Publication 514

Foreign Tax Credit for Individuals

For use in preparing

2023 Returns

Volume 2 of 4

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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 or value of all classes of 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 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 1 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 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 during the annual accounting period of that corporation, and you owned the stock on the last day of the foreign corporation's annual accounting period, you may have to file an annual information return on Form 5471. Under this rule, you generally had control of a foreign corporation if, at any time during your 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 more than 50% of the deductions or losses were allocated.

You may also 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. In most cases, 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 the IRS mails you notice of the failure to furnish the information.

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. Additional reductions apply if the failure continues for 90 days or more after the date the IRS mails you notice of the failure to furnish the information. The total reductions 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.

Taxes Related to a Foreign Tax Credit Splitting Event

Reduce taxes paid or accrued by any taxes paid or accrued with respect to a foreign tax credit splitting event. For foreign taxes paid or accrued in tax years beginning after 2010, if there is a foreign tax credit splitting event, you may not take the foreign tax into account before the tax year in which you take the income into account. There is a foreign tax credit splitting event with respect to a foreign income tax if (in connection with a splitter arrangement listed below) the related income is (or will be) taken into account by a covered person. A covered person is either of the following.

- An entity in which you hold, directly or indirectly, at least a 10% ownership interest (determined by vote or value).
- Any person who is related to you. For a list of related persons, see *Nondeductible Loss* in chapter 2 of Pub. 544.

A covered asset acquisition under Internal Revenue Code section 901(m) is not a foreign tax credit splitting event under Internal Revenue Code section 909.

For more information, see section 909 and the regulations under that section.

Splitter arrangements. The following paragraphs summarize the splitter arrangements. For more details, see Regulations section 1.909-2(b).

Reverse hybrid splitter arrangement. A reverse hybrid is a splitter arrangement if you pay or accrue foreign income taxes with respect to income of a reverse hybrid. A reverse hybrid is an entity that is a corporation for U.S. federal income tax purposes but is a fiscally transparent entity (under the principles of Regulations section 1.894-1(d) (3)) or a branch under the laws of a foreign country imposing tax on the income of the entity.

Loss-sharing splitter arrangement. A foreign group relief or other loss-sharing regime is a loss-sharing splitter arrangement to the extent that a shared loss of a U.S. combined income group could have been used to offset income of that group (usable shared loss) but is used instead to offset income of another U.S. combined income group.

U.S. equity hybrid instrument splitter arrangement. A U.S. equity hybrid instrument is a splitter arrangement if payments or accruals on or with respect to this instrument meet all of the following conditions.

1. They give rise to foreign income taxes paid or accrued by the owner of this instrument.
2. They give rise to income tax deductions for the issuer under the laws of a foreign jurisdiction in which the issuer is subject to tax.
3. They do not give rise to income for U.S. federal income tax purposes.

A U.S. equity hybrid instrument is an instrument that is treated as equity for U.S. federal income tax purposes but is treated as indebtedness for foreign tax purposes, or with respect to which the issuer is otherwise entitled to a deduction for foreign tax purposes for amounts paid or accrued with respect to the instrument.

U.S. debt hybrid instrument splitter arrangement. A U.S. debt hybrid instrument is an instrument that is treated as equity for foreign tax purposes but as indebtedness for U.S. federal income tax purposes.

A U.S. debt hybrid instrument is a splitter arrangement if the issuer of the U.S. debt hybrid instrument pays or accrues foreign income taxes with respect to income in an amount equal to the interest (including original issue discount) paid or accrued on the instrument that is deductible for U.S. federal income tax purposes but that does not give rise to a deduction under the laws of a foreign jurisdiction in which the issuer is subject to tax.

Partnership interbranch payment splitter arrangement. An allocation of foreign income tax that a partnership pays or accrues with respect to an interbranch payment as described in Regulations section 1.704-1(b)(4) (viii)(d)(3) (the interbranch payment tax) is a splitter arrangement to the extent the interbranch payment tax is not allocated to the partners in the same proportion as the distributive shares of income in the creditable foreign tax expenditures (CFTE) category to which the interbranch payment tax is or would be assigned under Regulations section 1.704-1(b)(4)(viii)(d) without regard to Regulations section 1.704-1(b)(4)(viii)(d)(3).

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 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 later under *Separate Limit Income*. The limit treats all foreign income and expenses in each separate category as a single unit and limits the credit to the U.S. income tax on the taxable income in that category from all sources outside the United States.

Determining the foreign tax credit limit if you elect to be taxed at corporate tax rates under section 962. If you elect under Internal Revenue Code section 962 to be taxed initially at corporate rates on your section 951(a) amount and GILTI inclusion for the tax year, determine the limit on the related foreign tax credit on the applicable separate category Forms 1118. For purposes of completing the Forms 1118, the numerator determined for each separate category includes only your foreign source section 951(a) amount and your foreign source GILTI inclusion (less its portion of the section 250 deduction), as applicable. The total taxable income in the denominator is equal to your total section 951(a) amount and GILTI inclusion less your section 250 deduction. Your total U.S. tax liability multiplied by this fraction is the amount of your U.S. tax liability computed with respect to amounts subject to section 962 for the tax year (before taking into account foreign tax credits).

Complete Form 1116 to determine the limit on the credit that you are allowed to take with respect to any other foreign income taxes that you paid or accrued during the tax year, but do not include in the numerator or denominator of the fraction your section 951(a) amount, your GILTI inclusion, and the amount of your section 250 deduction for the tax year. Do not include in the amount of your total U.S. tax liability, which you multiply by this fraction, the amount of your U.S. tax liability computed with respect to amounts subject to section 962 for the tax year (before taking into account foreign tax credits). See Internal Revenue Code sections 960 and 962 and the regulations under those sections for more information. See, in particular, Regulations section 1.962-1(c) for a detailed example of computing separate foreign tax credit limits required when you are filing both a Form 1116 and a Form 1118.

Separate Limit Income

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

- Section 951A category income.
- Foreign branch category income.
- Passive category income.
- General category income.
- Section 901(j) income.
- Certain income re-sourced by treaty.

- Lump-sum distributions (LSDs).

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 (CFCs). As a U.S. shareholder, certain income that you receive or accrue from a 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 or value of all classes of the corporation's stock.

In most cases, subpart F inclusions are treated as separate limit income in the same category to which they are attributable at the level of the CFC. Interest, rents, and royalties from a CFC are treated as passive category income if they are attributable to the passive category income of the CFC. A dividend paid or accrued out of the earnings and profits of a CFC is treated as passive category income in the same proportion that the part of earnings and profits attributable to passive category income bears to the total earnings and profits of the CFC. The portions of interest, rents, royalties, and dividends that are not treated as passive category income are treated as separate limit income in another category following the rules described below for each category as applied at the level of the U.S. shareholder.

Partnership distributive share. In most cases, 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 treated as passive income in most cases. For more information, see the Partner's Instructions for Schedule K-3 (Form 1065), and Regulations section 1.904-4(n).

Section 951A Category Income

Section 951A category income, a new category beginning in 2018, consists of the GILTI a U.S. shareholder of a CFC is required to include in income under section 951A (other than GILTI that is passive category income). A U.S. shareholder's GILTI is determined based on its aggregate pro rata share of the tested income of all CFCs it owns, offset by its pro rata share of tested loss of any CFCs it owns, and the shareholder's net deemed tangible income return with respect to the CFCs. A CFC's tested income does not include effectively connected income, subpart F income, foreign oil and gas income, or certain related party payments. GILTI is included in income in a manner generally similar to inclusions of subpart F income. See Internal Revenue Code section 951A for more information.

Foreign Branch Category Income

Foreign branch category income consists of the business profits of a U.S. person that are attributable to one or more QBUs in one or more foreign countries. Foreign branch category income does not include any passive category income. See Internal Revenue Code section 904(d)(2)(J) and Regulations section 1.904-4(f).

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 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, in most cases, the income is 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.

Passive income also does not include financial services income 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 tax 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. 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.

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 FMV of the property is due to imports into the United States.

High-taxed income. High-taxed income is income if the foreign taxes you paid on the income (after allocation of expenses) exceed the highest U.S. tax that can be imposed on the income. See Regulations section 1.904-4(c) for more information.

Specified passive category income. Specified passive income consists of:

1. Dividends from a domestic international sales corporation (DISC) or former DISC to the extent the dividends are treated as foreign source income; and

2. Distributions from a former foreign sales corporation (FSC) 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 is income that is not section 951A category income, foreign branch category income, or passive category income, or does not fall into one of the other separate limit categories discussed later. In most cases, it 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 the tax year. Financial services income of a financial services entity includes income derived in the active conduct of a banking, financing, insurance, or similar business.

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 U.S. source income as foreign source, and you elect to apply the treaty, the income will be treated as foreign source.

You must figure 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. This rule does not apply to income that is re-sourced by reason of the relief from double taxation rules in any U.S. income tax treaty that is solely applicable to U.S. citizens who are residents of the foreign treaty country. See Internal Revenue Code sections 865(h), 904(d)(6), and 904(h)(10) and the regulations under those sections (including Regulations section 1.904-4(k)) for any grouping rules and other exceptions.

See *Tax Treaties*, later, for further information regarding income re-sourced by treaty.

Lump-Sum Distributions (LSDs)

If you receive a foreign source LSD from a retirement plan, and you figure the tax on it using the special averaging treatment for LSDs, you must make a special computation. Follow the Form 1116 instructions and complete the worksheet in those instructions to determine your foreign tax credit on the LSD.

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

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 regulations under Internal Revenue Code sections 861 and 904.

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 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).

$$\frac{\$75{,}759 \text{ (net wages)}}{\$78{,}600 \text{ (total income)}} \times \$3{,}200 = \$3{,}0841$$

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

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

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

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 foreign tax information from the Schedule K-3 you received from the partnership or S corporation. See the Instructions for Form 1116, and the partner and shareholder instructions for Schedule K-3 (Form 1065 or 1120-S) for instructions on 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. For individuals, this is the amount shown on line 15 of Form 1040, 1040-SR, or 1040-NR. 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 foreign tax credit limit if you elect to be taxed at corporate tax rates under section 962*, earlier, for more details that apply to you if you make a section 962 election.

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*, later, for a more detailed discussion on determining the source of these types of income.

Determining the source of income from U.S. possessions. In most cases, the rules for determining whether income is from sources in a U.S. possession are the same as those for determining whether income is from U.S. sources. However, exceptions do apply. See Pub. 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.

Number of days you performed services in the foreign country during the year

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, a U.S. citizen, worked 240 days for a U.S. company during the tax year. Christina 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 × $^{180}/240$) is Christina’s foreign source income.

Example 2. Robert, a U.S. citizen, is employed by a U.S. corporation. Robert’s principal place of work is in the United States. Robert’s annual salary is $100,000. None of Robert’s annual salary is for fringe benefits. During the first quarter of the year, Robert worked entirely within the United States. On April 1, Robert was transferred to Singapore for the remainder of the year. Robert 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 Robert's annual salary is attributable to the first quarter of the year (0.25 × $100,000). All of it is U.S. source income because Robert worked entirely within the United States during that quarter. The remaining $75,000 is attributable to the last 3 quarters of the year. During those quarters, Robert worked 150 days in Singapore and 30 days in the United States. Robert's periodic performance of services in the United States did not result in distinct, separate, and continuous periods of time. Of Robert's $75,000 salary, $62,500 ($75,000 × $^{150}/180$) is foreign source income for the year.

Multi-year compensation. In most cases, the source of multi-year compensation is 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 1 tax year but that is attributable to a period that includes 2 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 appropriate) that you the facts and circumstances of your case.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.

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 Patents, 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 *Determining the Source of Income From the Sales or Exchanges of Certain Personal Property*, 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 FMV of product at export terminal. For more information, see Regulations section 1.863-1(b).

* Exception: 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.

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.

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 you 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 a 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% 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. In most cases, the source of a moving expense reimbursement is 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 in most cases, 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).
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.

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.

Transportation Income

Transportation income is income from the use of a vessel or aircraft or for the performance of services directly related to the use of any vessel or aircraft. This is true whether the vessel or aircraft is owned, hired, or leased. The term “vessel or aircraft” includes any container used in connection with a vessel or aircraft.

All income from transportation that begins and ends in the United States is treated as derived from sources in the United States. If the transportation begins or ends in the United States, 50% of the transportation income is treated as derived from sources in the United States.

For transportation income from personal services, 50% of the income is U.S. source income if the transportation is between the United States and a U.S. possession. For nonresident aliens, this only applies to income derived from, or in connection with, an aircraft.

Determining the Source of Income From the Sales or Exchanges of Certain Personal Property

In most cases, 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. In most cases, 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 if the foreign country would have imposed a 10% or higher marginal tax rate had the sale resulted in a gain.

Inventory. Gains, profits, and income from the sale or exchange of inventory property produced partly in, and partly outside, the United States must be sourced on the basis of the location of production with respect to that property. For example, income derived from the sale of inventory property to a foreign jurisdiction is sourced wholly within the United States if the property was produced entirely in the United States, even if title passage occurred elsewhere. Likewise, income derived from inventory property sold in the United States, but produced entirely in another country, is sourced in that country even if title passage occurs in the United States. If the inventory property is produced partly in, and partly outside, the United States, the income derived from its sale is sourced partly in the United States. See Internal Revenue Code section 863(b).

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 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.

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. In most cases, 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 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 if the foreign country would have imposed a 10% or higher marginal tax rate had the sale resulted in a gain.

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 canceled debts.
- Your share of partnership gross income.
- Income in respect of a decedent.
- Income from an estate or trust.

- Global intangible low-taxed income (GILTI).

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.

$$\frac{\text{Gross income in separate limit category}}{\text{Total gross income in the class}} \times \$4{,}400$$

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

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

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

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

Limited partners with partnership interests of less than 10% must directly allocate their distributive shares of partnership interest expense to their distributive shares of partnership gross income. They must apportion the interest expense according to their relative distributive shares of gross foreign source income in each income category and of U.S. source income from the partnership. For special rules that may apply, see Regulations sections 1.861-9T(e) and 1.861-9(e)(2) and (3). Also, see the Partner's Instructions for Schedule K-3 (Form 1065) for further information.

Home mortgage interest. This is your deductible home mortgage interest, including points from Schedule A (Form 1040). Apportion it under the 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 home (as defined in Pub. 936) that is rented is considered a business asset for the period in which it is rented. You therefore apportion this interest under the rules for passive activity or business interest.

Example. You are operating a business as a sole proprietorship. Your business generates only U.S. source income. Your investment portfolio consists of several less-than-10% stock investments. You have stocks with an adjusted basis of $100,000. Some of your stocks (with an adjusted basis of $40,000) generate U.S. source income. Your other stocks (with an adjusted basis of $60,000) generate foreign passive income. You own your main home, which is subject to a mortgage of $120,000. Interest on this loan is home mortgage interest. You also have a bank loan in the amount of $40,000. The proceeds from the bank loan were divided equally between your business and your investment portfolio. Your gross income from your business is $50,000. Your investment portfolio generated $4,000 in U.S. source income and $6,000 in foreign source passive income. All of your debts bear interest at the annual rate of 10%.

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

The interest expense for your investments is also $2,000. It is apportioned on the basis of investment assets. $800 ($40,000/$100,000 × $2,000) of your investment interest is apportioned to U.S. source income and $1,200 ($60,000/$100,000 × $2,000) is apportioned to foreign source passive income.

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

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

Foreign income not exempt from state tax. If the state does not specifically exempt foreign income from tax, the following rules apply.

- If the total income taxed by the state is greater than the amount of U.S. source income for federal tax purposes, then the state tax is allocable to both U.S. source and foreign source income.
- If the total income taxed by the state is less than or equal to the U.S. source income for federal tax purposes, none of the state tax is allocable to foreign source income.

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

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

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

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

Deductions not definitely related. You must apportion to your foreign income in each separate limit category a fraction of your other deductions that are not definitely related to a specific class of gross income. If you itemize, these deductions are medical expenses, general sales taxes, and real estate taxes for your home. 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 Schedule 1 (Form 1040), Part II, Adjustments to Income.

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. The overall limitation on itemized deductions is suspended for tax years beginning after 2017 and before 2026.

Qualified Dividends

Qualified dividends are the amounts you entered on line 3a of Form 1040, 1040-SR, or 1040-NR. 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 18 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 18 in the Instructions for Form 1116 to determine the adjustments you may be required to make before taking U.S. or foreign qualified dividends into account on line 18 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 18 (taxable income before subtracting exemptions) of Form 1116.

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 (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 (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.

Form 1116, line 18. If you have U.S. or foreign source capital gains, you may be required to adjust the amount you enter on line 18 of Form 1116. Use the instructions for line 18 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. 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 among your foreign source capital gains using the following steps.

Table 4. **Rate Groups**

A capital gain or loss is in the...	**IF...**
28% rate group	it is included on the 28% Rate Gain Worksheet in the Instructions for Schedule D.
25% rate group	it is included on lines 1 through 13 of the Unrecaptured Section 1250 Gain Worksheet in the

	Instructions for Schedule D.
20% rate group	it is a long-term capital gain that is not in the 28% or 25% rate group and is taxed at a 20% rate **or** it is a long-term capital loss that is not in the 28%, 25%, or 15% rate group.
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%, 25%, or 20% 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.

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. Alfie figures the net gains and U.S. capital loss adjustment as follows.

$$\frac{\text{Foreign source capital gain}}{((\$1{,}000 + \$300) - \$400)} = \$900$$

$$\frac{\text{Worldwide capital gain}}{((\$1{,}000 + \$300) - (\$400 + \$150))} = \$750$$

$$\frac{\text{U.S. capital loss adjustment}}{(\$900 - \$750)} = \$150$$