net capital gain in a short-term rate group. Include the amount of net capital gain in any short-term rate group on line 1 of the applicable Form 1116 without adjustment.

Example 4. Beth has $200 of capital gains in the 28% rate group in the general limitation category and no other items of capital gain or loss. Beth must adjust the capital gain before she includes it on line 1 as follows.

$$\$200 \times 0.8 = \$160$$

Beth includes $160 of capital gain on line 1 of Form 1116 for the general limitation category.

Example 5. The facts are the same as *Example 3*. Mary includes the following amounts on line 1 of Form 1116 for the passive category.

Mary includes $260 of the 28% capital gain ($200 × 0.8) + $100

Mary includes $92.86 of the 15% capital gain ($100 × 0.4286) + $50

Example 6. The facts are the same as *Example 2*. After making the U.S. capital loss adjustment, Dennis has the following:

Income category	28% rate	15% rate	short-term
Passive	$133.33	($100)	$66.67
General limitation		$200	

Dennis now determines the amount of the remaining net capital gain in each separate category long-term rate group that must be adjusted.

Dennis' net long-term capital loss from U.S. sources is $300. His U.S. long-term loss adjustment amount is $33.33 ($300 – $266.67). Dennis must allocate this amount between the $133.33 of net capital gain remaining in the 28% rate group in the passive category and the $200 of net capital gain remaining in the 15% rate group in the general limitation category.

Dennis allocates $13.33 ($33.33 × $133.33 ÷ $333.33) of the U.S. long-term loss adjustment to the 28% rate group in the passive category. Therefore, Dennis must adjust $120 ($133.33 – $13.33) of the $133.33 net capital gain remaining in the 28% rate group in the passive category. Dennis includes $109.33 (($120 × 0.8) + 13.33 of 28% capital gain and $66.67 of short-term capital gain on line 1 of Form 1116 for the passive category.

Dennis allocates $20 ($33.33 × $200 ÷ $333.33) to the 15% rate group in the general limitation category. Therefore, Dennis must adjust $180 ($200 – $20) of the $200 net capital gain remaining in the 15% rate group in the general limitation category. Dennis includes $97.15 (($180 × 0.4286) + $20) of 15% capital gain on line 1 of Form 1116 for the general limitation category.

Net capital loss in a separate category rate group. If you have a net capital loss in a separate category rate group, you must do the following.

1. First determine the rate group of the capital gain offset by that net capital loss. See *How to determine the rate group of the capital gain offset by the net capital loss,* next.
2. Then make the capital gain rate differential adjustment. See *Capital gain rate differential adjustment for net capital loss,* later.

How to determine the rate group of the capital gain offset by the net capital loss. Use the following ordering rules to determine the rate group of the capital gain offset by the net capital loss.

Determinations under the following ordering rules are made after you have taken into account any U.S. capital loss adjustment. However, determinations under the following ordering rules do not take into account any capital gain rate differential adjustments that you made to any net capital gain in a separate category rate group.

Step 1. Net capital losses from each separate category rate group are netted against net capital gains in the same rate group in other separate categories.

Step 2. U.S. source capital losses are netted against U.S. source capital gains in the same rate group.

Step 3. Net capital losses from each separate category rate group in excess of the amount netted against foreign source net capital gains in *Step 1* are netted against your remaining foreign source net capital gains and your U.S. source net capital gains as follows.

1. First, against U.S. source net capital gains in the same rate group, and
2. Next, against net capital gains in other rate groups (without regard to whether such net

capital gains are U.S. or foreign source net capital gains) as follows.

a. A foreign source net capital loss in the short-term rate group is first netted against any net capital gain in the 28% rate group, then against any net capital gain in the 25% rate group, and finally against any net capital gain in the 15% rate group.

b. A foreign source net capital loss in the 28% rate group is netted first against any net capital gain in the 25% rate group, and then against any net capital gain in the 15% rate group.

c. A foreign source net capital loss in the 15% rate group is netted first against any net capital gain in the 28% rate group, and then against any net capital gain in the 25% rate group.

The net capital losses in any separate category rate group are treated as coming pro rata from each separate category that contains a net capital loss in that rate group to the extent netted against:

- Net capital gains in any other separate category under *Step 1,*
- Any U.S. source net capital gain under *Step 3(1),* or
- Net capital gains in any other rate group under *Step 3(2)*.

Capital gain rate differential adjustment for net capital loss. After you have determined the rate group of the capital gain offset by the net capital loss, you make the capital gain rate differential adjustment by doing the following.

- To the extent a net capital loss in a separate category rate group offsets capital gain in the 15% rate group, multiply the capital loss by 0.4286.
- To the extent that a net capital loss in a separate category rate group offsets capital gain in the 25% rate group, multiply that amount of the net capital loss by 0.7143.
- To the extent that a net capital loss in a separate category rate group offsets capital gain in the 28% rate group, multiply that amount of the capital loss by 0.8.

Include the results on line 5 of the applicable Form 1116.

No adjustment is required to the extent a net capital loss offsets short-term capital gains. Thus, a net capital loss is included on line 5 of the applicable Form 1116 without adjustment to the extent the net capital loss offsets net capital gain in the short-term rate group.

Example 7. The facts are the same as *Example 2*. Dennis has a $100 foreign source 15% capital loss in the passive category.

This loss is netted against the $200 foreign source 15% capital gain in the general limitation category according to *Step 1*.

Dennis includes $42.86 of the capital loss on line 5 of the Form 1116 for the general limitation category.

($100 × 0.4286)

Example 8. Dawn has a $20 net capital loss in the 15% rate group in the passive category, a $40 net capital loss in the 15% rate group in the general limitation category, a $50 U.S. source net capital gain in the 15% rate group, and a $50 net capital gain in the 28% rate group in the passive category, as shown in the following table.

Income category	28% rate	15% rate
Foreign Passive	$50	($20)
Foreign General Limitation		($40)
U.S. Source		$50

Of the total $60 of foreign source net capital losses in the 15% rate group, $50 is treated as offsetting the $50 U.S. source net capital gain in the 15% rate group. (See *Step 3(1)*.)

$16.67 of the $50 is treated as coming from the passive category.
($50 × $20/60)
$33.33 of the $50 is treated as coming from the general limitation category.
($50 × $40/$60)

The remaining $10 of foreign source net capital losses in the 15% rate group are treated as offsetting net capital gain in the 28% rate group. (See *Step 3(2)(c)*.)

$3.33 is treated as coming from the passive category.
($10 × $20/60)
$6.67 is treated as coming from the general limitation category.
($10 × $40/$60)

Dawn includes $9.80 of the capital loss in the amount she enters on line 5 of Form 1116 for the passive category.

This is $7.14
($16.67 × 0.4286)
plus $2.66.
($3.33 ×0.8)

Dawn includes $19.63 of capital loss in the amount she enters on line 5 of Form 1116 for the general limitation category.

This is $14.29
($33.33 × 0.4286)
plus $5.34.
($6.67 × 0.8)

Dawn also includes $40.00 ($50 × 0.8) of capital gain in the amount she enters on line 1 of Form 1116 for the passive category.

Allocation of Foreign and U.S. Losses

You must allocate foreign losses for any taxable year and U.S. losses for any taxable year (to the extent such losses do not exceed the separate limitation incomes for such year) among incomes on a proportionate basis.

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.

Note. The amount of your taxable income (or loss) in a separate category is determined after any adjustments you make to your foreign source qualified dividends or your foreign source capital gains (losses). See *Qualified Dividends* and *Adjustments to Foreign Source Capital Gains and Losses* earlier under *Capital Gains and Losses*.

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 must 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 a FSC. You must allocate the $2,000 loss to the income in the other separate categories. 60% ($3,000/$5,000) of the $2,000 loss (or $1,200) reduces passive income and 40% ($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 the remaining loss to reduce U.S. source income. For this purpose, the amount of your U.S. source income is your taxable income from U.S. sources increased by the amount of capital losses from U.S. sources that reduced foreign source capital gains as part of a U.S. capital loss adjustment. See *U.S. capital loss adjustment* earlier under *Adjustments to Foreign Source Capital Gains and Losses.* 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.

CAUTION

Do not recharacterize the tax.

Example. The facts are the same as in the previous example. However, 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 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 $3,000 ($5,000 – $1,200 – $800).

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 earlier,
2. Recapturing any prior year overall foreign loss as described below, and
3. Recharacterizing foreign source income as described above.

The amount of your net loss from sources in the United States is equal to the excess of (1) your foreign source taxable income in all of your separate categories in the aggregate, after taking into account any adjustments under *Qualified Dividends* and *Adjustments to Foreign Source Capital Gains and Losses* over (2) the amount of taxable income you enter on Form 1116, line 17.

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 in the same separate limit category. You must recapture the overall loss regardless of whether you chose to claim the foreign tax credit for the loss year.

You recapture the loss by treating part of your taxable income from foreign sources in a later year as U.S. source income. In addition, if, in a later year, you sell or otherwise dispose of property used in your foreign trade or business, you may have to recognize gain and treat it as U.S. source income, even if the disposition would otherwise be nontaxable. See *Dispositions*, later. The amount you treat as U.S. source income reduces the 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 expenses, losses, or other deductions that you allocated and apportioned to foreign income under the rules explained earlier under *Determining Taxable Income From Sources Outside the United States.* But see *Losses not considered*, later, for exceptions.

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 $80,000. You also have itemized deductions of $6,100 that are not definitely 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 $6,100 in itemized deductions to the foreign source income. You figure the ratable part of the $6,100 that is for foreign source income, based on gross income, as follows:

$$\frac{\$100{,}000 \text{ (Foreign gross income)}}{\$110{,}000 \text{ (Total gross income)}} \times \$6{,}100 = \$5{,}545$$

Therefore, your overall foreign loss for the year is $8,545, figured as follows:

Foreign gross income		$100,000
Less:		
Foreign earned income exclusion	$80,000	
Allowable definitely related expenses ($20,000/ $100,000 × $115,000) . .	23,000	
Ratable part of itemized deductions	5,545	108,545
Overall foreign loss		$ 8,545

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

- Net operating loss deduction.
- Foreign expropriation loss not compensated by insurance or other reimbursement.
- Casualty or theft loss not compensated by insurance or other reimbursement.

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 foreign source taxable income (in the same separate limit category as the loss) for each succeeding year is treated as U.S. source taxable income. The part that is treated as U.S. source taxable income is the smallest of:

1. The balance in the applicable overall foreign loss account,
2. 50% (or a larger percentage that you can choose) of your total foreign source taxable income for the succeeding tax year, or
3. The foreign source taxable income for the succeeding tax year which is in the same separate limit category as the loss after the allocation of foreign losses (discussed earlier).

Example. During 2003 and 2004, you were single and a 20% general partner in a partnership that derived its income from Country X. You also received dividend income from U.S. sources during those years.

For 2003, the partnership had a loss and your share was $20,000, consisting of $100,000 gross income less $120,000 expenses. Your net loss from the partnership was $4,000, after deducting the foreign earned income exclusion and definitely related allowable expenses. This loss is related to 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 2003, you deducted your share of the partnership loss from Country X from your U.S. source income.

During 2004, 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 was $8,000, after deducting the foreign earned income exclusion and the definitely 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 definitely 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 2004, 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 2003 Overall Foreign Loss		
1) Partnership loss from Country X		$4,000
2) Add: Part of itemized deductions allocable to gross income from Country X $\frac{\$100{,}000}{\$120{,}000} \times \$5{,}000 =$		$4,167
3) Overall foreign loss for 2003		$8,167
B. Amount of Recapture for 2004		
1) Balance in general limitation category foreign loss account		$8,167
2) Foreign source net income . . .	$8,000	
Less: Itemized deductions allocable to foreign source net income ($100,000 / $120,000 × $6,000)	5,000	$3,000
3) 50% of foreign source taxable income subject to recapture		$1,500
4) Taxable income in general limitation category after allocation of foreign losses— General limitation income	$8,000	
Less: Itemized deductions allocable to that income ($100,000 / $120,000 × $6,000)	5,000	
General limitation taxable income less allocated foreign losses ($3,000 – 0)		$3,000
5) Recapture for 2004 (smallest of (1), (3), or (4))		$1,500

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. If you change a prior year's election, you should file Form 1040X.

The statement you attach to Form 1116 must show:

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

Deduction for foreign taxes. You must 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:

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

Dispositions. If you dispose of appreciated trade or business property used predominantly outside the United States, and that property generates foreign source taxable income of the same separate limit category that resulted in an overall foreign loss, the disposition is subject to the recapture rules. Generally, you are considered to recognize foreign source taxable income in the same separate limit category as the overall foreign loss to the extent of the lesser of:

- The fair market value of the property that is more than your adjusted basis in the property, or
- The remaining amount of the overall foreign loss not recaptured in prior years or in the current year as described earlier under *Recapture provision* and *Recapturing more overall foreign loss than required.*

This rule applies to a disposition whether or not you actually recognized gain on the disposition and irrespective of the source (U.S. or foreign) of any gain recognized on the disposition.

This rule also generally applies to a gain on the disposition of stock in a controlled foreign corporation (CFC) after October 22, 2004, if you owned more than 50 percent (by vote or value) of the stock right before you disposed of it. See Internal Revenue Code section 904(f)(3)(D) for more information.

The foreign source taxable income that you are considered to recognize is generally subject to recapture as U.S. source income in an amount equal to the lesser of:

1. Your foreign source taxable income in the same separate limit category as the overall foreign loss, or
2. 100% of your total foreign source taxable income for the year.

If you actually recognized foreign source gain in the same separate limit category as the overall foreign loss on a disposition of property described earlier, you must reduce the foreign source taxable income in that separate limit category by the amount of gain you are required to recapture. If you recognized foreign source gain in a different separate limit category than the overall foreign loss on a disposition of property described earlier, you are required to reduce your foreign source taxable income in that separate limit category for gain that is considered foreign source taxable income in the overall foreign loss category and subject to recapture. If you did not otherwise recognize gain on a disposition of property described earlier, you must include in your U.S. source income the foreign source taxable income you are required to recognize and recapture.

Predominant use outside United States. Property is used predominantly outside the United States if it was located outside the United States more than 50% of the time 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 the following transactions.

- A sale, exchange, distribution, or gift of property.
- A transfer upon the foreclosure of a security interest (but not a mere transfer of title to a creditor or debtor upon creation or termination of a security interest).
- An involuntary conversion.
- A contribution to a partnership, trust, or corporation.
- A transfer at death.
- Any other transfer of property whether or not gain or loss is normally recognized on the transfer.

The character of the income (for example, as ordinary income or capital gain) 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 either of the following:

- A disposition of property that is not a material factor in producing income. (This exception does not apply to the disposition of stock in a controlled foreign corporation (CFC) after October 22, 2004, to which Internal Revenue Code section 904(f)(3)(D) applies.)
- A transaction in which gross income is not realized.

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 must 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 United States is a party to tax treaties that are designed, in part, to prevent double taxation of the same income by the United States and the treaty country. Many treaties do this by allowing you to treat U.S. source income as foreign source income. 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 rules 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 additional credit include those with Australia, Austria, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Luxembourg, Mexico, the Netherlands, New Zealand, Portugal, Slovenia, South Africa, Sweden, Switzerland, and the United Kingdom. There is a worksheet at the end of this publication to help you figure the additional credit. But do not use this worksheet to figure the additional credit under the treaties with Australia and New Zealand. Also, do not use this worksheet for income that is in the "Income Re-Sourced By Treaty" category discussed earlier under *Separate Limit Income*.

You can get more information, and the worksheet to figure the additional credit under the Australia and New Zealand treaties, by writing to:

Internal Revenue Service
International Section
P.O. Box 920
Bensalem, PA 19020–8518.

You can also contact the United States Tax Attaché at the U.S. Embassies in Berlin, London, and Paris, 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. For example, if a treaty provision allows you to take a foreign tax credit for a specific tax that is not allowed by the Internal Revenue Code, you must report this information with your return. To report the necessary information, use Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).

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

TIP *You do not have to file Form 8833 if you are claiming the additional foreign tax credit (discussed previously).*

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 10-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 10 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 by which the qualified taxes paid or accrued are more than 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 foreign taxes paid on the income are as follows:

	Your limit	Tax paid	Unused foreign tax (+) or excess limit (–)
2002	$100	$ 50	– 50
2003	$200	$100	–100
2004	$300	$500	+200

In 2004, you had unused foreign tax of $200 to carry to other years. You are considered to have paid this unused foreign tax first in 2002 (the second preceding tax year) up to the excess limit in that year of $50, and then in 2003 (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 general limitation income category. In 2000, you had an unused foreign tax of $200. Since you had no foreign income in 1998 and 1999, you cannot carry back the unused foreign tax to those years. However, you may be able to carry forward the unused tax to the next 10 years. The limit on your credit and the qualified foreign taxes paid on general limitation income for 2000–2005 are as follows:

	Your limit	Tax paid	Unused foreign tax (+) or excess limit (–)
2000	$600	$800	+200
2001	$600	$700	+100
2002	$500	$700	+200
2003	$550	$400	–150
2004	$800	$700	–100
2005	$500	$550	+ 50

You cannot carry the $200 of unused foreign tax from 2000 to 2001 or 2002 since you have no excess limit in either of those years. Therefore, you carry the tax forward to 2003, 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 from 2000 can be carried to 2004. At this point, you have fully absorbed the unused foreign tax from 2000 and can carry it no further. You can also carry forward the unused foreign tax from 2001 and 2002.

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 cents 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 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.

- You cannot claim a credit carryback or carryover from a year in which you deducted qualified foreign taxes.
- 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.
- 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.
- You cannot carry back or carry over any unused foreign taxes to or from a year for which you elect not to be subject to the foreign tax credit limit. See *Exemption from foreign tax credit limit* under *How To Figure the Credit,* earlier.

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. If 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 absorbed 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 absorbed in a deduction year, you will get no tax benefit for them unless you file an amended return to reverse your choice from deducting the taxes to claiming the credit. You have 10 years from the due date of the return for the deduction year to make this change. See *Making or Changing Your Choice,* under *Choosing To Take Credit or Deduction,* earlier.

Example. In 2004, you paid foreign taxes of $600 on income in the general limitation income category. You have a foreign tax credit carryover of $200 from the same category from 2003. For 2004, your foreign tax credit limit is $700.

If you choose to claim a credit for your foreign taxes in 2004, you would be allowed a credit of $700, consisting of $600 paid in 2004 and $100 of the $200 carried over from 2003. You will have a credit carryover to 2005 of $100, which is your unused 2003 foreign tax credit carryover.

If you choose to deduct your foreign taxes in 2004, your deduction will be limited to $600, which is the amount of taxes paid in 2004. You are not allowed a deduction for any part of the carryover from 2003. However, you must treat $100 of the credit carryover as used in 2004, because you have an unused credit limit of $100 ($700 limit minus $600 of foreign taxes paid in 2004). This reduces your carryover to later years.

If you claimed the deduction for 2004 and later decided you wanted to receive a benefit for that $100 part of the 2003 carryover, you could reverse the choice of a deduction for 2004. You would have to claim a credit for those taxes by filing an amended return for 2004 within the time allowed.

Married Couples

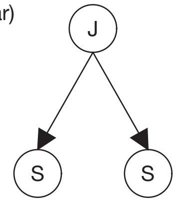
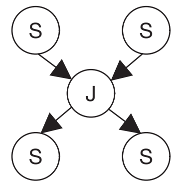
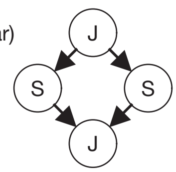
For a tax year in which you and your spouse file a joint return, you must figure the unused foreign tax or excess limit in each separate limit category on the basis of your combined income, deductions, taxes, and credits.

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

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

(In the following situations, you have to allocate an unused foreign tax or excess limit for a tax year in which you and your spouse filed a joint return.)

You and your spouse file separate returns for the current tax year (2004), to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return.	2003 (Joint return—Unused foreign tax year) 2004 (Separate return—Excess limit year)	
You and your spouse file separate returns for the current tax year (2004), 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.	2002 (Separate returns—Unused foreign tax year) 2003 (Joint return—Excess limit year) 2004 (Separate returns—Excess limit year)	
You and your spouse file a joint return for the current tax year (2004), 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.	2002 (Joint return—Unused foreign tax year) 2003 (Separate returns—Excess limit year) 2004 (Joint return—Excess limit year)	

J—Joint return filed
S—Separate return filed

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.*

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, 2004 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 2000, 2002, and 2003, and separate returns for 2001 and 2004. Neither H nor W had any unused foreign tax or excess limit for any year before 2000. 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 4.

W's allocated part of the unused foreign tax from 2000 ($30) is partly absorbed by her separate excess limit of $20 for 2001, and then fully absorbed by her allocated part of the joint excess limit for 2002 ($20). H's allocated part of

Table 4. **Carryback/Carryover**

Tax year	**2000**	**2001**	**2002**	**2003**	**2004**
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 2000	—	20W	10W	—	—
H's from 2000	—	—	50H	—	—
H's from 2001	—	—	15H	—	—
〃	—	—	10W	—	—
W's from 2003	—	—	—	—	10W
H's from 2003	—	—	—	—	50H
W = Absorbed by W's excess limit					
H = Absorbed by H's excess limit					

* General limitation income category only

the unused foreign tax from 2000 ($50) is fully absorbed by his allocated part of the joint excess limit ($65) for 2002.

H's separate unused foreign tax from 2001 ($25) is partly absorbed (up to $15) by his remaining excess limit in 2002, and then fully absorbed by W's remaining part of the joint excess limit for 2002 ($10). Each spouse's excess limit on the 2002 joint return is reduced by:

1. Each spouse's carryover from earlier years (W's carryover of $10 from 2000 and H's carryovers of $50 from 2000 and $15 from 2001).
2. The other spouse's carryover. (H's carryover of $10 from 2001 is absorbed by W's remaining excess limit.)

W's allocated part of the unused foreign tax of $69 from 2003 is partly absorbed by her excess limit in 2004 ($10), and the remaining $59 will be a carryover to the general limitation income category for 2005 and the following 8 years unless absorbed sooner. H's allocated part of the unused foreign tax of $104 from 2003 is partly absorbed by his excess limit in 2004 ($50), and the remaining $54 will be a carryover to 2005 and the following 8 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.

How To Claim the Credit

You must file Form 1116 to claim the foreign tax credit unless you meet one of the following exceptions.

Exceptions. If you meet the requirements discussed under *Exemption from foreign tax limit,* earlier, and choose to be exempt from the foreign tax credit limit, do not file Form 1116. Instead, enter your foreign taxes directly on Form 1040, line 46.

If you are a shareholder of a controlled foreign corporation and chose to be taxed at corporate rates on the amount you must include in gross income from that corporation, use Form 1118 to claim the credit. See *Controlled foreign corporation shareholder* under *You Must Have Paid or Accrued the Tax,* earlier.

Form 1116

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.

- Passive income.
- High withholding tax interest.
- Financial services income.
- Shipping income.
- Dividends from a DISC or former DISC.
- Certain distributions from an FSC or former FSC.
- Lump-sum distributions.
- Section 901(j) income.
- Income re-sourced by treaty.
- General limitation income—all other income from sources outside the United States.

A Form 1116 consists of four parts as explained next.

1. *Part I—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. Do not include income you excluded on Form 2555 or Form 2555-EZ. 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.
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

RECORDS

You should keep the following records in case you are later asked to verify the taxes shown on your Form 1116 or Form 1040. You do not have to attach these records to your Form 1040.

- A receipt for each foreign tax payment.
- The foreign tax return if you claim a credit for taxes accrued.
- Any payee statement (such as Form 1099-DIV or Form 1099-INT) showing foreign taxes reported to you.

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 have a certified translation of it. Revenue Ruling 67-308 in Cumulative Bulletin 1967-2 discusses in detail the requirements of the certified translation. You can buy the Cumulative Bulletin from the Government Printing Office. Issues of the Cumulative Bulletin 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. A foreign tax credit may be allowed in figuring this tax. See the instructions for Form 6251, Alternative Minimum Tax—Individuals, for a discussion of the alternative minimum tax foreign tax credit.

Simple Example — Filled-In Form 1116

Betsy Wilson is single, under 65, and is a U.S. citizen. She earned $21,000 working as a night auditor in Pittsburgh. She owns 200 shares in XYZ mutual fund that invests in Country Z corporations. She received a dividend of $620 from XYZ, which withheld and paid tax of $93 to Country Z on her dividend. XYZ reported this information to her on Form 1099-DIV.

Betsy elects to be exempt from the foreign tax credit limit because her only foreign taxable income is passive income (dividend of $620) and the amount of taxes paid ($93) is not more than $300. To claim the $93 as a credit, Betsy enters $93 on Form 1040, line 46. (She can claim her total taxes paid of $93 because it is less than her "regular tax," shown on Form 1040 line 43.) She does not file Form 1116. However, she cannot carry any unused foreign taxes to this tax year.

If Betsy does not elect to be exempt from the foreign tax credit limit, she will need to complete a Form 1116 as follows.

Betsy fills in her name and social security number, and checks the box for passive income.

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

Betsy enters 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. None of the dividends are qualified dividends. Next, since Betsy does not itemize her deductions, she puts her standard deduction ($4,850) 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 enters $139 on line 6. Line 7 is $481, the difference between lines 1 and 6.

Part II—Foreign Taxes Paid or Accrued

Betsy checks the “Paid” box and enters $93 on line A, columns (t) and (x), and on line 8.

Since the income was reported to Betsy in U.S. dollars on Form 1099-DIV, she does not have to convert the amount shown into foreign currency. She enters “1099 taxes” on line A, column (o).

Part III—Figuring the Credit

Betsy figures her credit as shown on the completed form. The computation shows that she may take only $49 of the amount paid to Country Z as a credit against her U.S. income tax. The remaining $44 is available for a carryback and/or carryover.

Part IV—Summary of Credits From Separate Parts III

Because this is the only Form 1116 that Betsy must complete, she does not need to fill in lines 22 through 30 of Part IV

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 2004, 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. None of the dividends are qualified dividends.

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)	$450 (900 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 $80,000 of the wages earned in Country X.

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

Interest on home mortgage	$2,900
Real estate tax	940
Charitable contribution made before July 28, 2004	460
Employee business expenses (See the following discussion for computation.)	872
Total	$5,172

Employee business expenses. Robert paid $3,400 of unreimbursed business expenses, of which $1,000 were definitely related to the wages earned in the United States 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 (related to the wages earned in Country X) as follows:

$$\frac{\$20{,}000}{\$100{,}000} \times \$2{,}400 = \$480$$

His employee business expense deduction is $872. This is the difference between his business expenses of $1,480 ($480 + $1,000 from U.S. business trip) and the 2%-of-adjusted-gross-income limit ($608).

Forms 1116

Robert must use two Forms 1116 to figure his allowable foreign tax credit. On one Form 1116, he will mark the block to the left of *General limitation income,* and figure his foreign tax credit on the wages of $20,000 (Country X wages minus excluded wages). On the other Form 1116, he will mark the block to the left of *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 near 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 $22,128 figured as follows:

Gross Income	
Wages (Country X)	$100,000
Less: Foreign earned income exclusion	80,000
	$ 20,000
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)	$30,400
Less: Total Itemized Deductions	5,172
Taxable income before the personal exemption	$25,228
Less: Personal Exemption	3,100
Taxable Income	$22,128

On each Form 1116, Robert enters $25,228 (his taxable income before the personal exemption) on line 17 of Part III.

Part I—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 (Form 1116, line 7).

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.

Line 1. Robert enters the wages earned in Country X of $20,000 on line 1.

Line 2. The unreimbursed employee business expenses related to these foreign source wages included in income are $480, as shown earlier. Robert must determine which part of the 2%-of-adjusted-gross-income limit ($608) is allocable to these employee business expenses. He figures this as follows:

$$\frac{\$480}{\$1{,}480} \times \$608 = \$197$$

The denominator ($1,480) is the total allowable unreimbursed business expenses ($1,000 + $480). The amount of deductible expenses definitely related to $20,000 of taxable foreign wages is $283 ($480 – $197). He enters $283 on line 2. He attaches this explanation to his Form 1116 that he files with his tax return.

Line 3a–g. 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 include the $80,000 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.

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

Line 4a. Robert apportions his qualified home mortgage interest, $2,900, to general limitation income as follows:

1. Enter gross foreign source income of the type shown on Form 1116. **Do not** enter income excluded on Form 2555	. . . .	$20,000
2. Enter gross income from all sources. **Do not** enter income excluded on Form 2555	. . . .	$30,400
3. Divide line 1 by line 2 and enter the result as a decimal	. . . .	.6579
4. Enter deductible home mortgage interest (from Schedule A (Form 1040))	. . . .	$ 2,900
5. Multiply line 4 by line 3. Enter the result here and on Form 1116, line 4a	. . . .	$ 1,908

Robert enters this amount, $1,908 on line 4a.

Line 6. Robert adds the amounts on lines 2, 3g, and 4a, and enters that total ($3,459) on line 6.

Line 7. He subtracts the amount on line 6 from the amount on line 1 to arrive at foreign source taxable income of $16,541 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.

Line 1. He adds the $1,000 interest income and the $4,000 dividend income ($5,000) from Country X and enters the total ($5,000) on line 1. None of the dividends are qualified dividends.

Line 3a – g. Robert figures the part of his itemized deductions (real estate tax and charitable contributions) allocable to passive income as follows and enters the amount on line 3g.

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

Line 4a. Robert apportions the qualified home mortgage interest to passive income as follows:

1. Enter gross foreign source income of the type shown on Form 1116. Do not enter income excluded on Form 2555	. . . . . .	$ 5,000
2. Enter gross income from all sources. Do not enter income excluded on Form 2555	. . . . . .	$30,400
3. Divide line 1 by line 2 and enter the result as a decimal	. . . . . .	.1645
4. Enter deductible home mortgage interest (from Schedule A (Form 1040))	. . . .	$ 2,900
5. Multiply line 4 by line 3. Enter the result here and on Form 1116, line 4a	. . . .	$ 477

He enters this amount, $477, on line 4a.

Line 6. Robert adds the amounts on lines 3g and 4a and enters that total ($540) on line 6.

Line 7. He subtracts the amount on line 6 from the amount on line 1 to arrive at foreign source taxable income of $4,460 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 (withheld at source), 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.

Line 10. He has a carryover of $200 for unused foreign taxes paid in 2003 and enters that amount on line 10. He attaches a schedule showing how he figured his $200 carryover to 2004 after carrying back the unused $350 tax paid in 2003 to the 2 preceding tax years. (This schedule is shown in Table 5.) The unused foreign tax in 2003 and the excess limits in 2001 and 2002 are in the general limitation income category. The unused foreign tax of $200 is carried over to the general limitation income category in 2004.

Line 12. 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 ($80,000) minus a proportionate part of his definitely related business expenses ($2,400 – $480 = $1,920). The denominator of the fraction is his total foreign wages ($100,000) minus his total definitely related business expenses ($2,400).

$$\$27{,}400 \times \frac{\$80{,}000 - \$1{,}920}{\$100{,}000 - \$2{,}400} = \$21{,}920$$

He enters the result, $21,920, on line 12.

Line 13. His total foreign taxes available for credit are $5,680 ($200 carryover from 2003 + $5,480 paid in 2004 ($27,400 – $21,920)).

Line 20. By completing the rest of Part III, Robert finds that his limit is $1,942.

Line 21. The foreign tax credit on the general limitation income is the lesser of the foreign tax available for credit, $5,680, or the limit, $1,942.

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 $524.

The foreign tax credit is the lesser of the foreign tax paid, $500, or the limit, $524.

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 leaves line 32 blank because he did not participate in or cooperate with an international boycott during the tax year. The allowable foreign tax credit is $2,442 ($500 + $1,942), shown on line 33. He also enters this amount on Form 1040, line 46.

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 2004 unused foreign taxes of $3,538 ($5,480 – $1,942) and $200 of 2003 unused foreign taxes available as a carryover to 2005 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 2004 unused taxes to 2002 or 2003 as shown in Table 5.

Passive income. Since the foreign tax Robert paid on his interest and dividend income is less than the amount for which he could have claimed a credit in 2004 under the limit for this separate income category, he has no unused foreign tax and therefore no carryback or carryover to other tax years.

Table 5. **Robert's Schedule Showing Computation of His Carryover**

	2001	**2002**	**2003**
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 2003	50	100	
Net excess tax to be carried over to 2004	0	0	+$350
Less carrybacks to 2001 and 2002	. . . . .	. . . . .	150
Amount carried over to 2004	. . . . .	. . . . .	$200

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

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

▶ See separate instructions.

OMB No. 1545-0121

2004

Attachment Sequence No. **19**

Name	Identifying number as shown on page 1 of your tax return
Betsy Wilson	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.

- **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
- **h** ☐ Section 901(j) income
- **i** ☐ Certain income re-sourced by treaty
- **j** ☐ General limitation income

k 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.*

Part I 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.)
l Enter the name of the foreign country or U.S. possession ▶	Country Z			
1 Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions): Dividends	620			**1** 620
Deductions and losses (*Caution: See pages 13 and 14 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)	4,850			
b Other deductions (attach statement)	-0-			
c Add lines 3a and 3b	4,850			
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 (see instructions)	.0287			
g Multiply line 3c by line 3f	139			
4 Pro rata share of interest expense (see instructions):				
a Home mortgage interest (use worksheet on page 13 of the instructions)				
b Other interest expense				
5 Losses from foreign sources				
6 Add lines 2, 3g, 4a, 4b, and 5	139			**6** 139
7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ▶				**7** 481

Part II Foreign Taxes Paid or Accrued (see page 14 of the instructions)

Country	Credit is claimed for taxes (you must check one) (m) ☒ Paid (n) ☐ Accrued — (o) Date paid or accrued	In foreign currency — Taxes withheld at source on: (p) Dividends	(q) Rents and royalties	(r) Interest	(s) Other foreign taxes paid or accrued	In U.S. dollars — Taxes withheld at source on: (t) Dividends	(u) Rents and royalties	(v) Interest	(w) Other foreign taxes paid or accrued	(x) Total foreign taxes paid or accrued (add cols. (t) through (w))
A	1099 taxes					93				93
B										
C										

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

For Paperwork Reduction Act Notice, see page 18 of the instructions. Cat. No. 11440U Form **1116** (2004)

Part III Figuring the Credit

9	Enter the 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 15 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 the 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 15 of the instructions)	14	481		
15	Adjustments to line 14 (see page 16 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. However, if you are filing more than one Form 1116, you must complete line 19.)	16	481		
17	**Individuals:** Enter the amount from Form 1040, line 40. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	17	16,770		
	Caution: *If you figured your tax using the lower rates on qualified dividends or capital gains, see page 17 of the instructions.*				
18	Divide line 16 by line 17. If line 16 is more than line 17, enter "1"			18	.0287
19	**Individuals:** Enter the amount from Form 1040, line 43. If you are a nonresident alien, enter the amount from Form 1040NR, line 40. **Estates and trusts:** Enter the amount from Form 1041, Schedule G, line 1a, or the total of Form 990-T, lines 36 and 37			19	1,694
	Caution: *If you are completing line 19 for separate category **g** (lump-sum distributions), see page 18 of the instructions.*				
20	Multiply line 19 by line 18 (maximum amount of credit)			20	49
21	Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 18 of the instructions) ▶			21	49

Part IV Summary of Credits From Separate Parts III (see page 18 of the instructions)

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 and certain distributions from a FSC or former FSC	26			
27	Credit for taxes on lump-sum distributions	27			
28	Credit for taxes on certain income re-sourced by treaty	28			
29	Credit for taxes on general limitation income	29			
30	Add lines 22 through 29			30	
31	Enter the **smaller** of line 19 or line 30			31	49
32	Reduction of credit for international boycott operations. See instructions for line 12 on page 15			32	
33	Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 46; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶			33	49

Form **1116** (2004)

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

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

▶ See separate instructions.

OMB No. 1545-0121

2004

Attachment Sequence No. **19**

Name	Identifying number as shown on page 1 of your tax return
Robert Smith	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.

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
h ☐ Section 901(j) income
i ☐ Certain income re-sourced by treaty
j ☒ General limitation income

k 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.*

Part I 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.)
l **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 13 of the instructions): Wages	20,000			1	20,000
Deductions and losses (***Caution:*** *See pages 13 and 14 of the instructions*):					
2 Expenses **definitely related** to the income on line 1 (attach statement)	283				
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 (see instructions)	.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 13 of the instructions)	1,908				
b Other interest expense					
5 Losses from foreign sources					
6 Add lines 2, 3g, 4a, 4b, and 5	3,459			6	3,459
7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ▶				7	16,541

Part II Foreign Taxes Paid or Accrued (see page 14 of the instructions)

Country	Credit is claimed for taxes (you must check one) (m) ☒ Paid (n) ☐ Accrued — (o) Date paid or accrued	In foreign currency — Taxes withheld at source on: (p) Dividends	(q) Rents and royalties	(r) Interest	(s) Other foreign taxes paid or accrued	In U.S. dollars — Taxes withheld at source on: (t) Dividends	(u) Rents and royalties	(v) Interest	(w) Other foreign taxes paid or accrued	(x) Total foreign taxes paid or accrued (add cols. (t) through (w))
A	12-31-04				54,800				27,400	27,400
B										
C										

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

For Paperwork Reduction Act Notice, see page 18 of the instructions. Cat. No. 11440U Form **1116** (2004)

Part III Figuring the Credit

9	Enter the 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 15 of the instructions) . . .	12	21,920	
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit . . .			13 5,680
14	Enter the 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 15 of the instructions) .	14	16,541	
15	Adjustments to line 14 (see page 16 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. However, if you are filing more than one Form 1116, you must complete line 19.)	16	16,541	
17	**Individuals:** Enter the amount from Form 1040, line 40. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	17	25,228	
	Caution: *If you figured your tax using the lower rates on qualified dividends or capital gains, see page 17 of the instructions.*			
18	Divide line 16 by line 17. If line 16 is more than line 17, enter “1”			18 .6557
19	**Individuals:** Enter the amount from Form 1040, line 43. If you are a nonresident alien, enter the amount from Form 1040NR, line 40. **Estates and trusts:** Enter the amount from Form 1041, Schedule G, line 1a, or the total of Form 990-T, lines 36 and 37			19 2,961
	Caution: *If you are completing line 19 for separate category **g** (lump-sum distributions), see page 18 of the instructions.*			
20	Multiply line 19 by line 18 (maximum amount of credit)			20 1,942
21	Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 18 of the instructions) . . . . ▶			21 1,942

Part IV Summary of Credits From Separate Parts III (see page 18 of the instructions)

22	Credit for taxes on passive income	22	500	
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 and certain distributions from a FSC or former FSC	26		
27	Credit for taxes on lump-sum distributions	27		
28	Credit for taxes on certain income re-sourced by treaty	28		
29	Credit for taxes on general limitation income	29	1,942	
30	Add lines 22 through 29			30 2,442
31	Enter the **smaller** of line 19 or line 30			31 2,442
32	Reduction of credit for international boycott operations. See instructions for line 12 on page 15 .			32
33	Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 46; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a . . . . . ▶			33 2,442

Form **1116** (2004)

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

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

▶ See separate instructions.

OMB No. 1545-0121

2004

Attachment Sequence No. **19**

Name	Identifying number as shown on page 1 of your tax return
Robert Smith	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.

- **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
- **h** [ ] Section 901(j) income
- **i** [ ] Certain income re-sourced by treaty
- **j** [ ] General limitation income

k 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.*

Part I 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.)
I **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 13 of the instructions): Dividend Interest	5,000			1	5,000
Deductions and losses (***Caution:*** *See pages 13 and 14 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 (see instructions)	.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 13 of the instructions)	477				
b Other interest expense					
5 Losses from foreign sources					
6 Add lines 2, 3g, 4a, 4b, and 5	540			6	540
7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ▶				7	4,460

Part II Foreign Taxes Paid or Accrued (see page 14 of the instructions)

Credit is claimed for taxes (you must check one): **(m)** [X] Paid **(n)** [ ] Accrued

Country	(o) Date paid or accrued	In foreign currency: Taxes withheld at source on: (p) Dividends	(q) Rents and royalties	(r) Interest	(s) Other foreign taxes paid or accrued	In U.S. dollars: Taxes withheld at source on: (t) Dividends	(u) Rents and royalties	(v) Interest	(w) Other foreign taxes paid or accrued	(x) Total foreign taxes paid or accrued (add cols. (t) through (w))
A	12-31-04	900		100		450		50		500
B										
C										

8 Add lines A through C, column (x). Enter the total here and on line 9, page 2 ▶ **8** 500

For Paperwork Reduction Act Notice, see page 18 of the instructions. Cat. No. 11440U Form **1116** (2004)

Part III Figuring the Credit

9	Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I	9	500		
10	Carryback or carryover (attach detailed computation)	10	-0-		
11	Add lines 9 and 10	11	500		
12	Reduction in foreign taxes (see page 15 of the instructions)	12	-0-		
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit			13	500
14	Enter the 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 15 of the instructions)	14	4,460		
15	Adjustments to line 14 (see page 16 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. However, if you are filing more than one Form 1116, you must complete line 19.)	16	4,460		
17	**Individuals:** Enter the amount from Form 1040, line 40. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	17	25,228		
	Caution: *If you figured your tax using the lower rates on qualified dividends or capital gains, see page 17 of the instructions.*				
18	Divide line 16 by line 17. If line 16 is more than line 17, enter "1"			18	.1768
19	**Individuals:** Enter the amount from Form 1040, line 43. If you are a nonresident alien, enter the amount from Form 1040NR, line 40. **Estates and trusts:** Enter the amount from Form 1041, Schedule G, line 1a, or the total of Form 990-T, lines 36 and 37			19	2,961
	Caution: *If you are completing line 19 for separate category* ***g*** *(lump-sum distributions), see page 18 of the instructions.*				
20	Multiply line 19 by line 18 (maximum amount of credit)			20	524
21	Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 18 of the instructions) ▶			21	500

Part IV Summary of Credits From Separate Parts III (see page 18 of the instructions)

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 and certain distributions from a FSC or former FSC	26			
27	Credit for taxes on lump-sum distributions	27			
28	Credit for taxes on certain income re-sourced by treaty	28			
29	Credit for taxes on general limitation income	29			
30	Add lines 22 through 29			30	
31	Enter the **smaller** of line 19 or line 30			31	
32	Reduction of credit for international boycott operations. See instructions for line 12 on page 15			32	
33	Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 46; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶			33	

Form **1116** (2004)

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate toll free at 1-877-777-4778.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call 1-800-829-4059 if you are a TTY/TDD user.
- Visit *www.irs.gov/advocate*.

For more information, see Publication 1546, The Taxpayer Advocate Service of the IRS—How To Get Help With Unresolved Tax Problems.

Free tax services. To find out what services are available, get Publication 910, IRS Guide to Free Tax Services. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Internet. You can access the IRS website 24 hours a day, 7 days a week, at *www.irs.gov* to:

- *E-file* your return. Find out about commercial tax preparation and *e-file* services available free to eligible taxpayers.
- Check the status of your 2004 refund. Click on *Where's My Refund*. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using our Form W-4 calculator.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call 703-368-9694 from the telephone connected to your fax machine. When you call, you will hear instructions on how to use the service. The items you request will be faxed to you.

For help with transmission problems, call 703-487-4608.

Long-distance charges may apply.

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-829-3676 to order current-year forms, instructions, and publications and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at 1-800-829-1040.
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to *www.irs.gov/localcontacts* or look in the phone book under *United States Government, Internal Revenue Service*.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call 1-800-829-4477 and press 2 to listen to pre-recorded messages covering various tax topics.
- *Refund information.* If you would like to check the status of your 2004 refund, call 1-800-829-4477 and press 1 for automated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to *www.irs.gov/localcontacts* or look in the phone book under *United States Government, Internal Revenue Service*.

Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 business days after your request is received. Use the address that applies to your part of the country.

- **Western part of U.S.:**
  Western Area Distribution Center
  Rancho Cordova, CA 95743-0001
- **Central part of U.S.:**
  Central Area Distribution Center
  P.O. Box 8903
  Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**
  Eastern Area Distribution Center
  P.O. Box 85074
  Richmond, VA 23261-5074

CD-ROM for tax products. You can order Publication 1796, IRS Federal Tax Products CD-ROM, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, or saved for recordkeeping.
- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) at *www.irs.gov/cdorders* for $22 (no handling fee) or call 1-877-233-6767 toll free to buy the CD-ROM for $22 (plus a $5 handling fee). The first release is available in early January and the final release is available in late February.

CD-ROM for small businesses. Publication 3207, The Small Business Resource Guide, CD-ROM 2004, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions, and publications needed to successfully manage a business. In addition, the CD provides other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in early April. You can get a free copy by calling 1-800-829-3676 or by visiting *www.irs.gov/smallbiz*.

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. Subtract line 5b from line 5a		______
6. a. Gross rent, real property	______	
b. Direct expenses	______	
c. Net rent. Subtract line 6b from line 6a		______
7. Other ______	______	______
8. Add lines 1–5a, 6a and 7 in columns A and lines 1–4, 5c, 6c an 7 in column B	______	______
9. Enter tax from Form 1040 (see instructions)		______
10. Enter adjusted gross income (AGI) from line 36, Form 1040		______
11. Divide line 9 by line 10. Enter the result as a decimal. This is the average tax rate on your AGI.		______
12. Multiply line 11 by line 8 (column B). This is your estimated U.S. tax on your U.S. source income.		______
II. Tax at source allowable under treaty		
A. Items fully taxable by U.S.		
13. a. Identify ______	______	
b. Multiply line 13a 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 line 13b, 14c, and 15c)		______
C. Identify each item of U.S. source income from Col. A, Step I, on which the 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 33 of Part IV 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. source 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 in column B.

Line 9 — Enter the amount from Form 1040, line 43.

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 on line 13a.

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. (See Publication 901, *U.S. Tax Treaties*.)

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 1) 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 the 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 21 — This amount may be claimed as a foreign tax credit on Form 1116. Complete Form 1116 according to the instructions. Add the additional credit to line 33, 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.

Index

To help us develop a more useful index, please let us know if you have ideas for index entries. See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

■