



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Flow-Through Entities Effects on FTC	
Primary UIL Code	9432.02-02	Categorization of Income and Foreign Taxes

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Knowledge Base	International
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Chapter	Calculation of Amount of Allowable FTC

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General Overview

Flow-Through Entities Effects on FTC

NOTE: This Practice Unit is updated to reflect the recent finalized Treas. Reg. 1.861-9.

Flow-through entities (FTEs) affect an individual's Foreign Tax Credit (FTC) by impacting foreign source gross income, foreign source taxable income, worldwide gross income, worldwide taxable income and foreign taxes available for credit.

Each U.S. partner of a partnership must report the partner's distributive share of the partnership's gains, income, deductions, losses, or credits on the partner's return, and each U.S. shareholder of an S corporation must report the shareholder's share of the S corporation's gains, income, deductions, losses or credits on the shareholder's return. IRC 704(b); IRC 1366.

Partners and shareholders that are U.S. citizens, resident aliens, domestic corporations, domestic trusts, and domestic estates are generally taxed on their distributive shares of the partnership's or S corporation's worldwide income regardless of the source. Items flowing through to partners or shareholders generally retain their character in the hands of the partners or shareholders.

S corporations are treated as partnerships and the shareholders of S corporations are treated as partners of a partnership for purposes of FTC. IRC 1373. When there is only a reference to a partner or partnership in this unit, the reference will also apply to S corporations and/or S corporation shareholders.

This concept unit is applicable for individual taxpayers that receive Schedule K-1(s) from partnerships or S corporations that report foreign income, related deductions and taxes. Members of LLCs who file a Form 1065 and beneficiaries of a Trust which files a Form 1041 are also subject to the rules discussed in this Practice Unit.

Relevant Key Factors

Flow-Through Entities Effects on FTC

Key Factors

- The character of any item of income, gain, loss, deduction, or credit described in IRC 702(a)(1) through (7) in the hands of a partner, will be determined as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership. IRC 702(b); IRC 1366(b).
- Limited partners who own an interest of less than 10 percent of the partnership, and S corporation shareholders who do not actively participate in the business of the S corporation and own an interest of less than 10 percent of the S corporation, generally categorize their distributive share of foreign source income from their respective entities, as passive income. See Treas. Reg. 1.904-5(h)(2) for additional details and exceptions.
- IRC 901 generally allows U.S. persons to elect to claim a credit for foreign income taxes paid or accrued by that person. In the case of foreign taxes paid or accrued by a partnership, IRC 703(a)(2)(B) and Treas. Reg. 1.703-1(a)(2)(iii) prohibit a partnership from deducting taxes described in IRC 901 that are paid or accrued to a foreign country, so the foreign taxes are passed through to the partners. IRC 702(a)(6) allows individual partners to take into account separately the partner's distributive share of the foreign taxes paid or accrued by the partnership. Partners may elect to treat all of their qualifying foreign taxes for the year as either a deduction on Schedule A or as a credit on Form 1116. The election applies to taxes paid directly by the partner and taxes paid by the partnership. Each partner elects separately and the partnership has nothing to do with the partner's choice. IRC 703(b)(3); Treasury Reg. 1.703-1(b)(2)(i).


Detailed Explanation of the Concept

Flow-Through Entities Effects on FTC

Reporting of Foreign Transactions on the K-1

Analysis	Resources
<ul style="list-style-type: none"> ▪ Foreign transactions from partnerships are reported on Form 1065, Schedule K-1, lines 16A through 16X. The information from this section of the K-1 is used to complete Form 1116, Foreign Tax Credit. On Page 2 of the Schedule K-1 under Foreign Transactions, the codes identify where on Form 1116 the amount for each code should be input. ▪ Foreign transactions from S Corporations are reported on Form 1120S, Schedule K-1, lines 14A through 14V. The information from this section of the K-1 is used to complete Form 1116, <i>Foreign Tax Credit</i>. On Page 2 of the Schedule K-1 under Foreign Transactions, the codes identify where on Form 1116 the amount for each code should be input. ▪ The foreign transactions codes for line 16 of the Form 1065, Schedule K-1 and line 14 of the Form 1120S, Schedule K-1 are essentially the same. <ul style="list-style-type: none"> – Code A: Name of foreign country or U.S. possession. – Code B: Gross income from all sources. Combine the distributive share of “gross income from all sources” with all other gross income and enter the total on line 3e. “Gross income from all sources” is a constant amount that will be entered on line 3e of all Form 1116s filed for each category of income. 	<ul style="list-style-type: none"> ▪ Form 1065, Schedule K-1 (2019) ▪ Form 1065, Schedule K-1 Instructions (2019) ▪ Form 1120S, Schedule K-1 (2019) ▪ Form 1120S, Schedule K-1 instructions (2019) ▪ Form 1065 Instructions (2019) ▪ Form 1120S Instructions (2019) ▪ Form 1116 (2019) ▪ Form 1116 Instructions (2019)

Detailed Explanation of the Concept (cont'd)

Flow-Through Entities Effects on FTC	
Analysis	Resources
<p>- Code C: Gross income sourced at partner or shareholder level. This line includes income from the sale of personal property other than inventory, depreciable property and certain intangible property. Include foreign source income in Part I of the applicable Form 1116 for each category of income as provided.</p> <p>As with all aspects of the FTC, properly sourcing income from FTEs is important to ensure taxpayers are not overstating the amount of foreign source income, which is a critical component of the FTC computation. Sourcing rules are covered in other practice units in greater detail, but are mentioned here to the extent they apply to FTEs.</p> <p>The next slide provides a table that summarizes various types of income and how they are generally sourced.</p> <p> CAUTION: The Schedule K-1 is being revamped to include more details to the international transactions. The changes are projected for 2021.</p>	<ul style="list-style-type: none">▪ IRC 865▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i> ▪ Practice Unit - <i>Sourcing of Income</i>

Detailed Explanation of the Concept (cont'd)

Flow-Through Entities Effects on FTC


Analysis

Resources

- IRC 861
- IRC 862
- IRC 863

Item of Income	Sourcing Determination
Interest	Residence of payer
Dividends	Residence of corporation, in general
Rents	Location of property
Royalties from natural resources	Location of property
Royalties from patents, copyrights, etc.	Where property is used
Sale of real property	Location of property
Sale of personal property	Tax home of seller
Sale of purchased inventory	Where property is sold
Sale of produced inventory	Allocate based on IRC 863(b)

Detailed Explanation of the Concept (cont'd)

Flow-Through Entities Effects on FTC	
Analysis	Resources
<p> CAUTION: Although all income reported on this line has been apportioned to separate categories of income, you must first determine whether the income on this line is U.S. or foreign source income, by determining the tax home of the seller. Then only enter foreign source income in part 1 of each of the applicable Forms 1116 for the category of income received. For information on determining tax home, see the instructions for Form 1116 or Pub. 514.</p> <p>If the partnership or S corporation specifically identifies any capital gains or losses or unrecaptured section 1250 gain on this line and the gains or losses are foreign source, see the instructions for Form 1116 before entering any amount in Part I.</p> <ul style="list-style-type: none"> - Codes D, E, F, G, H: Foreign gross income sourced at partnership or corporate level. Income on this line has already been sourced by the partnership or S corporation by country and category of income. Include these amounts in Part I of the applicable Form 1116 for each category of income as provided. - Code I: Interest expense on this line must be allocated and apportioned as described in the instructions to Form 1116. Any interest expense allocated to U.S. source income should not be entered in Part I of Form 1116. 	<ul style="list-style-type: none"> ▪ IRC 865 ▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i>

Detailed Explanation of the Concept (cont'd)

Flow-Through Entities Effects on FTC	
Analysis	Resources
<p>Rules of sourcing partnership interest deduction to individuals who are general partners or partners whose interest in the partnership is 10% or more:</p> <p>They first must classify their distributive share of partnership interest expense as interest in the following categories:</p> <ul style="list-style-type: none"> ▪ Interest incurred in the active conduct of a trade or business, ▪ Passive activity interest, or ▪ Investment interest. <p>Then they must apportion their interest expense under the following rules:</p> <ul style="list-style-type: none"> ▪ Individuals who incur business interest apportion that interest expense using an asset method by reference to the individual's business assets, ▪ Individuals who incur investment interest apportion that interest expense on the basis of the individual's investment assets, or ▪ Individuals who incur passive activity interest apportion that interest expense on the basis of the individual's passive activity assets. ▪ The individual's assets for the purpose of these allocations include its proportionate share of the partnership's assets. <p>Limited partners whose interest in the partnership is 10 percent or less, generally allocate interest expense proportionately based on the partner's distributive share of foreign source gross income in each limitation category.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.861-9T(d)(1) ▪ Treas. Reg. 1.861-9(e)(4)(i)

Detailed Explanation of the Concept (cont'd)

Flow-Through Entities Effects on FTC

Analysis

Resources

- Code J: Other expenses. The amount on this line includes expenses (other than interest) of the partnership or S corporation that must be allocated at the partner or shareholder level. Research and experimental expenditure is one example.
- Codes K, L, M, N, O: Deductions allocated and apportioned at the partnership or S corporation level to foreign source income. These expenses have been allocated at the partnership or S corporation level and are reported by country and category of income. Include these amounts on line 2 of each Form 1116 for each category of income received.
- Codes P, Q: Total foreign taxes paid or accrued. Foreign taxes reported on this line should have already been allocated and apportioned by the partnership or S corporation, by country and category of income. These amounts are included in Part II of each applicable Form 1116 by category. If there are multiple foreign countries/U.S. possessions, or more than one category of foreign income, and there is no breakdown of foreign taxes paid or accrued by country and/or category of income, ask the taxpayer to provide such detailed breakdown.
- Code R: Reduction in taxes available for credit. The reduction in taxes reported on this line should have already been allocated and apportioned by the partnership or S corporation, by country and category of income. Include these amounts on line 12 of each applicable Form 1116 by category.



CONSULTATION: Refer to the instructions to Form 1116, as well as Form 1065 and Form 1120S for more explanation.

Examples of the Concept

Flow-Through Entities Effects on FTC

Examples

Part III, Schedule K-1 (Form 1065)

Final K-1

Amended K-1

OMB No. 1545-0123

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items			
1	Ordinary business income (loss)	15	Credits
	200,000		
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions
		A	Country Y
4	Guaranteed payments	B	750,000
5	Interest income	G	10,000
6a	Ordinary dividends	N	4,000
6b	Qualified dividends	Q	2,500
6c	Dividend equivalents		
7	Royalties		

Name of country or U.S. possession

Gross income from all sources

Foreign gross income sourced at partnership level - general category

Deductions allocated and apportioned at partnership level to foreign source income - general category

Total foreign taxes accrued


Examples of the Concept (cont'd)

Flow-Through Entities Effects on FTC

Examples

As mentioned earlier, the same codes apply to line 16 of the Form 1065, Schedule K-1 as to line 14 of the Form 1120S, Schedule K-1. For the purposes of this example, only the Form 1065, Schedule K-1 is illustrated. The amounts shown on the K-1 in the previous slide are reported on Form 1116 (next slide) as follows:

- Line 16 code B: Gross income from all sources, both U.S. and foreign, is reported on line 3e of Form 1116. If there are multiple Form 1116s, this amount will be the same on all Form 1116s. This example assumes the K-1 is the only income activity of the taxpayer.
- Line 16 code G: Foreign gross income sourced at partnership level - general category is reported on line 1a and 3d of the Form 1116 for general category income.
- Line 16 code N: Deductions allocated and apportioned at partnership level to foreign source income - general category is reported on line 2 of Form 1116 for general category income.
- Line 16 code Q: Total foreign taxes accrued is reported in the applicable columns in Part II of Form 1116 for the applicable category of income, in our example, the general category. The partnership reports this amount by category of income and country. The partnership is also required to report the exchange rates used and the amounts in both the foreign currency and the U.S. dollar, as well as the dates paid or accrued.

 **CAUTION:** The amount of \$200,000 on line 1 of the K-1, ordinary business income (loss), is not reported directly on Form 1116. This amount should be included in the gross income from all sources. If any amount of the ordinary business income (loss) is foreign source, that amount should be included in foreign gross income sourced at partnership level in the appropriate category of income determined by the partnership.

Examples of the Concept (cont'd)

Flow-Through Entities Effects on FTC

Examples

Form 1116, Part I

- a Section 951A income c Passive category income e Section 901(j) income g Lump-sum distributions
 b Foreign branch income d General category income f Certain income re-sourced by treaty

h Resident of (name of country) ► **USA**

Note: If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession.

Part I Taxable Income or Loss From Sources Outside the United States (for category checked above)

i	Enter the name of the foreign country or U.S. possession ►	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
		A	B	C	
	Y				
1a	Gross income from sources within country shown above and of the type checked above (see instructions):				
		10,000			1a
b	Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is \$250,000 or more, and you used an alternative basis to determine its source (see instructions) ► <input type="checkbox"/>				
Deductions and losses (Caution: See instructions.):					
2	Expenses definitely related to the income on line 1a (attach statement)	4,000			
3	Pro rata share of other deductions not definitely related:				
a	Certain itemized deductions or standard deduction (see instructions)				
b	Other deductions (attach statement)				
c	Add lines 3a and 3b				
d	Gross foreign source income (see instructions)	10,000			
e	Gross income from all sources (see instructions)	750,000			
f	Divide line 3d by line 3e (see instructions)				
g	Multiply line 3c by line 3f				

Examples of the Concept (cont'd)

Flow-Through Entities Effects on FTC

Examples

Form 1116, Part II

Part II Foreign Taxes Paid or Accrued (see instructions)

Country	Credit is claimed for taxes (you must check one)		Foreign taxes paid or accrued							
	(j) <input type="checkbox"/> Paid	(k) <input checked="" type="checkbox"/> Accrued	In foreign currency				In U.S. dollars			
	(l) Date paid or accrued	Taxes withheld at source on:			(p) Other foreign taxes paid or accrued	Taxes withheld at source on:			(t) Other foreign taxes paid or accrued	(u) Total foreign taxes paid or accrued (add cols. (q) through (t))
		(m) Dividends	(n) Rents and royalties	(o) Interest		(q) Dividends	(r) Rents and royalties	(s) Interest		
A	12/31/2018				xx				2,500	2,500
B										
C										
8 Add lines A through C, column (u). Enter the total here and on line 9, page 2 ▶									8	2,500

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11440U

Form **1116** (2018)

Index of Referenced Resources

Flow-Through Entities Effects on FTC
IRC 702
IRC 703
IRC 704(b)
IRC 861
IRC 862
IRC 863
IRC 865
IRC 901
IRC 1366
IRC 1373
Treas. Reg. 1.703-1
Treas. Reg. 1.861-9
Treas. Reg. 1.861-9T
Treas. Reg. 1.904-5(h)(2)
Form 1065, Schedule K-1
Form 1116
Form 1120S, Schedule K-1

Index of Referenced Resources (cont'd)

Flow-Through Entities Effects on FTC

Form 1065, Schedule K-1 Instructions

Form 1120S, Schedule K-1 Instructions

Form 1065 Instructions

Form 1116 Instructions

Form 1120S Instructions

Pub. 514 - *Foreign Tax Credit for Individuals*

Training and Additional Resources

Flow-Through Entities Effects on FTC	
Type of Resource	Descriptions
Saba Meeting Sessions	▪ <i>How to Audit FTC - FTC Concepts - 2015 Saba Meeting</i>
Issue Toolkits	▪ <i>Audit Tool - FTC Workbooks</i>
Databases / Research Tools	▪ <i>Kuntz & Peroni - U.S. Int'l Tax Para B7.07</i>
Other Training Materials	▪ <i>YouTube - International Taxpayers - Foreign Tax Credit</i>

Glossary of Terms and Acronyms

Term/Acronym	Definition
FTC	Foreign Tax Credit
FTEs	Flow-Through Entities
IRC	Internal Revenue Code

Index of Related Practice Units

Associated UILs	Related Practice Unit
9432.01	<i>FTC General Principles</i>
9432.02-01	<i>Sourcing of Income</i>