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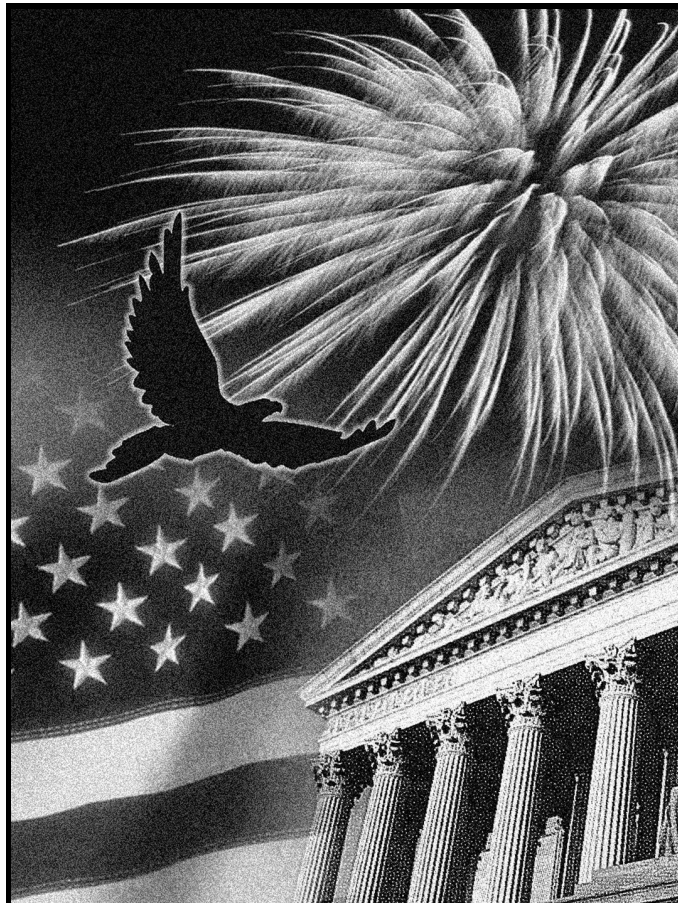
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Foreign Tax Credit for Individuals

For use in preparing
2009 Returns

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What's New for 2009

Taxes on foreign oil related income. Beginning in 2009, taxes on foreign oil related income will be subject to the same rules that apply to taxes on foreign oil and gas extraction income in determining the amount allowed as a foreign tax credit. For more information, see *Taxes on Combined Foreign Oil and Gas Income*, later.

Reminders

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.

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-6526
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.

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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 whether 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.



Figure your tax both ways—claiming the credit and claiming the deduction. Then fill out your return the way that benefits you more. 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 paid withholding tax on income or gain to the extent you had to make related payments on positions in similar or related property,
- 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 in which the taxes were actually paid or accrued. 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 2009, you file an amended return for tax year 1998 choosing to take a credit for your 1998 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 1998 return was April 15, 1999, this choice is timely (within 10 years).

Because there is a limit on the credit for your 1998 foreign tax, you have unused 1998 foreign taxes. Ordinarily, you first carry back unused foreign taxes arising in 1998 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 1996 and 1997 has passed, you cannot change your choice and carry the unused 1998 foreign taxes back to tax years 1996 and 1997.

Because the 10-year periods for changing the choice have not passed for your 1999 through 2003 income tax returns, you can still choose to claim the credit for those years and carry forward any unused 1998 foreign taxes. However, you must reduce the unused 1998 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 1996 and 1997.



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. See Foreign Earned Income and Housing Exclusions under Foreign Taxes for Which You Cannot Take a Credit, later.

Why Choose the Credit?

The foreign tax credit is intended to relieve you of a 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 2009, you and your spouse have adjusted gross income of \$80,300, 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 \$3,650 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 \$15,000. Your taxable income then is \$58,000 and your tax is \$7,869.

If you take the credit instead, your itemized deductions are only \$13,000. Your taxable income then is \$60,000 and your tax before the credit is \$8,169. After the credit, however, your tax is only \$6,169. Therefore, your tax is \$1,700 lower (\$7,869 – \$6,169) by taking the credit.

Example 2. In 2009, 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 \$3,650 exemption, and have other itemized deductions of \$6,950. If you deduct the foreign tax on your U.S. return, your taxable income is \$46,900 (\$5,000 + \$56,000 – \$3,500 – \$6,950 – \$3,650) and your tax is \$7,919.

If you take the credit instead, your taxable income is \$50,400 (\$5,000 + \$56,000 – \$3,650 – \$6,950) and your tax before the credit is \$8,794. You can take a credit of only \$721 because of limits discussed later. Your tax after the credit is \$8,073 (\$8,794 – \$721), which is \$154 (\$8,073 – \$7,919) more than if you deduct the foreign tax.

If you choose the credit, you will have unused foreign taxes of \$2,779 (\$3,500 – \$721). 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. Generally, this occurs on the last day of the tax year for which your foreign return is filed.

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 generally imposed on income expressed in foreign currency. Therefore, fluctuations in the value of the foreign currency relative to the U.S. dollar will affect the foreign tax credit.

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, 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.

3. The foreign tax liability is not denominated in an inflationary currency (defined in the Form 1116 instructions). (This condition applies to taxes paid or accrued in tax years beginning after November 6, 2007.)

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

Election to use exchange rate on date paid. If you have accrued foreign taxes that you are otherwise required to convert using the average exchange rate, you may elect to use the exchange rate in effect on the date the foreign taxes are paid if the taxes are denominated in a nonfunctional foreign currency. If any of the accrued taxes are unpaid, you must translate them into U.S. dollars using the exchange rate on the last day of the U.S. tax year to which those taxes relate. You may make the election for all nonfunctional currency foreign income taxes or only those nonfunctional currency foreign income taxes that are attributable to qualified business units with a U.S. dollar functional currency. Once made, the election applies to the tax year for which made and all subsequent tax years unless revoked with the consent of the IRS. The election is available for tax years beginning after 2004. It must be made by the due date (including extensions) for filing the tax return for the first tax year to which the election applies. Make the election by attaching a statement to the applicable tax return. The statement must identify whether the election is made for all foreign taxes or only for foreign taxes attributable to qualified business units with a U.S. dollar functional currency.

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 if any of the following conditions apply.

1. The accrued taxes when paid differ from the amounts 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.

If this applies to you, you must reduce the credit previously claimed by the amount of the unpaid taxes. 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*.

3. The foreign taxes you paid are refunded in whole or in part.
4. For taxes taken into account when accrued but translated into dollars on the date of payment, the dollar value of the accrued

tax differs from the dollar value of the tax paid because of fluctuations in the exchange rate between the date of accrual and the date of payment. However, no re-determination is required if the change in foreign tax liability for each foreign country is solely attributable to exchange rate fluctuations and is less than the smaller of:

- a. \$10,000, or
- b. 2% of the total dollar amount of the foreign tax initially accrued for that foreign country for the U.S. tax year.

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

Notice to the Internal Revenue Service (IRS) of Redetermination

You are required to notify the IRS about a foreign tax credit redetermination that affects your U.S. tax liability for each tax year affected by the redetermination. You generally must file Form 1040X, Amended U.S. Individual Income Tax Return, with a revised Form 1116 and a statement that contains information sufficient for the IRS to redetermine your U.S. tax liability for the year or years affected. See *Contents of statement* later.

You are not required to attach Form 1116 for a tax year affected by a redetermination if:

1. The amount of your creditable taxes paid or accrued during the tax year is not more than \$300 (\$600 if married filing a joint return) as a result of the foreign tax redetermination, and
2. You meet the requirements listed under *Exemption from foreign tax credit limit* under *How To Figure the Credit*, later.

There are other exceptions to this requirement. They are discussed later under *Due date of notification to IRS*.

Contents of statement. The statement must include all of the following.

- Your name, address, and taxpayer identification number.
- The tax year or years that are affected by the foreign tax redetermination.
- The date or dates the foreign taxes were accrued, if applicable.
- The date or dates the foreign taxes were paid.
- The amount of foreign taxes paid or accrued on each date (in foreign currency) and the exchange rate used to translate each amount.
- Information sufficient to determine any interest due from or owing to you, including the amount of any interest paid to you by the foreign government and the dates received.

In the case of any foreign taxes that were not paid before the date two years after the close of the tax year to which those taxes relate, you

must provide the amount of those taxes in foreign currency and the exchange rate that was used to translate that amount when originally claimed as a credit.

If any foreign tax was refunded in whole or in part, you must provide the date and amount (in foreign currency) of each refund, the exchange rate that was used to translate each amount when originally claimed as a credit, and the exchange rate for the date the refund was received (for purposes of computing foreign currency gain or loss under Internal Revenue Code section 988).

Due date of notification to IRS. If you pay less foreign tax than you originally claimed a credit for, you generally must file a notification by the due date (with extensions) of your original return for your tax year in which the foreign tax 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.

Exceptions to this due date are explained in the next three paragraphs.

Redeterminations occurring in 2005, 2006, and 2007. If the redetermination occurred in 2005, 2006, or 2007, you must file the notification by the due date (including extensions) of your 2009 Form 1040 or Form 1040NR.

Multiple redeterminations of U.S. tax liability for same tax year. Where more than one foreign tax redetermination requires a redetermination of U.S. tax liability for the same tax year and those redeterminations occur in the same tax year or within two consecutive tax years, you can file for that tax year one notification (Form 1040X with a Form 1116 and the required statement) that reflects all those tax redeterminations. If you choose to file one notification, the due date for that notification is the due date of the original return (with extensions) for the year in which the first foreign tax redetermination that reduced your foreign tax liability occurred. However, foreign tax redeterminations with respect to the tax year for which a redetermination of U.S. tax liability is required may occur after the due date for providing that notification. In this situation, you may have to file more than one Form 1040X for that tax year.

Additional U.S. tax due eliminated by foreign tax credit carryback or carryover. If a foreign tax redetermination requires a redetermination of U.S. tax liability that would otherwise result in an additional amount of U.S. tax due, but the additional tax is eliminated by a carryback or carryover of an unused foreign tax, you do not have to amend your tax return for the year affected by the redetermination. Instead, you can notify the IRS by attaching a statement to the original return for the tax year in which the foreign tax redetermination occurred. You must file the statement by the due date (with extensions) of that return. The statement must show the amount of the unused foreign taxes paid or accrued and a detailed schedule showing the computation of the carryback or carryover (including the amounts carried back or over to the

year for which a redetermination on U.S. tax liability is required).

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. Interest also is owed from the time you receive a refund until you pay the additional tax due.

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 2007, and received a foreign tax refund of \$500 in 2009 on which a foreign tax of \$100 was imposed. When you refigure your credit for 2007, 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 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.

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).



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 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 or other regulated investment company (RIC), 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 or other RIC a Form 1099-DIV, or similar statement, showing 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 credit 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, because 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 requirements.

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.

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 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.

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 mineral income,
- Taxes from international boycott operations,
- A portion of taxes on combined foreign oil and gas income, and
- Taxes of U.S. persons controlling foreign corporations and partnerships who fail to file required information returns.

Taxes on Excluded Income

You cannot take a credit for foreign taxes paid or accrued on certain income that is 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 . . .	\$125,000
Unreimbursed business travel expenses	20,000
Income tax paid to Country A	30,000
Exclusion of foreign earned income and housing allowance	91,400

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.

$$\$20,000 \times \frac{\$91,400}{\$125,000} = \$14,624$$

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 (\$14,624) from excluded wages (\$91,400). The result is \$76,776.

Then, find the denominator of the fraction by subtracting all your deductible expenses from all your foreign earned income (\$125,000 – \$20,000 = \$105,000).

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

$$\$30,000 \times \frac{\$76,776}{\$105,000} = \$21,936$$

The amount of Country A tax you cannot take a credit for is \$21,936.

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, 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 2009. Income taxes paid or accrued to these countries in 2009 do not qualify for the credit.

- Cuba.
- Iran.
- Libya (but see *Note* later).
- North Korea.
- Sudan.
- Syria.

Income that is paid through one or more entities is treated as coming from a foreign country

Table 1. Countries Removed From the Sanction List or Granted Presidential Waiver

Country	Sanction Period	
	Starting Date	Ending Date
Iraq	February 1, 1991	June 27, 2004
Libya	January 1, 1987	December 9, 2004*

*Presidential waiver granted for qualified income taxes arising after December 9, 2004.

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.

Note. Effective December 10, 2004, the President granted a waiver to Libya. Income taxes arising on or after this date qualify for the credit if they meet the other requirements in this publication.

Limit on credit. In figuring the foreign tax credit limit, discussed later, income from a sanctioned country is a separate category of foreign income unless a Presidential waiver is granted. 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 Syria 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 Syria. Because the income earned in Syria 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 Syria, but that income is taxable by the United States.

Figuring the credit when a sanction ends. Table 1 lists the countries for which sanctions have ended or for which a Presidential waiver has been granted. 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 or the date the Presidential waiver was granted.

Example. The sanctions against Country X ended 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 ended, 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 (or a Presidential waiver is granted) during your tax year and you are not able to determine the actual income and taxes

for that 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 that 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 2009 on which you paid tax of \$4,500. Sanctions against Country X ended on July 11, 2009. 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 ended on July 11, 2009, 173 days of your tax year are in the nonsanctioned period. You would compute the income for the nonsanctioned period as follows:

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

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

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

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

Further information. The rules for figuring the foreign tax credit after a country's sanction period ends are more fully explained in Revenue Ruling 92-62, 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 if either of the following applies to the dividends.

1. 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).
2. 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). Because 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 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 positions in similar or related property. See section 901(l)(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 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 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. As of October 2009, the following countries are listed.

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

Iraq is not included in this list, but its status with respect to future lists remains under review by the Department of Treasury.



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. Cumulative Bulletins are 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 a 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. See the Instructions for Form 5713 for information on when and where to file the form.

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 Combined Foreign Oil and Gas Income

You must reduce your foreign taxes by a portion of any foreign taxes imposed on combined foreign oil and gas income. The amount of the reduction is the amount by which your foreign oil and gas taxes exceed the amount of your combined foreign oil and gas income multiplied by a fraction equal to your pre-credit U.S. tax liability (Form 1040, line 44) divided by your worldwide taxable income. You may be entitled to carry over to other years taxes reduced under this rule. See Internal Revenue Code section 907(f).

Combined foreign oil and gas income means the sum of foreign oil related income and foreign oil and gas extraction income. Foreign oil and gas taxes are the sum of foreign oil and gas extraction taxes and foreign oil related taxes.

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 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 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 1 tax year and forward to the next 10 tax years. See *Carryback and Carryover*, later.

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 category income. Passive category income is defined later under *Separate Limit Income*. However, for purposes of this rule, high taxed income and export financing interest are also passive category income.
- 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.



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 44 on 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* next. 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 category income.
- General category income.
- Section 901(j) income.
- Certain income re-sourced by treaty.
- Any lump sum distribution from an employer benefit plan for which the special averaging treatment is used to determine your tax.

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 Regulations section 1.904-5.

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 Regulations section 1.904-5(h).

Passive Category Income

Passive category income consists of passive income and specified passive category income.

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 or other regulated investment company that elects to pass through to you the foreign tax credit, the income is generally considered passive. The mutual fund will provide you with a Form 1099-DIV or substitute 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.
- 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 by you or a related person, and
- 50% or less of the fair market 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 passive category income into general category income. See Regulations section 1.904-4(c) for more information.

Specified passive category income. Specified passive income consists of:

1. Dividends from a DISC (domestic international sales corporation) or former DISC to the extent the dividends are treated as foreign source income, and
2. Distributions from a former FSC (foreign sales corporation) out of earnings and profits that are attributable to:
 - a. Foreign trade income, or
 - b. Interest and carrying charges derived from a transaction that results in foreign trade income.

General Category Income

General category income includes income from sources outside the United States that is not passive category income or does not fall into one of the other separate limit categories discussed later. It generally includes active business income and wages, salaries, and overseas allowances of an individual as an employee. General category income includes high-taxed income that would otherwise be passive income. See *High-taxed income* earlier under *What is not passive income*.

Financial services income. In general, financial services income is treated as general category income if it is derived by a financial services entity. You are a financial services entity if you are predominantly engaged in the active conduct of a banking, insurance, financing, or similar business for any taxable year. Financial services income of a financial services entity generally includes income derived in the active

conduct of a banking, financing, insurance or similar business. Financial services income of a financial services entity also includes passive income and certain incidental income.

If you qualify as a financial services entity because you treat certain items of income as active financing income under Regulations section 1.904-4(e)(2)(i)(Y), you must show the type and amount of each item on an attachment to Form 1116.

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.

Certain Income Re-Sourced By Treaty

If a sourcing rule in an applicable income tax treaty treats any of the income listed 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(h)(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.

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.



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

Allocation of Foreign Taxes

Solely for purposes of allocating foreign taxes to separate limit income categories, those separate limit categories include any U.S. source income that is taxed by the foreign country or U.S. possession.

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 taxed by the foreign country in a separate category. The denominator is the total net income.

You figure net income by deducting from the gross income in each category and from the total gross income taxed by the foreign country or U.S. possession 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 category 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 category 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

2009 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 41 of Form 1040 (minus any amount shown on line 6 of Form 8914, Exemption Amount for Taxpayers Housing Midwestern Displaced Individuals). Then for each category of income, you must figure your taxable income from sources outside the United States.

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.

See *Determining the Source of Compensation for Labor or Personal Services* and *Determining the Source of Income From the Sales or Exchanges of Certain Personal Property* for a more detailed discussion on determining the source of these types of income.

Determining the source of income from U.S. possessions. The rules for determining whether income is from sources in a U.S. possession are generally the same as those for determining whether income is from U.S. sources. But exceptions apply. See Publication 570 for more information.

Determining the Source of Compensation for Labor or Personal Services

If you are an employee and receive compensation for labor or personal services performed both inside and outside the United States, special rules apply in determining the source of the compensation. Compensation (other than certain fringe benefits) is sourced on a time basis. Certain fringe benefits (such as housing and education) are sourced on a geographical basis.

Or, you may be permitted to use an alternative basis to determine the source of compensation. See *Alternative basis* later.

If you are self-employed, you determine the source of compensation for labor or personal services from self-employment on the basis that most correctly reflects the proper source of that income under the facts and circumstances of your particular case. In many cases, the facts and circumstances will call for an apportionment on a time basis as explained next.

Time basis. Use a time basis to figure your foreign source compensation (other than the fringe benefits discussed later). Do this by multiplying your total compensation (other than the fringe benefits discussed later) by the following fraction:

$$\frac{\text{Number of days you performed services in the foreign country during the year}}{\text{Total number of days you performed services during the year}}$$

You can use a unit of time less than a day in the above fraction, if appropriate. The time period for which the compensation is made does not have to be a year. Instead, you can use another distinct, separate, and continuous time period if you can establish to the satisfaction of the IRS that this other period is more appropriate.

Example 1. Christina Brooks, a U.S. citizen, worked 240 days for a U.S. company during the tax year. She received \$80,000 in compensation. None of it was for fringe benefits. Christina performed services in the United States for 60 days and performed services in the United Kingdom for 180 days. Using the time basis for determining the source of compensation, \$60,000 ($\$80,000 \times \frac{180}{240}$) is her foreign source income.

Example 2. Rob Waters, a U.S. citizen, is employed by a U.S. corporation. His principal place of work is in the United States. His annual salary is \$100,000. None of it is for fringe benefits. During the first quarter of the year he worked entirely within the United States. On April 1, Rob was transferred to Singapore for the remainder of the year. Rob is able to establish that the first quarter of the year and the last 3 quarters of the year are two separate, distinct, and continuous periods of time. Accordingly, \$25,000 of Rob's annual salary is attributable to the first quarter of

the year ($.25 \times \$100,000$). All of it is U.S. source income because he worked entirely within the United States during that quarter. The remaining \$75,000 is attributable to the last three quarters of the year. During those quarters, he worked 150 days in Singapore and 30 days in the United States. His periodic performance of services in the United States did not result in distinct, separate, and continuous periods of time. Of his \$75,000 salary, \$62,500 ($\$75,000 \times \frac{150}{180}$) is foreign source income for the year.

Multi-year compensation. The source of multi-year compensation is generally determined on a time basis over the period to which the compensation is attributable. Multi-year compensation is compensation that is included in your income in one tax year but that is attributable to a period that includes two or more tax years.

You determine the period to which the compensation is attributable based on the facts and circumstances of your case. For example, an amount of compensation that specifically relates to a period of time that includes several calendar years is attributable to the entire multi-year period.

The amount of compensation treated as from foreign sources is figured by multiplying the total multi-year compensation by a fraction. The numerator of the fraction is the number of days (or unit of time less than a day, if appropriate) that you performed labor or personal services in the foreign country in connection with the project. The denominator of the fraction is the total number of days (or unit of time less than a day if

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 <i>Determining the Source of Income From the Sales or Exchanges of Certain Personal Property</i> , later, for exceptions)
Pension distributions attributable to contributions	Where services were performed that earned the pension
Investment earnings on pension contributions	Location of pension trust
Sale of natural resources	Allocation based on fair market value of product at export terminal. For more information, see Regulations section 1.863-1(b).

* Exceptions include:

- Dividends paid by a U.S. corporation are foreign source if the corporation elects the American Samoa Economic Development Credit,
- 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.

appropriate) that you performed labor or personal services in connection with the project.

Geographical basis. Compensation you receive as an employee in the form of the following fringe benefits is sourced on a geographical basis.

- Housing.
- Education.
- Local transportation.
- Tax reimbursement.
- Hazardous or hardship duty pay.
- Moving expense reimbursement.

The amount of fringe benefits must be reasonable and you must substantiate them by adequate records or by sufficient evidence. Table 3 summarizes the factors used for determining the source of these fringe benefits.

Housing. The source of a housing fringe benefit is determined based on the location of your principal place of work. A housing fringe benefit includes payments to or on your behalf (and your family if your family resides with you) only for the following:

- Rent.
- Utilities (except telephone charges).
- Real and personal property insurance.
- Occupancy taxes not deductible under section 164 or 216(a).
- Nonrefundable fees for securing a leasehold.
- Rental of furniture and accessories.
- Household repairs.
- Residential parking.
- Fair rental value of housing provided in kind by your employer.

A housing fringe benefit does not include:

- Deductible interest and taxes (including deductible interest and taxes of a tenant-stockholder in a cooperative housing corporation),
- The cost of buying property, including principal payments on a mortgage,
- The cost of domestic labor (maids, gardeners, etc.),
- Pay television subscriptions,
- Improvements and other expenses that increase the value or appreciably prolong the life of property,
- Purchased furniture or accessories,
- Depreciation or amortization of property or improvements,
- The value of meals or lodging that you exclude from gross income, or
- The value of meals or lodging that you deduct as moving expenses.

Education. The source of an education fringe benefit for the education expenses of your dependents is determined based on the location of your principal place of work. An education

fringe benefit includes payments only for the following expenses for education at an elementary or secondary school.

- Tuition, fees, academic tutoring, special needs services for a special needs student, books, supplies, and other equipment.
- Room and board and uniforms that are required or provided by the school in connection with enrollment or attendance.

Local transportation. The source of a local transportation fringe benefit is determined based on the location of your principal place of work. Your local transportation fringe benefit is the amount that you receive as compensation for your local transportation or that of your spouse or dependents at the location of your principal place of work. The amount treated as a local transportation fringe benefit is limited to actual expenses incurred for local transportation and the fair rental value of any employer-provided vehicle used predominantly by you or your spouse or dependents for local transportation. Actual expenses do not include the cost (including interest) of any vehicle purchased by you or on your behalf.

Tax reimbursement. The source of a foreign tax reimbursement fringe benefit is determined based on the location of the jurisdiction that imposed the tax for which you are reimbursed.

Hazardous or hardship duty pay. The source of hazardous or hardship duty pay fringe benefit is determined based on the location of the hazardous or hardship duty zone for which the hazardous or hardship duty pay fringe benefit is paid. A hazardous or hardship duty zone is any place in a foreign country which meets either of the following conditions.

- The zone is designated by the Secretary of State as a place where living conditions are extraordinarily difficult, notably unhealthy, or where excessive physical hardships exist, and for which a post differential of 15 percent or more would be provided under section 5925(b) of Title 5 of the U.S. Code to any officer or employee of the U.S. government at that place.
- The zone is where civil insurrection, civil war, terrorism, or wartime conditions threaten physical harm or imminent danger to your health and well-being.

Compensation is treated as a hazardous or hardship duty pay fringe benefit only if your employer provides the hazardous or hardship duty pay fringe benefit only to employees performing labor or personal services in a hazardous or hardship duty zone.

The amount of compensation treated as a hazardous or hardship duty pay fringe benefit cannot exceed the maximum amount that the U.S. government would allow its officers or employees present at that location.

Moving expense reimbursement. The source of a moving expense reimbursement is generally based on the location of your new principal place of work. However, the source is determined based on the location of your former principal place of work if you have sufficient evidence that such determination of source is more appropriate under the facts and circumstances of your case. Sufficient evidence generally requires an agreement between you and your employer, or a written statement of company policy, which is reduced to writing before the move and which is entered into or established to induce you or other employees to move to another country. The written statement or agreement must state that your employer will reimburse you for moving expenses that you incur to return to your former principal place of work regardless of whether you continue to work for your employer after returning to that location. It may contain certain conditions upon which the right to reimbursement is determined as long as those conditions set forth standards that are definitely ascertainable and can only be fulfilled prior to, or through completion of, your return move to your former principal place of work.

Alternative basis. If you are an employee, you can determine the source of your compensation under an alternative basis if you establish to the satisfaction of the IRS that, under the facts and circumstances of your case, the alternative basis more properly determines the source of your compensation than the time or geographical basis. If you use an alternative basis, you must keep (and have available for inspection) records to document why the alternative basis more properly determines the source of your compensation. Also, if your total compensation from all sources was \$250,000 or more, you must check the box on Form 1116, line 1b, and attach a written statement to your tax return that sets forth all of the following:

1. Your name and social security number (written across the top of the statement),

Table 3. Source of Fringe Benefits

Fringe Benefit	Factor Determining Source
Housing, education, and local transportation	Location of your principal place of work
Tax reimbursement	Location of the jurisdiction that imposed the tax for which you were reimbursed
Hazardous or hardship duty pay	Location of the hazardous or hardship duty zone for which you received the pay
Moving expense reimbursement	Location of your new principal place of work*

*You can determine the source based on the location of your former principal place of work if you have sufficient evidence that such determination of source is more appropriate under the facts and circumstances of your case.

2. The specific compensation income, or the specific fringe benefit, for which you are using the alternative basis,
3. For each item in (2), the alternative basis of allocation of source used,
4. For each item in (2), a computation showing how the alternative allocation was computed, and
5. A comparison of the dollar amount of the U.S. compensation and foreign compensation sourced under both the alternative basis and the time or geographical basis discussed earlier.

Determining the Source of Income From the 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 Regulations section 1.865-1(f)(2). For stock losses, see Regulations section 1.865-2(e).

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 Regulations section 1.863-3.

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 Regulations section 1.865-1(f)(2).

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 Regulations section 1.865-1(f)(2). For stock losses, see Regulations section 1.865-2(e).

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.

- 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, the tax book value, or the alternative book value. For more information about the asset method, see Temporary Regulations section 1.861-9T(g).

If you use the tax book value method, you can elect to change to the fair market value method at any time without IRS approval. If you elect to use the fair market value method, you must continue to use that method unless you have IRS approval to change methods.

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 Regulations section 1.861-9T(e).

Home mortgage interest. This is your deductible home mortgage interest (including points and qualified mortgage insurance premiums) 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 ($\$40,000/\$100,000 \times \$2,000$) of your investment interest is apportioned to U.S. source income and \$1,200 ($\$60,000/\$100,000 \times \$2,000$) 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 ($\$6,000/\$60,000 \times \$12,000$) 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. 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 23-35, and the additional exemptions for housing Midwestern displaced individuals shown on Form 8914, line 6.

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 2009, you may have to reduce your itemized deductions on Schedule A (Form 1040) if your adjusted gross income is more than \$166,800 (\$83,400 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 11 shows the amount of the reduction.

To determine your taxable income from sources outside the United States, you must first divide the reduction (line 11 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 \$226,800. Your itemized deductions subject to the overall reduction (line 3 of the worksheet) total \$20,000. \$8,000 of these deductions are definitely related to the income on Form 1116, line 1a. The other \$12,000 (\$20,000 – \$8,000) are real estate taxes, which are not definitely related.

The amount of the overall reduction on line 11 of the worksheet is \$1,200. To figure the amount of the real estate taxes to include in the total for line 3a of Form 1116, divide the amount on line 11 (\$1,200) by the amount on line 3 (\$20,000). This is your reduction percentage (6%). You must reduce your \$12,000 deduction by \$720 (6% x \$12,000). The reduced deduction of \$11,280 (\$12,000 – \$720) is the amount to enter on line 3a of Form 1116. Make a similar computation to figure the amount of definitely related itemized deductions (\$7,520) to enter on line 2.

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. However, you can deduct additional exemptions for housing Midwestern displaced individuals claimed on Form 8914, line 6. These exemptions are not definitely related to a specific class of income as explained earlier under *Deductions not definitely related*.

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 1a 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 1a 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 1a (gains), line 5 (losses), or line 17 (taxable

income before subtracting exemptions) of Form 1116.

Lines 1a 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 1a or line 5 of Form 1116. Use the instructions under *Foreign Qualified Dividends and Capital Gains (and Losses)* in the Instructions for Form 1116 to determine if you are required to make adjustments. Also use the instructions under *Foreign Qualified Dividends and Capital Gains (and Losses)* in the Instructions for Form 1116 to determine if you can use those instructions to make adjustments or if you must use the instructions in this publication to make adjustments.

If you 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. Foreign source gain you elected to include on line 4g of Form 4952 must be entered directly on line 1a of Form 1116 without adjustment.

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 adjustment* 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 that is passive category income, a \$1,000 foreign source capital gain that is general category income, a \$400 foreign source capital loss that is general category income, 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 income and the general category income based on the amount of net capital gain in each separate category.

\$50 apportioned to passive category income
(\$150 x \$300/\$900)

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

\$100 apportioned to general category income
(\$150 x \$600/\$900)

Alfie reduces his \$600 of net capital gain that is general category income by \$100 and includes the resulting \$500 on line 1a of the Form 1116 for the general category income.

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, the 0% rate group, and the short-term rate group. The 28%

rate group, the 25% rate group, the 15% rate group and the 0% rate group are "long term" rate groups. *Table 4* 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		\$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 passive category income and general category income based on the amount of net capital gain in each separate category.

Dennis' net capital gain, passive category income is \$200.

$((\$100 + \$200) - \$100)$

Dennis apportions \$100 to passive category income.

$(\$300 \times \$200/\$600)$

Dennis' net capital gain, general category income is \$400.

$(\$700 - \$300)$

Dennis apportions \$200 to general category income.

$(\$300 \times \$400/\$600)$

Dennis has net capital gain in more than one rate group that is passive category income. Therefore, the \$100 apportioned to passive category income 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.

$(\$100 \times \$100/\$300)$

Dennis apportions \$66.67 to the 28% rate group.

$(\$100 \times \$200/\$300)$

After the U.S. capital loss adjustment, Dennis has \$100 of foreign source 15% capital loss

Table 4. Rate Groups

A capital gain or loss is in the...	IF...
28% rate group	it is included on the <i>28% Rate Gain Worksheet</i> in the instructions for Schedule D.
25% rate group	it is included on line 1 through line 13 of the <i>Unrecaptured Section 1250 Gain Worksheet</i> in the instructions for Schedule D.
15% rate group	it is a long-term capital gain that is not in the 28% or 25% rate group and is taxed at a 15% rate or it is a long-term capital loss that is not in the 28% or 25% rate group.
0% rate group	it is a long-term capital gain that is not in the 25% or 28% rate group and is taxed at a rate of 0%.
Short-term rate group	it is a short-term capital gain or loss.

that is passive category income, \$66.67 of foreign source short-term capital gain that is passive category income, \$133.33 of foreign source 28% gain that is passive category income, and \$200 of foreign source 15% capital gain that is general category income, 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		\$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.

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* earlier. 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.

You must adjust the portion of your net capital gain in a separate category long-term rate group in excess of the U.S. long-term loss adjustment amount you allocated to that separate category long-term rate group. See the instructions later under *Capital gain rate differential adjustment for net capital gains*. The remaining portion of your net capital gain in the separate category long-term rate group must be entered on line 1a of Form 1116 without adjustment.

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 foreign sources that are passive category income.

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 that is passive category income. Therefore, \$200 (\$300 - \$100) of her \$300 28% capital gain must be adjusted before it is included on line 1a. The remaining \$100 of 28% capital gain is included on line 1a without adjustment.

Mary allocates \$50 (\$150 x \$150/\$450) to the 15% rate group that is passive category income. Therefore, only \$100 (\$150 - \$50) of her \$150 15% capital gain must be adjusted before it is included on line 1a. The remaining \$50 of 15% capital gain is included on line 1a 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 0% rate group, do not include the applicable amount on Form 1116.
- 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 1a 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 1a of the applicable Form 1116 without adjustment.

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

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

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

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

$$\text{Mary includes } \$260 \text{ of the } 28\% \text{ capital gain } (\$200 \times 0.8) + \$100$$

Mary includes \$92.86 of the 15% capital gain $(\$100 \times 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		\$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 that is passive category income and the \$200 of net capital gain remaining in the 15% rate group that is general category income.

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

Dennis allocates \$20 $(\$33.33 \times \$200 \div \$333.33)$ to the 15% rate group for general category income. Therefore, Dennis must adjust \$180 $(\$200 - \$20)$ of the \$200 net capital gain remaining in the 15% rate group that is general category income. Dennis includes \$97.15 $(\$180 \times 0.4286) + \20 of 15% capital gain on line 1a of Form 1116 for general category income.

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, then against any net capital gain in the 15% rate group, and finally to offset capital gain net income in the 0% 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, then against any net capital gain in the 15% rate group, and finally to offset capital gain net income in the 0% rate group.
 - c. A foreign source net capital loss in the 15% rate group is netted first against any net capital gain in the 15% rate group, is netted first against any net capital gain in the 0% rate group, then any net capital gain in the 28% rate group, and finally 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 0% rate group, multiply the net capital loss by zero.
- 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 that is passive category income.

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

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

$$(\$100 \times 0.4286)$$

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

Income category	28% rate	15% rate
Foreign Passive	\$50	(\$20)
Foreign General		(\$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 passive category income.

$$(\$50 \times \$20/\$60)$$

\$33.33 of the \$50 is treated as coming from general category income.

$$(\$50 \times \$40/\$60)$$

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 passive category income.

$$(\$10 \times \$20/\$60)$$

\$6.67 is treated as coming from general category income.

$$(\$10 \times \$40/\$60)$$

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

$$\begin{aligned} &\text{This is } \$7.14 \\ &\quad (\$16.67 \times 0.4286) \\ &\text{plus } \$2.66 \\ &\quad (\$3.33 \times 0.8) \end{aligned}$$

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

$$\begin{aligned} &\text{This is } \$14.29 \\ &\quad (\$33.33 \times 0.4286) \\ &\text{plus } \$5.34 \\ &\quad (\$6.67 \times 0.8) \end{aligned}$$

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

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 passive category income and incur a loss of \$5,000 of general category income. You must use the \$5,000 loss to offset \$5,000 of passive category income.

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 that is general category income, \$3,000 of passive category income, and \$2,000 of income re-sourced by treaty. 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 category income and 40% ($\$2,000/\$5,000$) or \$800 reduces the income re-sourced by treaty.

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 Prior Year Overall Foreign Loss Accounts*.

U.S. Losses

You should allocate any net loss from sources in the United States among the different categories of foreign income **after** allocating all foreign losses as described earlier, and **before** any of the adjustments discussed later.

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 Prior Year Overall Foreign Loss Accounts

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. You have an overall foreign loss if your gross income from foreign sources for a tax year is less than 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 general category income. You are a bona fide resident of a foreign country and you elect to exclude your foreign earned income. You exclude the maximum \$91,400. You also have itemized deductions of \$6,100 that are not definitely related to any item of income.

In figuring your overall foreign loss for general category income 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 \$6,835 figured as follows:

Foreign gross income	\$100,000	
Less:		
Foreign earned income exclusion	\$91,400	
Allowable definitely related expenses (\$8,600/\$100,000 × \$115,000)	9,890	
Ratable part of itemized deductions	5,545	<u>106,835</u>
Overall foreign loss		<u>\$ 6,835</u>

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 smaller of the following:

1. The total amount of maximum potential recapture in all overall foreign loss accounts. The maximum potential recapture in any account for a category is the lesser of:
 - a. The current year taxable income from foreign sources in that category (the amount from Form 1116, line 14, less any adjustment for allocation of foreign losses and U.S. losses for that category, discussed earlier), or
 - b. The balance in the overall foreign loss account for that category.
2. 50% (or more, if you choose) of your total taxable income from foreign sources.

If the total foreign income subject to recharacterization is the amount described in 1 above, then for each separate category the recapture amount is the maximum potential recapture amount for that category. If the total foreign income subject to recharacterization is

the amount described in 2 above, then for each separate category the recapture amount is computed by multiplying the total recapture amount by the following fraction:

Maximum potential recapture amount
for the overall foreign loss account in
the separate category

Total amount of maximum potential
recapture in all overall foreign loss
accounts

Example. During 2008 and 2009, 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 2008, the partnership had a loss and your share was \$20,000, consisting of \$110,000 gross income less \$130,000 expenses. Your net loss from the partnership was \$6,468, after deducting the foreign earned income exclusion and definitely related allowable expenses. This loss is related to general category income. Your U.S. dividend income was \$20,000. Your itemized deductions totaled \$6,000 and were not definitely related to any item of income. In figuring your taxable income for 2008, you deducted your share of the partnership loss from Country X from your U.S. source income.

During 2009, 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 \$14,840, after deducting the foreign earned income exclusion and the definitely related allowable expenses. This is general category income. 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 2009, 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 recharacterize as follows:

A. Determination of 2008 Overall Foreign Loss

1) Partnership loss from Country X	\$6,468
2) Add: Part of itemized deductions allocable to gross income from Country X	
	$\frac{\$110,000}{\$130,000} \times \$6,000 = \$5,077$
3) Overall foreign loss for 2008	<u>\$11,545</u>

B. Amount of Recapture for 2009

1) Balance for general category income foreign loss account	\$11,545
2) Taxable general category income after allocation of foreign losses—General category income	\$14,840
Less: Itemized deductions allocable to that income (\$100,000/\$120,000 × \$6,000)	<u>5,000</u>
General category taxable income less allocated foreign losses (\$9,840 – 0)	\$9,840

3) Total amount of maximum potential recapture in all foreign loss accounts (smaller of (1) or (2))	\$9,840
4) Foreign source net income	\$14,840
Less: Itemized deductions allocable to foreign source net income (\$100,000/\$120,000 × \$6,000)	<u>5,000</u>
5) 50% of foreign source taxable income subject to recharacterization	\$4,920
6) Recapture for 2009 (smaller of (3), or (5))	<u>\$4,920</u>

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) if you owned more than 50% (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.

All of the foreign source taxable income that you are considered to recognize under these rules is generally subject to recharacterization as U.S. source income. See Regulation section 1.904(f)-2(d).

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 recharacterize. 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 recharacterization. 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 recharacterize.

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) 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.

Recapture of Separate Limitation Loss Accounts

If, in a prior tax year, you reduced your foreign taxable income in the separate limit category by a pro rata share of a loss from another category, you must recharacterize in 2009 all or part of any income you receive in 2009 in that loss category. If you have separate limitation loss accounts in the loss category relating to more than one other category and the total balances in those loss accounts exceed the income you receive in 2009 in the loss category, then income in the loss category is recharacterized as income in those other categories in proportion to the balances of the separate limitation loss accounts for those other categories. You recharacterize the income by:

- Increasing foreign taxable income (adjusted by any of the other adjustments previously mentioned) for each of the separate categories (other than the loss category) previously reduced by any separate limitation loss, and
- Decreasing foreign taxable income (adjusted by any of the other adjustments previously mentioned) for the loss category by the amount of recharacterized income.

Example. In 2008, you had a \$2,000 loss that was general category income, \$3,000 of passive category income, and \$2,000 of income re-sourced by treaty. You had to allocate the \$2,000 loss to the income in the other separate categories. 60% ($\$3,000 \div \$5,000$) of the \$2,000 loss (or \$1,200) reduced passive category income and 40% ($\$2,000 \div \$5,000$) or \$800 reduced the income re-sourced by treaty.

In 2009, you have \$4,000 of passive category income, \$1,000 of income re-sourced by treaty, and \$5,000 of general category income. Because \$1,200 of the general category loss was used to reduce your passive category income in 2008, \$1,200 of the 2009 general category income of \$5,000 must be recharacterized as passive category income. This makes the 2009 total passive category income \$5,200 ($\$4,000 + \$1,200$). Similarly, because \$800 of the general category loss was used to reduce your income re-sourced by treaty, \$800 of the general category income must be recharacterized as income re-sourced by treaty. This makes the 2009 total of income re-sourced by treaty \$1,800 ($\$1,000 + \800). The total general category income is \$3,000 ($\$5,000 - \$1,200 - \800).



If you dispose of appreciated property that generates, or would generate, gain in a separate limitation loss account, the disposition is subject to recapture

rules similar to those applicable to overall foreign loss accounts. See Internal Revenue Code section 904(f)(5)(F).

Recapture of Overall Domestic Loss Accounts

If you have an overall domestic loss for any tax year beginning after 2006, you create, or increase the balance in, an overall domestic loss account and you must recharacterize a portion of your U.S. source taxable income as foreign source taxable income in succeeding years for purposes of the foreign tax credit.

The part that is treated as foreign source taxable income for the tax year is the smaller of:

- The total balance in your overall domestic loss account in each separate category (less amounts recaptured in earlier years), or
- 50% of your U.S. source taxable income for the tax year.

You must establish and maintain separate overall domestic loss accounts for each separate category in which foreign source income is offset by the domestic loss. The balance in each overall domestic loss account is the amount of the overall domestic loss subject to recapture. The recharacterized income is allocated among and increases foreign source income in separate categories in proportion to the balances of the overall domestic loss accounts for those separate categories.

For more information, see the Instructions for Form 1116.

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. The treaties that provide for this additional credit include those with Australia, Austria, Bangladesh, Belgium, Bulgaria, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Israel, Japan, 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 Beijing, London or Paris, or the U.S. consulate in Frankfurt, 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.



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 1-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 first 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 of your foreign income is general category income for 2008 and 2009. 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 (-)
2008	\$200	\$100	-100
2009	\$300	\$500	+200

In 2009, you had unused foreign tax of \$200 to carry to other years. You are considered to have paid this unused foreign tax first in 2008 (the first preceding tax year) up to the excess limit in that year of \$100. You can then carry forward the remaining \$100 of unused tax.

Example 2. All your foreign income is general category income for 2007 through 2010. Before 2007, all of your foreign income was in the general limitation income category. In 2005, you had an unused foreign tax of \$200. Because you had no foreign income in 2004, you cannot carry back the unused foreign tax to that year. 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 2005 and 2006 (general category income for 2007–2010) are as follows:

	Your limit	Tax paid	Unused foreign tax (+) or excess limit (-)
2005	\$600	\$800	+200
2006	\$600	\$700	+100
2007	\$500	\$700	+200
2008	\$550	\$400	-150
2009	\$800	\$700	-100
2010	\$500	\$550	+ 50

You cannot carry the \$200 of unused foreign tax from 2005 to 2006 or 2007 because you have no excess limit in either of those years. Therefore, you carry the tax forward to 2008, 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 2005 can be carried to 2009. At this point, you have fully absorbed the unused foreign tax from 2005 and can carry it no further. You can also carry forward the unused foreign tax from 2006 and 2007.

Special rules for carryforwards of pre-2007 unused foreign taxes. The foreign taxes carried forward generally are allocated to your post-2006 separate income categories to which those taxes would have been allocated if the taxes were paid or accrued in a tax year beginning after 2006. Alternatively, you can allocate unused foreign taxes in the pre-2007 separate category for passive income to the post-2006 separate category for passive category income, and you can allocate all other unused foreign taxes in the eliminated categories to the post-2006 separate category for general category income.

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 33 $\frac{1}{3}$ 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, the 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 preceding tax year, you should file Form 1040X for that tax year 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.

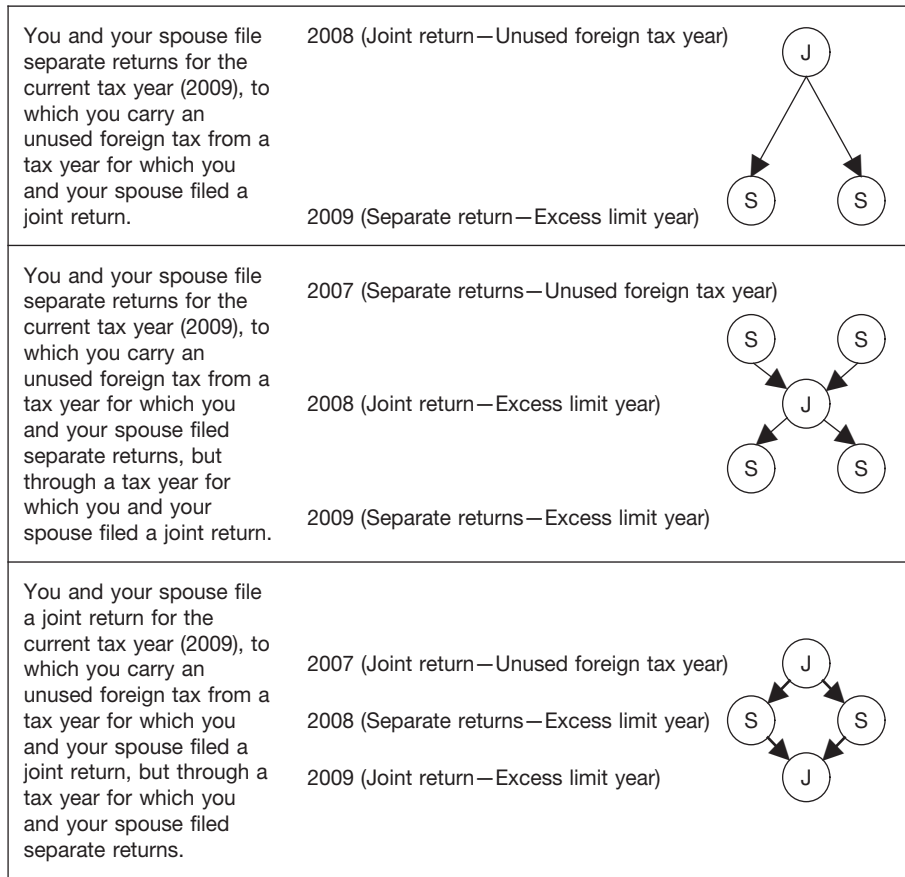
Because you cannot deduct or claim a credit for unused foreign taxes treated as absorbed in a deduction year, you will get no tax benefit for them unless you file an amended return to change your choice from deducting the taxes to claiming the credit. You have 10 years from the regular due date of the 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 2009, you paid foreign taxes of \$600 on general category income. You have a foreign tax credit carryover of \$200 from the same category from 2008. For 2009, your foreign tax credit limit is \$700.

If you choose to claim a credit for your foreign taxes in 2009, you would be allowed a credit of \$700, consisting of \$600 paid in 2009

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.)



J—Joint return filed
S—Separate return filed

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, 2009 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 2005, 2007, and 2008, and separate returns for 2006 and 2009. Neither H nor W had any unused foreign tax or excess limit for any year before 2005. For the tax years involved, the income, unused foreign tax, excess limits, and carrybacks and carryovers are general category income (general limitation income for 2005 and 2006) are shown in Table 5.

W's allocated part of the unused foreign tax from 2005 (\$30) is partly absorbed by her separate excess limit of \$20 for 2006, and then fully absorbed by her allocated part of the joint excess limit for 2007 (\$20). H's allocated part of the unused foreign tax from 2005 (\$50) is fully

and \$100 of the \$200 carried over from 2008. You will have a credit carryover to 2010 of \$100, which is your unused 2008 foreign tax credit carryover.

If you choose to deduct your foreign taxes in 2009, your deduction will be limited to \$600, which is the amount of taxes paid in 2009. You are not allowed a deduction for any part of the carryover from 2008. However, you must treat \$100 of the credit carryover as used in 2009, because you have an unused credit limit of \$100 (\$700 limit minus \$600 of foreign taxes paid in 2009). This reduces your carryover to later years.

If you claimed the deduction for 2009 and later decided you wanted to receive a benefit for that \$100 part of the 2008 carryover, you could change the choice of a deduction for 2009. You would have to claim a credit for those taxes by filing an amended return for 2009 within the time allowed.

Married Couples

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

For a tax year in which you and your spouse file separate returns, you figure the unused foreign tax or excess limit by using only your own separate income, deductions, taxes, and credits. However, if you file a joint return for any other

year involved in figuring a carryback or carryover of unused foreign tax to the current tax year, you will need to make an allocation, as explained under *Allocations Between Husband and Wife*, later.

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

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

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

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

Table 5. Carryback/Carryover

Tax year	2005	2006	2007	2008	2009
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 2005	—	20W	10W	—	—
H's from 2005	—	—	50H	—	—
H's from 2006	—	—	15H	—	—
"	—	—	10W	—	—
W's from 2008	—	—	—	—	10W
H's from 2008	—	—	—	—	50H
W = Absorbed by W's excess limit					
H = Absorbed by H's excess limit					

* General category income only

absorbed by his allocated part of the joint excess limit (\$65) for 2007.

H's separate unused foreign tax from 2006 (\$25) is partly absorbed (up to \$15) by his remaining excess limit in 2007, and then fully absorbed by W's remaining part of the joint excess limit for 2007 (\$10). Each spouse's excess limit on the 2007 joint return is reduced by:

1. Each spouse's carryover from earlier years (W's carryover of \$10 from 2005 and H's carryovers of \$50 from 2005 and \$15 from 2006).
2. The other spouse's carryover. (H's carryover of \$10 from 2006 is absorbed by W's remaining excess limit.)

W's allocated part of the unused foreign tax of \$69 from 2008 is partly absorbed by her excess limit in 2009 (\$10), and the remaining \$59 will be a carryover to general category income for 2010 and the following 8 years unless absorbed sooner. H's allocated part of the unused foreign tax of \$104 from 2008 is partly absorbed by his excess limit in 2009 (\$50), and the remaining \$54 will be a carryover to 2010 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 47, or Form 1040NR, line 44.

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 or Form 1040NR. You must file a separate Form 1116 for each of the following categories of income for which you claim a foreign tax credit.

- Passive category income.
- General category income.
- Section 901(j) income.
- Income re-sourced by treaty.
- Lump-sum distributions.

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. You do not need to report income passed through from a regulated investment company (RIC) on a country by country basis. Aggregate all income passed through from a RIC in a single column in Part I. Enter "RIC" on line g of Part I.

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. If you receive income passed through from a RIC, aggregate all foreign taxes paid or accrued on that income on a single line in Part II.
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 (the one with the largest amount entered on line 21) to summarize the foreign tax credits figured on separate Forms 1116.

Records To Keep



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

- 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. Issues of the Cumulative Bulletin are available in most IRS offices and you are welcome to read them there.

Simple Example — Filled-In Form 1116

Betsy Wilson is single, under 65, and is a U.S. citizen. She earned \$45,000 working as a night auditor in Pittsburgh. She owns 200 shares in XYZ mutual fund that invests in foreign corporations. She received a dividend of \$620 from XYZ, which includes tax of \$93 paid on her behalf to foreign countries 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 47. (She can claim her total taxes paid of \$93 because it is less than her "regular tax," shown on Form 1040 line 44.) 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 category income.

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

Betsy enters "RIC" on line g because mutual funds and other regulated investment companies (RICs) are not required to report the names of foreign countries on Form 1099-DIV. Also, she shows on line 1a the amount of income (\$620) and type of income (dividends) she received from XYZ. None of the dividends are qualified dividends. Next, because Betsy does not itemize her deductions, she puts her standard deduction (\$5,700) 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 \$45,620. She enters \$78 on line 6. Line 7 is \$542, the difference between lines 1a and 6.

Part II—Foreign Taxes Paid or Accrued

Betsy checks the "Paid" box and enters \$93 on line A, columns (o) and (s), and on line 8.

Because 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 (j).

Part III—Figuring the Credit

Betsy figures her credit as shown on the completed form. The computation shows that she may take only \$71 of the amount paid to foreign countries as a credit against her U.S. income tax. The remaining \$22 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 26 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 2009, 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
\$130,000 wages (260,000 pesos)	\$32,400 (64,800 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 \$91,400 of the wages earned in Country X.

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

Interest on home mortgage	\$5,900
Real estate tax	1,500
Charitable contribution	460
Employee business expenses (See the following discussion for computation.)	733
Total	<u>\$8,593</u>

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:

$$\frac{\$38,600}{\$130,000} \times \$2,400 = \$713$$

His employee business expense deduction is \$733. This is the difference between his business expenses of \$1,713 (\$713 + \$1,000 from U.S. business trip) and the 2%-of-adjusted-gross-income limit (\$980).

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 category income*, and figure his foreign tax credit on the wages of \$38,600 (Country X wages minus excluded wages). On the other Form 1116, he will mark the block to the left of *Passive category 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 \$36,757 figured as follows:

Gross Income

Wages (Country X)	\$130,000
Less: Foreign earned income exclusion	<u>91,400</u>
	\$ 38,600
Wages (U.S.)	2,400
Interest income (Country X)	1,000
Dividend income (U.S.)	3,000
Dividend income (Country X)	<u>4,000</u>
Total (Adjusted gross income)	\$49,000
Less: Total Itemized Deductions	<u>8,593</u>
Taxable income before the personal exemption	\$40,407
Less: Personal Exemption	<u>3,650</u>
Taxable Income	<u>\$36,757</u>

On each Form 1116, Robert enters \$40,407 (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 category income. On this Form 1116, Robert figures his taxable income from Country X for general category income only. He does not include his passive category income of interest and dividends.

Line 1a. Robert enters the foreign wages after exclusion of \$38,600 on line 1a.

Line 2. The unreimbursed employee business expenses related to these foreign source wages included in income are \$713, as shown earlier. Robert must determine which part of the 2%-of-adjusted-gross-income limit (\$980) is allocable to these employee business expenses. He figures this as follows:

$$\frac{\$713}{\$1,713} \times \$980 = \$408$$

The denominator (\$1,713) is the total allowable unreimbursed business expenses (\$1,000 + \$713). The amount of deductible expenses definitely related to \$38,600 of taxable foreign wages is \$305 (\$713 – \$408). He enters \$305 on line 2. He attaches this explanation to his Form 1116 that he files with his tax return.

Line 3a–g. Robert enters \$1,500 on line 3a. This is his real estate tax, which is not definitely related to income from any source. Robert must prorate this itemized deduction by using the ratio of gross income from Country X in general category income (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 \$91,400 of wages that qualify for the foreign earned income exclusion. He figures the ratable part of deductions, \$1,389, as follows and enters it on line 3g.

$$\frac{\$130,000}{\$140,400} \times \$1,500 = \$1,389$$

Line 4a. Robert apportions his qualified home mortgage interest, \$5,900, to general category income as follows:

- Enter gross foreign source income of the type shown on Form 1116.
Do not enter income excluded on Form 2555 \$38,600
- Enter gross income from all sources. **Do not** enter income excluded on Form 2555 \$49,000
- Divide line 1 by line 2 and enter the result as a decimal7878
- Enter deductible home mortgage interest (from Schedule A (Form 1040)) \$ 5,900
- Multiply line 4 by line 3. Enter the result here and on Form 1116, line 4a \$ 4,648

Robert enters this amount, \$4,648, on line 4a.

Line 6. Robert adds the amounts on lines 2, 3g, and 4a, and enters that total (\$6,342) on line 6.

Line 7. He subtracts the amount on line 6 from the amount on line 1a to arrive at foreign source taxable income of \$32,258 in this category. Robert enters this amount on line 7.

Form 1116—Passive category income. On this Form 1116, Robert determines the taxable income from Country X for passive interest and dividend income.

Line 1a. 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 1a. None of the dividends are qualified dividends.

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

$$\frac{\$5,000}{\$140,400} \times \$1,500 = \$53$$

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

- Enter gross foreign source income of the type shown on Form 1116. Do not enter income excluded on Form 2555 \$ 5,000
- Enter gross income from all sources. Do not enter income excluded on Form 2555 \$49,000
- Divide line 1 by line 2 and enter the result as a decimal1020
- Enter deductible home mortgage interest (from Schedule A (Form 1040)) \$ 5,900
- Multiply line 4 by line 3. Enter the result here and on Form 1116, line 4a \$ 602

He enters this amount, \$602, on line 4a.

Line 6. Robert adds the amounts on lines 3g and 4a and enters that total (\$655) on line 6.

Line 7. He subtracts the amount on line 6 from the amount on line 1a to arrive at foreign source taxable income of \$4,345 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.

Table 6. Robert's Schedule Showing Computation of His Carryover

	2007	2008
Maximum credit allowable under limit	\$750	\$1,200
Foreign tax paid in tax year	<u>600</u>	<u>1,550</u>
Unused foreign tax (+) to be carried over or excess of limit (-) over tax	-\$150	+\$350
Tax credit carried back from 2008	<u>150</u>	
Net excess tax to be carried over to 2009	0	+\$350
Less carrybacks to 2007		<u>150</u>
Amount carried over to 2009		<u>\$200</u>

Form 1116—General category 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 category 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 category 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 2008 and enters that amount on line 10. He attaches a schedule showing how he figured his \$200 carryover to 2009 after carrying back the unused \$350 tax paid in 2008 to 2007. (This schedule is shown in Table 6.) The unused foreign tax in 2008 and the excess limit in 2007 are general category income. The unused foreign tax of \$200 is carried over to general category income in 2009.

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 \$32,400 foreign tax he paid on his foreign wages by a fraction. The numerator of the fraction is his foreign earned income exclusion (\$91,400) minus a proportionate part of his definitely related business expenses (\$2,400 – \$713 = \$1,687). The denominator of the fraction is his total foreign wages (\$130,000) minus his total definitely related business expenses (\$2,400).

$$\$32,400 \times \frac{\$91,400 - \$1,687}{\$130,000 - \$2,400} = \$22,780$$

He enters the result, \$22,780 on line 12.

Line 13. His total foreign taxes available for credit are \$9,820 (\$200 carryover from 2008 + \$9,620 paid in 2009 (\$32,400 – \$22,780)).

Line 19. Robert figured his tax using the Foreign Earned Income Tax Worksheet in the Form 1040 instructions.

Line 20. By completing the rest of Part III, Robert finds that his maximum credit is \$8,211.

Line 21. The foreign tax credit on the general category income is the lesser of the foreign tax available for credit, \$9,820, or the maximum credit on line 20, \$8,211.

Form 1116—Passive category 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 his maximum credit for passive category income on line 20 is \$1,106.

The foreign tax credit for passive category income is limited to the amount of tax paid, \$500.

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 the Form 1116

with the largest amount on line 21. He uses the Part IV of Form 1116—General category income.

Robert leaves line 28 blank because he did not participate in or cooperate with an international boycott during the tax year. The allowable foreign tax credit is \$8,711 (\$500 + \$8,211), shown on line 29. He also enters this amount on Form 1040, line 47.

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 category income. Robert has 2009 unused foreign taxes of \$1,409 (\$9,620 – \$8,211) and \$200 of 2008 unused foreign taxes available as a carryover to 2010 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 2009 unused taxes to 2008 as shown in Table 6.

Passive category income. Robert has no unused foreign taxes for 2009.

Foreign Tax Credit
 (Individual, Estate, or Trust)
 ▶ Attach to Form 1040, 1040NR, 1041, or 990-T.
 ▶ See separate instructions.

Name Betsy Wilson Identifying number as shown on page 1 of your tax return
111-00-1111

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** beginning 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 category income **c** Section 901(j) income **e** Lump-sum distributions
b General category income **d** Certain income re-sourced by treaty

f 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)

g Enter the name of the foreign country or U.S. possession ▶	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
<u>RIC</u>				
1a Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions): <u>Dividends</u>				
	<u>620</u>			1a <u>620</u>
b Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is \$250,000 or more, and you used an alternative basis to determine its source (see instructions) . . . ▶ <input type="checkbox"/>				
Deductions and losses (Caution: See pages 13 and 14 of the instructions):				
2 Expenses definitely related to the income on line 1a (attach statement)				
3 Pro rata share of other deductions not definitely related:				
a Certain itemized deductions or standard deduction (see instructions)	<u>5,700</u>			
b Other deductions (attach statement)	<u>-0-</u>			
c Add lines 3a and 3b	<u>5,700</u>			
d Gross foreign source income (see instructions)	<u>620</u>			
e Gross income from all sources (see instructions)	<u>45,620</u>			
f Divide line 3d by line 3e (see instructions)	<u>.0136</u>			
g Multiply line 3c by line 3f	<u>78</u>			
4 Pro rata share of interest expense (see instructions):				
a Home mortgage interest (use worksheet on page 14 of the instructions)				
b Other interest expense				
5 Losses from foreign sources				
6 Add lines 2, 3g, 4a, 4b, and 5	<u>78</u>			6 <u>78</u>
7 Subtract line 6 from line 1a. Enter the result here and on line 14, page 2 ▶				7 <u>542</u>

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

Country	Credit is claimed for taxes (you must check one)		Foreign taxes paid or accrued							
	(h) <input checked="" type="checkbox"/> Paid (i) <input type="checkbox"/> Accrued	In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			(n) Other foreign taxes paid or accrued	Taxes withheld at source on:			(r) Other foreign taxes paid or accrued	(s) Total foreign taxes paid or accrued (add cols. (o) through (r))
		(j) Date paid or accrued	(k) Dividends	(l) Rents and royalties		(m) Interest	(o) Dividends	(p) Rents and royalties		
A	<u>1099 taxes</u>					<u>93</u>				<u>93</u>
B										
C										
8	Add lines A through C, column (s). Enter the total here and on line 9, page 2 ▶									8 <u>93</u>

For Paperwork Reduction Act Notice, see page 19 of the instructions.

Cat. No. 11440U

Form **1116** (2009)

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 pages 15 and 16 of the instructions)	12	-0-	
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit (see instructions)	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 16 of the instructions)	14	542	
15	Adjustments to line 14 (see pages 16 and 17 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	542	
17	Individuals: Enter the amount from Form 1040, line 41 (minus any amount on Form 8914, line 6). If you are a nonresident alien, enter the amount from Form 1040NR, line 38 (minus any amount on Form 8914, line 6). Estates and trusts: Enter your taxable income without the deduction for your exemption	17	39,920	
	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		.0136
19	Individuals: Enter the amount from Form 1040, line 44. If you are a nonresident alien, enter the amount from Form 1040NR, line 41. 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		5,256
	Caution: If you are completing line 19 for separate category e (lump-sum distributions), see page 19 of the instructions.			
20	Multiply line 19 by line 18 (maximum amount of credit)	20		71
21	Enter the smaller of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 26 and enter this amount on line 27. Otherwise, complete the appropriate line in Part IV (see page 19 of the instructions) ▶	21		71

Part IV Summary of Credits From Separate Parts III (see page 19 of the instructions)

22	Credit for taxes on passive category income	22		
23	Credit for taxes on general category income	23		
24	Credit for taxes on certain income re-sourced by treaty	24		
25	Credit for taxes on lump-sum distributions	25		
26	Add lines 22 through 25	26		
27	Enter the smaller of line 19 or line 26	27		71
28	Reduction of credit for international boycott operations. See instructions for line 12 beginning on page 15	28		
29	Subtract line 28 from line 27. This is your foreign tax credit . Enter here and on Form 1040, line 47; Form 1040NR, line 44; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶	29		71

Foreign Tax Credit
 (Individual, Estate, or Trust)
 ▶ Attach to Form 1040, 1040NR, 1041, or 990-T.
 ▶ See separate instructions.

Name Robert Smith Identifying number as shown on page 1 of your tax return 000-00-0000

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** beginning 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 category income **c** Section 901(j) income **e** Lump-sum distributions
b General category income **d** Certain income re-sourced by treaty

f 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)

g Enter the name of the foreign country or U.S. possession ▶	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
Country X				
1a Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions): <u>Wages</u>	38,600			1a 38,600
b Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is \$250,000 or more, and you used an alternative basis to determine its source (see instructions) . . . ▶ <input type="checkbox"/>				
Deductions and losses (Caution: See pages 13 and 14 of the instructions):				
2 Expenses definitely related to the income on line 1a (attach statement)	305			
3 Pro rata share of other deductions not definitely related:				
a Certain itemized deductions or standard deduction (see instructions)	1,500			
b Other deductions (attach statement)				
c Add lines 3a and 3b	1,500			
d Gross foreign source income (see instructions)	130,000			
e Gross income from all sources (see instructions)	140,400			
f Divide line 3d by line 3e (see instructions)9259			
g Multiply line 3c by line 3f	1,389			
4 Pro rata share of interest expense (see instructions):				
a Home mortgage interest (use worksheet on page 14 of the instructions)	4,648			
b Other interest expense				
5 Losses from foreign sources				
6 Add lines 2, 3g, 4a, 4b, and 5	6,342			6 6,342
7 Subtract line 6 from line 1a. Enter the result here and on line 14, page 2 ▶				7 32,258

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

Country	Credit is claimed for taxes (you must check one)		Foreign taxes paid or accrued							
	(h) <input checked="" type="checkbox"/> Paid (i) <input type="checkbox"/> Accrued	In foreign currency				In U.S. dollars				
		(j) Date paid or accrued	(k) Dividends	(l) Rents and royalties	(m) Interest	(n) Other foreign taxes paid or accrued	Taxes withheld at source on:			(r) Other foreign taxes paid or accrued
					(o) Dividends	(p) Rents and royalties	(q) Interest			
A	12-31-09				64,800				32,400	32,400
B										
C										
8	Add lines A through C, column (s). Enter the total here and on line 9, page 2 ▶									8 32,400

For Paperwork Reduction Act Notice, see page 19 of the instructions.

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	32,400	
10	Carryback or carryover (attach detailed computation)	10	200	
11	Add lines 9 and 10	11	32,600	
12	Reduction in foreign taxes (see pages 15 and 16 of the instructions)	12	22,780	
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit (see instructions)	13		9,820
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 16 of the instructions)	14	32,258	
15	Adjustments to line 14 (see pages 16 and 17 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	32,258	
17	Individuals: Enter the amount from Form 1040, line 41 (minus any amount on Form 8914, line 6). If you are a nonresident alien, enter the amount from Form 1040NR, line 38 (minus any amount on Form 8914, line 6). Estates and trusts: Enter your taxable income without the deduction for your exemption	17	40,407	
	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		.7983
19	Individuals: Enter the amount from Form 1040, line 44. If you are a nonresident alien, enter the amount from Form 1040NR, line 41. 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		10,285
	Caution: If you are completing line 19 for separate category e (lump-sum distributions), see page 19 of the instructions.			
20	Multiply line 19 by line 18 (maximum amount of credit)	20		8,211
21	Enter the smaller of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 26 and enter this amount on line 27. Otherwise, complete the appropriate line in Part IV (see page 19 of the instructions) ▶	21		8,211

Part IV Summary of Credits From Separate Parts III (see page 19 of the instructions)

22	Credit for taxes on passive category income	22	500	
23	Credit for taxes on general category income	23	8,211	
24	Credit for taxes on certain income re-sourced by treaty	24		
25	Credit for taxes on lump-sum distributions	25		
26	Add lines 22 through 25	26		8,711
27	Enter the smaller of line 19 or line 26	27		8,711
28	Reduction of credit for international boycott operations. See instructions for line 12 beginning on page 15	28		
29	Subtract line 28 from line 27. This is your foreign tax credit . Enter here and on Form 1040, line 47; Form 1040NR, line 44; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶	29		8,711

Foreign Tax Credit
 (Individual, Estate, or Trust)
 ▶ Attach to Form 1040, 1040NR, 1041, or 990-T.
 ▶ See separate instructions.

Name Robert Smith Identifying number as shown on page 1 of your tax return 000-00-0000

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** beginning 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 category income **c** Section 901(j) income **e** Lump-sum distributions
b General category income **d** Certain income re-sourced by treaty

f 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)

g Enter the name of the foreign country or U.S. possession ▶	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
Country X				
1a Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions): <u>Dividends, Interest</u>	5,000			1a 5,000
b Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is \$250,000 or more, and you used an alternative basis to determine its source (see instructions) . . . ▶ <input type="checkbox"/>				
Deductions and losses (Caution: See pages 13 and 14 of the instructions):				
2 Expenses definitely related to the income on line 1a (attach statement)				
3 Pro rata share of other deductions not definitely related:				
a Certain itemized deductions or standard deduction (see instructions)	1,500			
b Other deductions (attach statement)				
c Add lines 3a and 3b	1,500			
d Gross foreign source income (see instructions)	5,000			
e Gross income from all sources (see instructions)	140,400			
f Divide line 3d by line 3e (see instructions)0356			
g Multiply line 3c by line 3f	53			
4 Pro rata share of interest expense (see instructions):				
a Home mortgage interest (use worksheet on page 14 of the instructions)	602			
b Other interest expense				
5 Losses from foreign sources				
6 Add lines 2, 3g, 4a, 4b, and 5	655			6 655
7 Subtract line 6 from line 1a. Enter the result here and on line 14, page 2 ▶				7 4,345

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

Country	Credit is claimed for taxes (you must check one)		Foreign taxes paid or accrued							
	(h) <input checked="" type="checkbox"/> Paid (i) <input type="checkbox"/> Accrued	In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			(n) Other foreign taxes paid or accrued	Taxes withheld at source on:			(r) Other foreign taxes paid or accrued	(s) Total foreign taxes paid or accrued (add cols. (o) through (r))
		(j) Date paid or accrued	(k) Dividends	(l) Rents and royalties		(m) Interest	(o) Dividends	(p) Rents and royalties		
A	12-31-09	900		100		450		50		500
B										
C										
8	Add lines A through C, column (s). Enter the total here and on line 9, page 2 ▶									8 500

For Paperwork Reduction Act Notice, see page 19 of the instructions.

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 pages 15 and 16 of the instructions)	12	-0-	
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit (see instructions)	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 16 of the instructions)	14	4,345	
15	Adjustments to line 14 (see pages 16 and 17 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	4,345	
17	Individuals: Enter the amount from Form 1040, line 41 (minus any amount on Form 8914, line 6). If you are a nonresident alien, enter the amount from Form 1040NR, line 38 (minus any amount on Form 8914, line 6). Estates and trusts: Enter your taxable income without the deduction for your exemption	17	40,407	
	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		.1075
19	Individuals: Enter the amount from Form 1040, line 44. If you are a nonresident alien, enter the amount from Form 1040NR, line 41. 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		10,285
	Caution: If you are completing line 19 for separate category e (lump-sum distributions), see page 19 of the instructions.			
20	Multiply line 19 by line 18 (maximum amount of credit)	20		1,106
21	Enter the smaller of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 26 and enter this amount on line 27. Otherwise, complete the appropriate line in Part IV (see page 19 of the instructions) ▶	21		500

Part IV Summary of Credits From Separate Parts III (see page 19 of the instructions)

22	Credit for taxes on passive category income	22		
23	Credit for taxes on general category income	23		
24	Credit for taxes on certain income re-sourced by treaty	24		
25	Credit for taxes on lump-sum distributions	25		
26	Add lines 22 through 25	26		
27	Enter the smaller of line 19 or line 26	27		
28	Reduction of credit for international boycott operations. See instructions for line 12 beginning on page 15	28		
29	Subtract line 28 from line 27. This is your foreign tax credit . Enter here and on Form 1040, line 47; Form 1040NR, line 44; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶	29		

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get 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. The Taxpayer Advocate Service (TAS) is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should. Here are seven things every taxpayer should know about TAS:

- TAS is your voice at the IRS.
- Our service is free, confidential, and tailored to meet your needs.
- You may be eligible for TAS help if you have tried to resolve your tax problem through normal IRS channels and have gotten nowhere, or you believe an IRS procedure just isn't working as it should.
- TAS helps taxpayers whose problems are causing financial difficulty or significant cost, including the cost of professional representation. This includes businesses as well as individuals.
- TAS employees know the IRS and how to navigate it. We will listen to your problem, help you understand what needs to be done to resolve it, and stay with you every step of the way until your problem is resolved.
- TAS has at least one local taxpayer advocate in every state, the District of Columbia, and Puerto Rico. You can call your local advocate, whose number is in your phone book, in Pub. 1546, Taxpayer Advocate Service—Your Voice at the IRS, and on our website at www.irs.gov/advocate. You can also call our toll-free line at 1-877-777-4778 or TTY/TDD 1-800-829-4059.
- You can learn about your rights and responsibilities as a taxpayer by visiting our online tax toolkit at www.taxtoolkit.irs.gov.

Low Income Taxpayer Clinics (LITCs). The Low Income Taxpayer Clinic program serves individuals who have a problem with the IRS and whose income is below a certain level. LITCs are independent from the IRS. Most LITCs can provide representation before the IRS or in court on audits, tax collection disputes, and other issues for free or a small fee. If an individual's native language is not English, some clinics can provide multilingual information about taxpayer rights and responsibilities. For more information, see Publication 4134, Low Income Taxpayer Clinic List. This publication is available at IRS.gov, by calling 1-800-TAX-FORM (1-800-829-3676), or at your local IRS office.

Free tax services. To find out what services are available, get Publication 910, IRS Guide to

Free Tax Services. It contains lists of free tax information sources, including publications, services, and free tax education and assistance programs. It also has an index of over 100 TeleTax topics (recorded tax information) you can listen to on your telephone.

Accessible versions of IRS published products are available on request in a variety of alternative formats for people with disabilities.

Free help with your return. Free help in preparing your return is available nationwide from IRS-trained volunteers. The Volunteer Income Tax Assistance (VITA) program is designed to help low-income taxpayers and the Tax Counseling for the Elderly (TCE) program is designed to assist taxpayers age 60 and older with their tax returns. Many VITA sites offer free electronic filing and all volunteers will let you know about credits and deductions you may be entitled to claim. To find the nearest VITA or TCE site, call 1-800-829-1040.

As part of the TCE program, AARP offers the Tax-Aide counseling program. To find the nearest AARP Tax-Aide site, call 1-888-227-7669 or visit AARP's website at www.aarp.org/money/taxaide.

For more information on these programs, go to IRS.gov and enter keyword "VITA" in the upper right-hand corner.



Internet. You can access the IRS website at IRS.gov 24 hours a day, 7 days a week 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 2009 refund. Go to IRS.gov and click on *Where's My Refund*. Wait at least 72 hours after the IRS acknowledges receipt of your e-filed return, or 3 to 4 weeks after mailing a paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2009 tax return available so you can provide your social security number, 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.
- Use the online Internal Revenue Code, Regulations, or other official guidance.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using the withholding calculator online at www.irs.gov/individuals.
- Determine if Form 6251 must be filed by using our Alternative Minimum Tax (AMT) Assistant.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call 1-800-TAX FORM (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 to listen to pre-recorded messages covering various tax topics.
- *Refund information.* To check the status of your 2009 refund, call 1-800-829-1954 during business hours or 1-800-829-4477 (automated refund information 24 hours a day, 7 days a week). Wait at least 72 hours after the IRS acknowledges receipt of your e-filed return, or 3 to 4 weeks after mailing a paper return. If you filed Form 8379 with your return, wait 14 weeks (11 weeks if you filed electronically). Have your 2009 tax return available so you can provide your social security number, your filing status, and the exact whole dollar amount of your refund. Refunds are sent out weekly on Fridays. If you check the status of your refund and are not given the date it will be issued, please wait until the next week before checking back.
- *Other refund information.* To check the status of a prior year refund or amended return refund, call 1-800-829-1954.

Evaluating the quality of our telephone services. To ensure 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 listen in on or record random 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 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 for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you are more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary—just walk in. If you prefer, you can call your local Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. If you have an

ongoing, complex tax account problem or a special need, such as a disability, an appointment can be requested. All other issues will be handled without an appointment. To find the number of your local office, 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 address below. You should receive a response within 10 days after your request is received.

Internal Revenue Service
1201 N. Mitsubishi Motorway
Bloomington, IL 61705-6613



DVD for tax products. You can order Publication 1796, IRS Tax Products DVD, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.

- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.
- Tax Topics from the IRS telephone response system.
- Internal Revenue Code—Title 26 of the U.S. Code.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- Two releases during the year.
 - The first release will ship the beginning of January 2010.
 - The final release will ship the beginning of March 2010.

Purchase the DVD from National Technical Information Service (NTIS) at www.irs.gov/cdorders for \$30 (no handling fee) or call 1-877-233-6767 toll free to buy the DVD for \$30 (plus a \$6 handling fee).



I. U.S. tax on U.S. source income	COL. A	COL. B
(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 column A and lines 1-4, 5c, 6c and 7 in column B	_____	_____
9. Enter tax from Form 1040 (see instructions)	_____	_____
10. Enter adjusted gross income (AGI) from line 37, 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 line 14b)	_____	_____
15. a. Identify _____	_____	_____
b. Treaty rate	_____	_____
c. Allowable tax at source (Multiply line 15a by line 15b)	_____	_____
16. Total (Add lines 13b, 14c, and 15c)	_____	_____
C. Identify each item of U.S. source income from Col. A, Step I, on which 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 12 of Part III and line 29 of Part IV Form 1116.	_____	_____

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



Note. Complete a separate worksheet for each separate limit income category.

STEP I

Figure the estimated tax on U.S. source income in the separate limit income category using U.S. rules for determining the source of income.

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 44.

STEP II

Determine the amount of tax that the United States is allowed to collect at source under the treaty on income in the separate limit income category of residents of the other country who are not U.S. citizens. (Generally, this amount should be claimed, to the extent allowable, as a foreign tax credit on your foreign tax return.)

PART A Income in the separate limit income category fully taxable by the United States. This generally includes income from a U.S. trade or business and gains from dispositions of U.S. real property. Identify the type and amount on line 13a.

PART B Income in the separate limit income category for which treaty limits U.S. tax at source. This may include dividends, interest, royalties, and certain pensions.

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 in the separate limit income category not taxable at source by the United States under the treaty.

STEP III

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

Line 17 Enter the amount of the residence country tax on your U.S. source income before reduction for foreign tax credits. If possible, use 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. First, add this amount to the reduction in foreign taxes on line 12, Part III, and complete Form 1116 according to the instructions. Add this amount as an additional credit to line 29, Part IV, of Form 1116 as well and report that total on your Form 1040. File this worksheet with your Form 1040 as an attachment to Form 1116.



<p>A</p> <p>Accrual foreign taxes, adjustments 3</p> <p>Accrual method of accounting 3</p> <p>Allocation:</p> <p> Carryback/carryover between husband and wife 23</p> <p> Foreign losses 19</p> <p> Foreign taxes 11</p> <p> U.S. losses 19</p> <p>Alternative minimum tax 1</p> <p>Amended return 22</p> <p>American Samoa, resident of 8</p> <p>Assistance (See Tax help)</p> <hr/> <p>B</p> <p>Bankruptcy, effect of 22</p> <p>Beneficiary 6</p> <p>Bond, income tax 3</p> <p>Boycotting countries 9</p> <hr/> <p>C</p> <p>Capital gains and losses 16</p> <p>Carryback and carryover 2</p> <p> Allocations between husband and wife 23</p> <p> Claim for refund 22</p> <p> Joint return 23</p> <p> Joint return—deduction year 24</p> <p> Taxes all credited or deducted 22</p> <p> Time limit on tax assessment 22</p> <p>Choice to take credit or deduction:</p> <p> Changing your choice 2</p> <p> Choice applied to all qualified foreign taxes 2</p> <p>Claim for refund 22</p> <p>Classes of gross income 14</p> <p>Comments on publication 2</p> <p>Compensation for labor or personal services 12</p> <p> Geographical basis 13</p> <p>Comprehensive example 25</p> <p>Controlled foreign corporation shareholder 6, 10</p> <p>Credit:</p> <p> How to claim 24</p> <p> How to figure 10</p> <p> Limit on 10</p> <p>Credit for taxes paid or accrued 3</p> <hr/> <p>D</p> <p>Deduction for foreign taxes that are not income taxes 2</p> <p>Distributions:</p> <p> Lump-sum 11</p> <p>Dividends:</p> <p> Taxes on 8</p>	<p>Dual-capacity taxpayers 7</p> <hr/> <p>E</p> <p>Economic benefits 6</p> <p>Examples:</p> <p> Comprehensive 25</p> <p> Simple 25</p> <p>Excess limit 22</p> <p>Exchange rates 3</p> <p>Excluded income:</p> <p> Foreign earned 7</p> <p> Taxes on 7</p> <p>Exemption from foreign tax credit limit 10</p> <p>Export financing interest 11</p> <p>Extraterritorial income 8</p> <hr/> <p>F</p> <p>Financial services income 11</p> <p>Foreign corporation—U.S. shareholders, filing requirements 9</p> <p>Foreign country 6</p> <p>Foreign currency and exchange rates 3</p> <p>Foreign income, translating 3</p> <p>Foreign losses:</p> <p> Allocation of 19</p> <p> Recapture of 19</p> <p>Foreign mineral income, taxes on 9</p> <p>Foreign oil and gas extraction income, taxes on 9</p> <p>Foreign partnerships—U.S. partners, filing requirement 9</p> <p>Foreign tax refund 5, 6</p> <p>Foreign tax(es):</p> <p> Allocation to income categories 11</p> <p> For which you cannot take a credit 7</p> <p> Imposed on foreign refund 5</p> <p> Qualifying for credit 5</p> <p> Redetermination 4</p> <p> Refund 5</p> <p>Form:</p> <p> 1040X 22</p> <p> 1116 24, 25</p> <p> 5471 9</p> <p> 5713 9</p> <p> 8833 22</p> <p> 8865 9</p> <p> 8873 8</p> <p>Free tax services 34</p> <p>Functional currency 3</p> <hr/> <p>G</p> <p>General category income, separate limit 11</p>	<p>H</p> <p>Help (See Tax help)</p> <p>High-taxed income 11</p> <hr/> <p>I</p> <p>Income from sources in U.S. possessions 12</p> <p>Income re-sourced by treaty, separate limit 11</p> <p>Income tax 6</p> <p>Income tax bond 3</p> <p>Interest 7</p> <p>Interest expense, apportioning 15</p> <p>International boycott 9</p> <p>Itemized deduction 8</p> <p>Itemized deduction limit 15</p> <hr/> <p>J</p> <p>Joint return:</p> <p> Carryback and carryover 23</p> <p> Credit based on foreign tax of both spouses 6</p> <p> Filed in a deduction year 24</p> <hr/> <p>L</p> <p>Levy 6</p> <p>Limit on credit 10</p> <p>Losses, foreign 19</p> <p> Allocation of 19</p> <p> Recapture of 19</p> <p>Losses, U.S. 19</p> <p> Allocation of 19</p> <p>Lump-sum distributions 11</p> <hr/> <p>M</p> <p>Making or changing your choice 2</p> <p>Married couples:</p> <p> Carryback and carryover 23</p> <p> Joint return 6</p> <p>Mineral income, foreign 9</p> <p>More information (See Tax help)</p> <p>Mutual fund distributions 6, 10</p> <p>Mutual fund shareholder 6</p> <hr/> <p>N</p> <p>Nonresident aliens 5</p> <p>Notice to the IRS of change in tax 4</p> <hr/> <p>O</p> <p>Overall foreign loss 19</p> <hr/> <p>P</p> <p>Partner 6, 10, 11</p> <p>Passive category income 10</p> <p>Penalties 5, 7</p> <p> Failure to file Form 5471, 8865 10</p> <p> Failure to file Form 5713 9</p>	<p> Failure to notify, foreign tax change 5</p> <p> Failure to report treaty information 22</p> <p>Pension, employment, and disability fund payments 7</p> <p>Personal property, sales or exchanges of 14</p> <p>Possession exclusion 8</p> <p>Publications (See Tax help)</p> <p>Purchase or sale of oil or gas, taxes in connection with 9</p> <hr/> <p>Q</p> <p>Qualified business unit 4</p> <p>Qualified dividends 16</p> <hr/> <p>R</p> <p>Rate of exchange 4</p> <p>Recapture of foreign losses 19</p> <p>Records to keep 24</p> <p>Redetermination of foreign tax 4</p> <p>Refund claims, time limit 5</p> <p>Refund, foreign tax 6</p> <p>Reporting requirements (international boycott) 9</p> <p>Resident aliens 5</p> <hr/> <p>S</p> <p>S corporation shareholder 6, 11</p> <p>Sanctioned countries 8</p> <p>Section 901(j) income 11</p> <p>Section 901(j) sanctioned income 8</p> <p>Separate limit income 10</p> <p> General category income 11</p> <p> Income re-sourced by treaty 11</p> <p> Lump-sum distribution 11</p> <p> Passive category income 10</p> <p> Section 901(j) income 11</p> <p>Shareholder 6</p> <p>Simple example 25</p> <p>Soak-up taxes 7</p> <p>Social security taxes 7</p> <p>Source of compensation for labor or personal services:</p> <p> Alternative basis 13</p> <p> Multi-year compensation 12</p> <p> Time basis 12</p> <p>State income taxes 15</p> <p>Subsidy 6</p> <p>Suggestions for publication 2</p> <hr/> <p>T</p> <p>Tax help 34</p>
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Tax treaties	21	Taxpayer Advocate	34	U.S. losses:		When refunds can be	
Taxable income from sources		Time limit:		Allocation of	19	claimed	5
outside the U.S.,		Refund claims	5	U.S. possessions	6	When tax can be	
determination of	14	Tax assessment	22	Unused foreign tax credits,		assessed	22
Taxes:		Translating foreign		carryback or carryover	2 , 22	Who can take the credit	5
Excluded income	7	currency	3	<hr/> <hr/>		Why choose the credit	3
In lieu of income taxes	7	TTY/TDD information	34	<hr/> <hr/>			
On dividends	8	<hr/> <hr/>		W			
Paid or accrued	3	U		Wages	7		
Withheld on income or		U.S. citizens	5				
gain	9						

Tax Publications for Individual Taxpayers

See *How To Get Tax Help* for a variety of ways to get publications, including by computer, phone, and mail.

General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax For Individuals
- 334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
- 509 Tax Calendars for 2010
- 910 IRS Guide to Free Tax Services

Specialized Publications

- 3 Armed Forces' Tax Guide
- 54 Tax Guide for U.S. Citizens and Resident Aliens Abroad
- 225 Farmer's Tax Guide
- 463 Travel, Entertainment, Gift, and Car Expenses
- 501 Exemptions, Standard Deduction, and Filing Information
- 502 Medical and Dental Expenses (Including the Health Coverage Tax Credit)
- 503 Child and Dependent Care Expenses
- 504 Divorced or Separated Individuals
- 505 Tax Withholding and Estimated Tax
- 514 Foreign Tax Credit for Individuals
- 516 U.S. Government Civilian Employees Stationed Abroad
- 517 Social Security and Other Information for Members of the Clergy and Religious Workers
- 519 U.S. Tax Guide for Aliens
- 521 Moving Expenses
- 523 Selling Your Home
- 524 Credit for the Elderly or the Disabled
- 525 Taxable and Nontaxable Income
- 526 Charitable Contributions
- 527 Residential Rental Property (Including Rental of Vacation Homes)
- 529 Miscellaneous Deductions
- 530 Tax Information for Homeowners
- 531 Reporting Tip Income

- 535 Business Expenses
- 536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
- 537 Installment Sales
- 541 Partnerships
- 544 Sales and Other Dispositions of Assets
- 547 Casualties, Disasters, and Thefts
- 550 Investment Income and Expenses (Including Capital Gains and Losses)
- 551 Basis of Assets
- 552 Recordkeeping for Individuals
- 554 Tax Guide for Seniors
- 555 Community Property
- 556 Examination of Returns, Appeal Rights, and Claims for Refund
- 559 Survivors, Executors, and Administrators
- 561 Determining the Value of Donated Property
- 564 Mutual Fund Distributions
- 570 Tax Guide for Individuals With Income From U.S. Possessions
- 571 Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations
- 575 Pension and Annuity Income
- 584 Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)
- 587 Business Use of Your Home (Including Use by Daycare Providers)
- 590 Individual Retirement Arrangements (IRAs)
- 593 Tax Highlights for U.S. Citizens and Residents Going Abroad
- 594 The IRS Collection Process
- 596 Earned Income Credit (EIC)
- 721 Tax Guide to U.S. Civil Service Retirement Benefits
- 901 U.S. Tax Treaties
- 907 Tax Highlights for Persons with Disabilities

- 908 Bankruptcy Tax Guide
- 915 Social Security and Equivalent Railroad Retirement Benefits
- 919 How Do I Adjust My Tax Withholding?
- 925 Passive Activity and At-Risk Rules
- 926 Household Employer's Tax Guide For Wages Paid in 2010
- 929 Tax Rules for Children and Dependents
- 936 Home Mortgage Interest Deduction
- 946 How To Depreciate Property
- 947 Practice Before the IRS and Power of Attorney
- 950 Introduction to Estate and Gift Taxes
- 967 The IRS Will Figure Your Tax
- 969 Health Savings Accounts and Other Tax-Favored Health Plans
- 970 Tax Benefits for Education
- 971 Innocent Spouse Relief
- 972 Child Tax Credit
- 1542 Per Diem Rates (For Travel Within the Continental United States)
- 1544 Reporting Cash Payments of Over \$10,000 (Received in a Trade or Business)
- 1546 Taxpayer Advocate Service – Your Voice at the IRS

Spanish Language Publications

- 1SP Derechos del Contribuyente
- 17SP El Impuesto Federal sobre los Ingresos Para Personas Físicas
- 547SP Hechos Fortuitos Desastres y Robos
- 594SP El Proceso de Cobro del IRS
- 596SP Crédito por Ingreso del Trabajo
- 850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- 1544SP Informe de Pagos en Efectivo en Exceso de \$10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get Tax Help* for a variety of ways to get forms, including by computer, phone, and mail.

Form Number and Title	Form Number and Title
1040 U.S. Individual Income Tax Return	2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts
Sch A Itemized Deductions	2441 Child and Dependent Care Expenses
Sch B Interest and Ordinary Dividends	2848 Power of Attorney and Declaration of Representative
Sch C Profit or Loss From Business	3903 Moving Expenses
Sch C-EZ Net Profit From Business	4562 Depreciation and Amortization
Sch D Capital Gains and Losses	4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
Sch D-1 Continuation Sheet for Schedule D	4952 Investment Interest Expense Deduction
Sch E Supplemental Income and Loss	5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts
Sch EIC Earned Income Credit	6251 Alternative Minimum Tax—Individuals
Sch F Profit or Loss From Farming	8283 Noncash Charitable Contributions
Sch H Household Employment Taxes	8582 Passive Activity Loss Limitations
Sch J Income Averaging for Farmers and Fishermen	8606 Nondeductible IRAs
Sch L Standard Deduction for Certain Filers	8812 Additional Child Tax Credit
Sch M Making Work Pay and Government Retiree Credits	8822 Change of Address
Sch R Credit for the Elderly or the Disabled	8829 Expenses for Business Use of Your Home
Sch SE Self-Employment Tax	8863 Education Credits (American Opportunity, Hope, and Lifetime Learning Credits)
1040A U.S. Individual Income Tax Return	9465 Installment Agreement Request
1040EZ Income Tax Return for Single and Joint Filers With No Dependents	
1040-ES Estimated Tax for Individuals	
1040X Amended U.S. Individual Income Tax Return	
2106 Employee Business Expenses	
2106-EZ Unreimbursed Employee Business Expenses	