Publication 514

Foreign Tax Credit for Individuals

For use in preparing

2023 Returns

Volume 3 of 4

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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 × $300/$900)

Alfie reduces the $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 passive category income

($150 × $600/$900)

Alfie reduces the $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 20% 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 20% 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)	

Dennis figures the U.S. capital loss adjustment as follows.

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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 the $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 × $200/$600)

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

($700 − $300)

Dennis apportions $200 to general category income

($300 × $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 × $100/$300)

Dennis apportions $66.67 to the 28% rate group

($100 × $200/$300)

After the U.S. capital loss adjustment, Dennis has $100 of foreign source 15% capital loss 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 *Capital gain rate differential adjustment for net capital gains*, later. 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 the foreign source capital gain ($450) does not exceed the worldwide capital gain ($500).

Mary’s net long-term capital loss from U.S. sources is $150 ($200 − $50). The 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 the $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 the $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 0.4054.

- For each separate category that has a net capital gain in the 20% rate group, multiply the applicable amount of the net capital gain by 0.5405.
- 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 0.6757.
- 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 0.7568.

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 it is included on line 1a as follows.

$$\$200 \times 0.7568 = \$151.36$$

Beth includes $151.36 of capital gain on line 1a of Form 1116 for the general category income.

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

Mary includes $251.36 of the 28% capital gain

$$(\$200 \times 0.7568) + \$100$$

Mary includes $90.54 of the 15% capital gain ($100 × 0.4054) + $50

Example 6. The facts are the same as in *Example 2*, earlier. 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. The 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 × $133.33 ÷ $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 $104.15 (($120 × 0.7568) + $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 × $200 ÷ $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 $92.97 (($180 × 0.4054) + $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.

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 20% 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 20% 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 20% rate group is netted first against any net capital gain in the 15% rate group, then against any net capital gain in the 0% rate group, then against any net capital gain in the 28% rate group, and finally to offset net capital gain in the 25% rate group.

d. A foreign source net capital loss in the 15% rate group is netted first against any net capital gain in the 0% rate group, then against 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 that amount of the net capital loss by 0.4054.
- To the extent a net capital loss in a separate category rate group offsets capital gain in the 20% rate group, multiply that amount of the net capital loss by 0.5405.

- 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 0.6757.
- 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 net capital loss by 0.7568.

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 gain. 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 in *Example 2*, earlier. 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 $40.54 of the capital loss on line 5 of the Form 1116 for general category income.($100 × 0.4054)

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 × $20/$60)

$33.33 of the $50 is treated as coming from general category income.
($50 × $40/$60)

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

$3.33 is treated as coming from passive category income.
($10 × $20/$60)

$6.67 is treated as coming from general category income.
($10 × $40/$60)

Dawn includes $9.28 of the capital loss in the amount entered on line 5 of Form 1116 for passive category income.

This is $6.76
($16.67 × 0.4054)

plus $2.52
($3.33 × 0.7568)

Dawn includes $18.56 of capital loss in the amount entered on line 5 of Form 1116 for general category income.

This is $13.51
($33.33 × 0.4054)

plus $5.05
($6.67 × 0.7568)

Dawn also includes $37.84 ($50 × 0.7568) of capital gain in the amount entered on line 1a of Form 1116 for passive category income.

Allocation of Foreign and U.S. Losses

You must allocate foreign losses for any tax year and U.S. losses for any tax 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*, earlier; over (2) the amount of taxable income you enter on Form 1116, line 18.

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 $75,000 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 $220,000, and your share of its expenses is $235,000. Your only foreign source income is your share of partnership income, which is foreign branch 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 $120,000. You also have itemized deductions of $34,000 that are not definitely related to any item of income.

In figuring your overall foreign loss for foreign branch category income for the year, you must allocate a ratable part of the $34,000 in itemized deductions to the foreign source income. You figure the ratable part of the $34,000 that is for foreign source income, based on gross income, as follows.

$$\frac{\text{\$220,000 (Foreign gross income)}}{\text{\$295,000 (Total gross income)}} \times \$34,000 = \$25,346$$

Therefore, your overall foreign loss for the year is $32,174 figured as follows.

Foreign gross income.............		$220,000
Less: Foreign earned income exclusion........	$120,000	
Allowable definitely related expenses [($100,000/$220,000) × $235,000].............	106,818	

Ratable part of itemized deductions.....	25,356	252,174
Overall foreign loss..............		$ 32,174

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 15, 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 figured by multiplying the total recapture amount by the following fraction.

$$\frac{\text{Maximum potential recapture amount for the overall foreign loss account in the separate category}}{\text{Total amount of maximum potential recapture in all overall foreign loss accounts}}$$

Example. During 2022 and 2023, 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 2022, the partnership had a loss and your share was $20,000, consisting of $225,000 gross income less $245,000 expenses. Your net loss from the partnership was $10,044, after deducting the foreign earned income exclusion and definitely related allowable expenses. This loss is related to foreign branch category income. Your U.S. dividend income was $20,000. Your itemized deductions totaled $30,000 and were not definitely related to any item of income. In figuring your taxable income for 2022, you deducted your share of the partnership loss from Country X from your U.S. source income.

During 2023, the partnership had net income from Country X. Your share of the net income was $140,000, consisting of $200,000 gross income less $60,000 expenses. Your net income from the partnership was $56,000 after deducting the foreign earned income exclusion and the definitely related allowable expenses. This is foreign branch category income. You also received dividend income of $20,000 from U.S. sources. Your itemized deductions were $30,000, which are not definitely related to any item of income. You paid income taxes of $14,000 to Country X on your share of the partnership income.

When figuring your foreign tax credit for 2023, 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 2022 Overall Foreign Loss

A. Determination of 2022 Overall Foreign Loss

1) Partnership loss from Country X $10,044

2) Add: Part of itemized deductions allocable to gross income from Country X

$$\frac{\$225{,}000}{\$245{,}000} \times \$30{,}000 = \$27{,}551$$

3) Overall foreign loss for 2022................. $\underline{\underline{\$37{,}595}}$

B Amount of Recapture for 2023

1) Balance for foreign branch category income foreign loss account 37,595

2) Taxable foreign branch category income after allocation of foreign losses—Foreign branch category income................. $56,000

Less: Itemized deductions allocable to that income [($200,000/$220,000) × $30,000].................... <u>27,273</u>

Foreign branch category taxable income less allocated foreign losses ($28,727 − 0)................ $28,727

3) Total amount of maximum potential recapture in all foreign loss accounts (smaller of (1) or (2))....................... $28,727

4) Foreign source net income........... $56,000

Less: Itemized deductions allocable to foreign source net income [($200,000/ $220,000) × $30,000]..... 27,273 $28,727

5) 50% of foreign source taxable income subject to recharacterization.................. $14,364

6) Recapture for 2023 (smaller of (3) or (5)).......... $14,364

The amount of the recapture is shown on Form 1116, line 16.

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 1040-X.

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. In most cases, 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 FMV 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.

In most cases, this rule also applies to a gain on the disposition of stock in a 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 subject to recharacterization as U.S. source income in most cases. See Regulations 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 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 2023 all or part of any income you receive in 2023 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 2023 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 2022, 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 ÷ $5,000) of the $2,000 loss (or $1,200) reduced passive category income and 40% ($2,000 ÷ $5,000) (or $800) reduced the income re-sourced by treaty.

In 2023, 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 2022, $1,200 of the 2023 general category income of $5,000 must be recharacterized as passive category income. This makes the 2023 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 2023 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.

Internal Revenue Code section 904(g)(5) allows for an election to recapture up to 100% of an unused pre-2018 overall domestic loss from a prior year, as opposed to the 50% stated in the previous paragraph. This election is applicable for any tax year beginning after 2017 and before January 1, 2028.

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 limit the amount of U.S. source income that is treated as foreign source income. The treaties that provide for this type of restriction include those with Australia, Austria, Bangladesh, Belgium, Bulgaria, Canada, the Czech Republic, Denmark, Finland, France, Germany, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, Malta, Mexico, the Netherlands, New Zealand, Portugal, the

Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, and the United Kingdom. There is a worksheet near the end of this publication to help you figure the additional credit that is allowed by reason of these limited re-sourcing rules. But do not use this worksheet to figure the additional credit under the treaties with Australia and New Zealand. In addition, the worksheet only applies for tax years beginning on or before August 10, 2010, and tax years after the 2017 tax year.

You can get more information by writing to:

Internal Revenue Service
International Section
Philadelphia, PA 19255-0725

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). See the instructions for Form 8833, and Regulations section 301.6114-1 for more information.

TIP 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 that is allowed by reason of the limited re-sourcing rules discussed previously. See Regulations section 301.6114-1(c) for more information.

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 1-year carryback and 10-year carryover do not apply to unused taxes in the section 951A category.

Use Schedule B (Form 1116) to reconcile your prior year foreign tax carryover with your current year foreign tax carryover. See Schedule B (Form 1116) and its instructions for more information.

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 2022 and 2023. 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 (−)
2022	$200	$100	−100
2023	$300	$500	+200

In 2023, you had unused foreign tax of $200 to carry to other years. You are considered to have paid this unused foreign tax first in 2022 (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 2019 through 2024. In 2019, you had an unused foreign tax of $200. Because you had no foreign income in 2018, 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 category income for 2019 through 2024 are as follows.

	Your limit	Tax paid	Unused foreign tax (+) or excess limit (−)
2019	$600	$800	+200
2020	$600	$700	+100
2021	$500	$700	+200
2022	$550	$400	−150
2023	$800	$700	−100
2024	$500	$550	+ 50

You cannot carry the $200 of unused foreign tax from 2019 to 2020 or 2021 because you have no excess limit in any of those years. Therefore, you carry the tax forward to 2022, 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 2019 can be carried to 2023. At this point, you have fully absorbed the unused foreign tax from 2019 and can carry it no further. You can also carry forward the unused foreign tax from 2020 and 2021.

Special rules for carryforwards of pre-2018 unused foreign taxes. Unused foreign taxes in the pre-2018 separate category for general income carried forward are generally allocated to your post-2017 separate category for general income. Alternatively, you can allocate those foreign taxes to the post-2017 separate category for foreign branch category income to the extent the unused foreign taxes would have been allocated to your post-2017 separate category for foreign branch category income, and would have been unused foreign taxes with respect to that separate category, if that separate category had applied in the year or years the unused foreign taxes arose. A simplified safe harbor is also available for determining the portion of the unused foreign taxes that may be allocated to the post-2017 separate category for foreign branch category income. See Regulations section 1.904-2(j)(1)(iii) for further details.

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 $33^1/3$ 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 Pub. 908.

Note. No foreign tax carryovers are allowed for foreign taxes paid or accrued on section 951A category income. Leave line 10 of Form 1116 blank if you complete a Form 1116 for section 951A category income, as carrybacks and carryovers are not allowed for this category of income.

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 1 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 1040-X 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 2023, you paid foreign taxes of $600 on general category income. You have a foreign tax credit carryover of $200 from the same category from 2022. For 2023, your foreign tax credit limit is $700.

If you choose to claim a credit for your foreign taxes in 2023, you would be allowed a credit of $700, consisting of $600 paid in 2023 and $100 of the $200 carried over from 2022. You will have a credit carryover to 2024 of $100, which is your unused 2022 foreign tax credit carryover.

If you choose to deduct your foreign taxes in 2023, your deduction will be limited to $600, which is the amount of taxes paid in 2023. You are not allowed a deduction for any part of the carryover from 2022. However, you must treat $100 of the credit carryover as used in 2023, because you have an unused credit limit of $100 ($700 limit minus $600 of foreign taxes paid in 2023). This reduces your carryover to later years.

If you claimed the deduction for 2023 and later decided you wanted to receive a benefit for that $100 part of the 2022 carryover, you could change the choice of a deduction for 2023. You would have to claim a credit for those taxes by filing an amended return for 2023 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 Spouses*, 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 Spouses* next.

Allocations Between Spouses

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

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

from a tax year for which you and your spouse filed separate returns, but through a tax year for which you and your spouse filed a joint return.

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

These three situations are illustrated in Figure A. In each of the situations, 2023 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 spouses are needed, are illustrated by the following example.

Example. H and W filed joint returns for 2019, 2021, and 2022, and separate returns for 2020 and 2023. Neither H nor W had any unused foreign tax or excess limit for any year before 2019. For the tax years involved, the income, unused foreign tax, excess limits, and carrybacks and carryovers are general category income and are shown in Table 5.

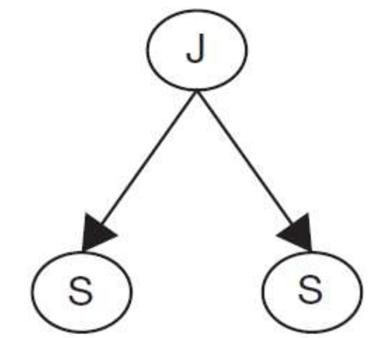
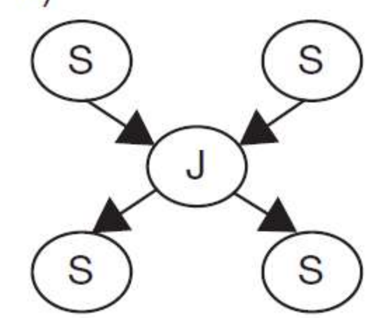
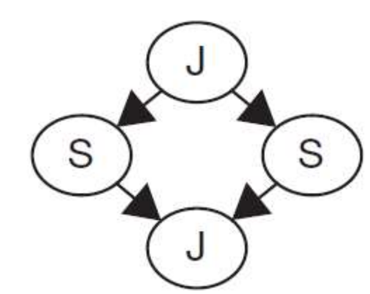
W's allocated part of the unused foreign tax from 2019 ($30) is partly absorbed by her separate excess limit of $20 for 2020 and then fully absorbed by her allocated part of the joint excess limit for 2021 ($20). H's allocated part of the unused foreign tax from 2019 ($50) is fully absorbed by his allocated part of the joint excess limit ($65) for 2021. ($10). Each spouse's excess

H's separate unused foreign tax from 2020 ($25) is partly absorbed (up to $15) by his remaining excess limit in 2021, and then fully absorbed by W's remaining part of the joint excess limit for 2021 ($10). Each spouse's excess limit on the 2021 joint return is reduced by the following.

1. Each spouse's carryover from earlier years. (W's carryover of $10 from 2019 and H's carryovers of $50 from 2019 and $15 from 2020.)
2. The other spouse's carryover. (H's carryover of $10 from 2020 is absorbed by W's remaining excess limit.)

Figure A. Allocation Between Spouses

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

You and your spouse file separate returns for the current tax year (2023), to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return.	2022 (Joint return—Unused foreign tax year) 2023 (Separate return—Excess limit year)	
You and your spouse file separate returns for the current tax year (2023), 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.	2021 (Separate returns—Unused foreign tax year) 2022 (Joint return—Excess limit year) 2023 (Separate returns—Excess limit year)	
You and your spouse file a joint return for the current tax year (2023), 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.	2021 (Joint return—Unused foreign tax year) 2022 (Separate returns—Excess limit year) 2023 (Joint return—Excess limit year)	

J—Joint return filed
S—Separate return filed

Table 5. **Carryback/Carryover**

Tax year	2019	2020	2021	2022	2023
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 2019	—	20W	10W	—	—
H's from 2019	—	—	50H	—	—
H's from 2020	—	—	15H	—	—
"	—	—	10W	—	—
W's from 2022	—	—	—	—	10W
H's from 2022	—	—	—	—	50H
W = Absorbed by W's excess limit					
H = Absorbed by H's excess limit					

* General category income only

W's allocated part of the unused foreign tax of $69 from 2022 is partly absorbed by her excess limit in 2023 ($10), and the remaining $59 will be a carryover to general category income for 2024 and the following 8 years unless absorbed sooner. H's allocated part of the unused foreign tax of $104 from 2022 is partly absorbed by his excess limit in 2023 ($50), and the remaining $54 will be a carryover to 2024 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 credit 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 Schedule 3 (Form 1040), line 1.

If you are a shareholder of a CFC 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 (CFC) 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, 1040-SR, or 1040-NR. You must file a separate Form 1116 for each of the following categories of income for which you claim a foreign tax credit.

- 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.

A Form 1116 consists of four parts.

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 U.S. possession, source income in the separate

limit category for which you are completing the form. Do not include income you excluded on Form 2555. 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 mutual fund or other regulated investment company (RIC) on a country-by-country basis. Total **all** income, in the applicable category, passed through from the mutual fund or other RIC and enter the total in a single column in Part I. Enter "RIC" on line i of Part I. Total **all** foreign taxes passed through and enter the total on a single line in Part II for the applicable category. Because computations for inclusions under section

951A are reported on separate Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI), you do not need to report those inclusions on a country-by-country basis. Enter the total inclusion in a single column in Part l and enter "951A" on line i. See the instructions for line i in the Instructions for Form 1116 for information about reporting section 863(b) gross income and deductions and high-taxed income.

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.

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