Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Foreign Tax Credit - Categorization of Income and Taxes Into Proper Basket	
Primary UIL Code	9432.02-02	Categorization of Income and Foreign Taxes

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Knowledge Base	International
Shelf	Individual Outbound
Book	Foreign Tax Credits Individual
Chapter	Calculation of Amount of Allowable FTC

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General Overview

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Note: This Practice Unit updates the May 15, 2023, Practice Unit with the same title. The update clarifies slide 5 regarding IRC 962 election and that the reduced corporate rate of 21% is before the IRC 250 deduction.

The Foreign Tax Credit (FTC) calculation must be applied separately to each category of income, sometimes referred to as income baskets. The foreign income and related taxes from one category cannot be combined with another category. This prevents averaging low- taxed income in one category with high-taxed income in another category which could overstate the FTC.

The FTC limitation must be calculated separately for different categories of foreign source income according to Internal Revenue Code (IRC) 904(d). TCJA, effective for taxable years starting after 2017, increased the number of income baskets from five to seven by adding categories for IRC 951A category income and foreign branch category income. The remaining categories include passive category income, general category income, IRC 901(j) income, certain income resourced by treaty and lump-sum distributions. Passive and general categories of income are the most common.

The limitation formula is based on the taxable income for each category. It is necessary to determine foreign source taxable income for each category of income. Taxable income for a particular FTC category is the gross income of that category, less any relevant expenses.

General Overview (cont'd)

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The limitation must be calculated for each separate category of foreign source income. The limit treats all foreign income and expenses in each separate category as a single unit and limits the credit to the United States (U.S.) income tax on the taxable income in that category from all sources outside the U.S.

Summary of concept and how and where categorization fits into the FTC computation:

- Foreign source income is included in each of the above categories, and a separate Form 1116 is prepared for each category. To prepare the separate Form 1116 for each category, the expenses, losses and deductions that are definitely related and not definitely related to that particular category of income must be determined, as well as the foreign taxes paid or accrued on the income in each category.
- Form 1116, Part IV, lines 25-31 (for 2021) summarize the credits added from separate Forms 1116 Part III. The taxpayer completes Part IV on only one Form 1116 to summarize the credits they figured on all of their separate Forms 1116. The form with the largest amount on line 24 is the form used to combine totals.

! **CAUTION:** This unit provides a general overview of IRC 951A category income and foreign branch category income. Comprehensive matters of these categories are beyond the scope of this unit.

Detailed Explanation of the Concept

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There are seven categories of income: IRC 951A, Foreign Branch, Passive, General. Section 901(j), Certain income resourced by treaty, lump sum distributions. Each will be discussed below.

Analysis	Resources
1. IRC 951A Category Income	
▪ IRC 951A category income is a new category added by the 2017 TCJA. Beginning in 2018, a U.S. shareholder who directly or indirectly owns 10% of the vote or value of the stock of a controlled foreign corporation (CFC) must include global intangible low-taxed income (GILTI) in their income (other than GILTI that is passive category income).	▪ IRC 951A ▪ Treas. Reg. 1.904-4(g)
▪ Generally, individual U.S. shareholders are not eligible for the GILTI deduction under IRC 250 or foreign tax credits for taxes deemed paid for GILTI under IRC 960.	▪ IRC 250 ▪ IRC 960
▪ However, there is an option to allow an individual U.S. shareholder to make an IRC 962 election. This election allows an individual to pay the GILTI tax as if the individual was a U.S. corporation (at the reduced corporate tax rate of 21%, before the IRC 250 deduction).	▪ IRC 962 ▪ Treas. Reg. 1.962-1 ▪ Form 1116 Instructions
▪ Computations for inclusion of IRC 951A category income are reported on Form 8992, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)* and Form 1118, *Foreign Tax Credit - Corporations* to claim foreign tax credits for taxes with respect to GILTI.	▪ Form 8992 ▪ Form 1118

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Detailed Explanation of the Concept (cont'd)

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Analysis	**Resources**
1. IRC 951A Category Income (cont'd) ▪ If an individual U.S. shareholder does not make an IRC 962 election, they would report IRC 951A income on Form 8992 and Form 1116 but would not be able to claim foreign tax credits for taxes with respect to GILTI or claim the IRC 250 deduction. ▪ No excess FTC carryovers or carrybacks are allowed for foreign taxes paid or accrued on IRC 951A category income.	 ▪ IRC 904(c)

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Analysis	**Resources**
<u>2. Foreign Branch Category Income</u> ▪ Foreign branch category income, is another new category beginning in 2018. It is defined by reference to the definition of a qualified business unit (QBU). It includes the income of a U.S. person that is: − income attributable to the foreign branch, − a distributive share of partnership income attributable to a foreign branch and − income of other pass-through entities attributable to a foreign branch. Pass-through entities cannot have foreign branch category income, but their non-pass-through U.S. owners can. ▪ Foreign branch category income does not include any passive category income. ▪ 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 post-2017 separate category for general income. − However, these foreign taxes can be allocated to the post-2017 separate category for foreign branch category income to the extent the unused foreign taxes would have been allocated to 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.	▪ Pub. 514 - *Foreign Tax Credit for Individuals* ▪ IRC 904(d)(1)(B) ▪ IRC 904(d)(2)(J) ▪ Treas. Reg. 1.904-4(f) ▪ Treas. Reg. 1.904-2(j)(1)(iii)

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Analysis	**Resources**
<u>3. Passive Category Income</u>	▪ IRC 904(d)(2)(A)(i)
This category includes passive income and specified passive category income.	▪ IRC 904(d)(2)(B) ▪ Treas. Reg. 1.904-4(b)(2)
▪ Passive income includes: − Interest. − Dividends. − Rents. − Royalties. − Gains from sale of real or personal property. − Income inclusions relating to passive foreign investment companies (PFICs), which are qualifying electing funds (QEFs).	▪ IRC 1293 ▪ Treas. Reg. 1.904-4(b)(2)(i)(B)
▪ Look-through rules address income received by U.S. persons having ownership of a CFC and noncontrolled IRC 902 corporations and treats this income as one of the separate categories.	▪ Treas. Reg. 1.904-5
▪ In general, limited partners who own less than 10 percent of the value in a partnership will treat their distributive share of partnership income from the partnership as passive income.	▪ Treas. Reg. 1.904-4(n)(ii)

Detailed Explanation of the Concept (cont'd) 4

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Analysis	**Resources**
3. Passive Category Income (cont'd) ▪ Specified passive category income includes: − Dividends from a domestic international sales corporation (DISC) or former DISC. − Distributions from a former foreign sales corporation (FSC). Note: The above specified passive categories of income are not common to individual taxpayers and are beyond the scope of this Practice Unit. The following items are not passive income: ▪ Passive income does not include export financing interest (EFI). ▪ Passive income generally does not include high-taxed income. This exception is also referred to as the "high tax kick-out," and treats what would normally be considered passive income as general category income. Passive income is high-taxed income if, after allocating to income the U.S. person's expenses, losses and other deductions, the sum of the foreign income taxes paid, accrued, or deemed paid or accrued on the income, exceeds the highest U.S. tax that can be imposed on the income. The look-through rules are applied before the high U.S. tax kick-out computation. High-taxed income is determined before adjustments for capital gains and the application of the loss recapture rules.	▪ IRC 904(d)(2)(B)(v) ▪ Treas. Reg. 1.904-4(b)(3) ▪ IRC 904(d)(2)(B)(v)(I) ▪ IRC 904(d)(2)(B)(v)(II) ▪ IRC 904(d)(2)(B)(iii) ▪ IRC 904(d)(2)(F) ▪ Treas. Reg. 1.904-4(c)

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Analysis	**Resources**
<u>3. Passive Category Income (cont'd)</u>	▪ Treas. Reg. 1.904-4(b)(2)(ii)
▪ Passive income generally does not include recharacterized passive income under the look-through rules of IRC 904(d)(3), (d)(4), and (d)(6)(C). This income is treated as general category income	▪ IRC 904(d)(3) ▪ IRC 904(d)(4) ▪ IRC 904(d)(6)(C)
▪ Active business rents and royalties are excluded from the passive income category and are treated as general category income.	▪ Treas. Reg. 1.904-4(b)(2)(iii)
▪ Passive income generally does not include items resourced under treaties. If an item is of a type that is usually passive income, but is resourced under a treaty, the item is treated as certain income resourced by treaty.	▪ IRC 904(d)(6)
▪ Any income defined in another separate limit category is not passive income.	

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Analysis	**Resources**
<u>4. General Category Income</u>	
IRC 904 defines general category income as income other than IRC 951A category income, foreign branch category income, or passive category income. It also includes income that does not fall into one of the other separate categories. In effect, it is a general catch-all category.	▪ IRC 904(d)(2)(A)(ii)
General category income includes: ▪ Wages, salary, other compensation and overseas allowances of an individual as an employee. ▪ Income earned in the active conduct of a trade or business. ▪ Gains from the sale of inventory or depreciable property used in a trade or business. ▪ Financial services income derived by a financial services entity.	▪ IRC 904(d)(2)(C) ▪ IRC 904(d)(2)(D)

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Analysis	Resources
<u>5. IRC 901(j) Income</u> This is income from activities conducted in sanctioned countries. No FTC is allowed for taxes paid or accrued to certain countries if the taxes are attributable to a period in which the country satisfies one or more criteria. IRS Publication 514 lists sanctioned countries designated by the Secretary of State. Key factors of this code section are: ▪ Income from each sanctioned country must still be subjected to a separate FTC limitation. ▪ Form 1116 for this category would be completed only through line 17. ▪ Presidential waiver may be provided by the President of the United States. ▪ Applies to any foreign country which: − The U.S. does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act, − The U.S. has severed diplomatic relations, − The U.S. has not severed diplomatic relations but does not conduct such relations, or − The Secretary of State has, pursuant to Section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country which repeatedly provides support for acts of international terrorism.	▪ IRC 901(j) ▪ Treas. Reg. 1.904–4(m) ▪ IRM 4.61.10.4.4 ▪ Pub. 514 - *Foreign Tax Credit for Individuals*

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<tr><th>Analysis</th><th>Resources</th></tr>
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<u>5. IRC 901(j) Income (cont’d)</u>
Income from a sanctioned country is a separate category of foreign income unless a Presidential waiver is granted. A separate Form 1116 must be prepared for this type of income.
If a sanction period ends (or a Presidential waiver is granted) during the tax year and the actual income and taxes for that period cannot be determined, then allocate amounts to that period based on the number of days in the period that fall in the tax year. Multiply the income or taxes for the year by the following fraction to determine the amounts allocable to that period.
$$\frac{\text{Number of Nonsanctioned Days in Year}}{\text{Number of Days in Year}}$$
IRS Publication 514 discusses the countries for which sanctions have ended or for which a Presidential waiver has been granted. For any of these countries, an FTC can be claimed for the taxes paid or accrued to that country on the income for the period that begins after the end date.
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Pub. 514 - Foreign Tax Credit for Individuals
Rev. Rul. 92-62

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Analysis	**Resources**
5. IRC 901(j) Income (cont'd) ▪ The following countries are sanctioned countries for 2021: − Iran. − Libya (see below). − North Korea. − Sudan. − Syria. ▪ Income taxes paid or accrued to these countries in 2020, except Libya, do not qualify for the credit.	▪ Pub. 514 - *Foreign Tax Credit for Individuals*

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Analysis	**Resources**
6. Certain Income Re-sourced by Treaty The U.S. is a party to tax treaties designed to prevent double taxation of the same income by the U.S. and the treaty country. If a sourcing rule in an applicable income tax treaty grants the right to tax income to a contracting state, the income is usually treated as being from sources in that state, notwithstanding how the code might source the income. The taxpayer must compute a separate foreign tax credit limitation for any such income for which the taxpayer claims benefits under a treaty, generally using a separate Form 1116 for each treaty. Form 8833 is used by the taxpayer to elect or disclose a treaty-based return position. T **TREATY IMPLICATION:** Look to the applicable treaty which provides for any special sourcing rules.	▪ IRC 904(d)(6) ▪ Treas. Reg. 1.904-5(m)(7) ▪ Pub. 901 - *U.S. Tax Treaties* ▪ Form 8833 - *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)* ▪ IRS.gov - *Tax Treaty Tables* ▪ IRS.gov - *United States Income Tax Treaties - A to Z*

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Analysis	**Resources**
7. Lump-sum Distributions ▪ FTC is allowed for taxes paid or accrued on a foreign source lump-sum distribution from a pension plan. ▪ Special formulas may be used to figure a separate tax on a qualified lump-sum distribution for the year in which the distribution is received. ▪ Elect by checking Form 1116 box g above Part I. Skip Part I. Complete Part II showing only foreign taxes that are attributable to the lump-sum distribution.	▪ Form 1116 Instructions ▪ Pub. 575 - *Pension and Annuity Income* ▪ Form 4972 ▪ IRC 402(d)

Index of Referenced Resources

Foreign Tax Credit - Categorization of Income and Taxes Into Proper Basket
Form 1116 Instructions
Form 1118
Form 4972
Form 8833
Form 8992
IRC 250
IRC 402(d)
IRC 901(j)
IRC 904
IRC 951A
IRC 960
IRC 962
IRC 1293
IRM 4.61.10.4.4

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Foreign Tax Credit - Categorization of Income and Taxes Into Proper Basket
IRS.gov - *Tax Treaty Tables*
IRS.gov - *United States Income Tax Treaties - A to Z*
Pub. 514
Pub. 575
Pub. 901
Treas. Reg. 1.904-2(j)(1)(iii)
Treas. Reg. 1.904-4
Treas. Reg. 1.904-5
Treas. Reg. 1.962-1
Rev. Rul. 92-62

Training and Additional Resources

Foreign Tax Credit - Categorization of Income and Taxes Into Proper Basket	
Type of Resource	**Description(s)**
Saba Meeting Sessions	▪ *How To Audit FTC-FTC Concepts-IIC FY15 CPE* Saba Meeting
Databases / Research Tools	• *BNA Tax Management Portfolio - Foreign Income Series*: 900-2nd Sec. III • *BNA Tax Management Portfolio - Foreign Income Series*: 6060-1st Sec. VI

Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
DISC	Domestic International Sales Corporation
EFI	Export Financing Interest
FSC	Foreign Sales Corporation
FTC	Foreign Tax Credit
GILTI	Global Intangible Low-Taxed Income
IRC	Internal Revenue Code
PFIC	Passive Foreign Investment Company
QBU	Qualified Business Unit
QEF	Qualified Electing Fund
TCJA	Tax Cuts and Jobs Act
U.S.	United States

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Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9412	*Concepts of Global Intangible Low-Taxed Income under IRC 951A*
9432	*FTC General Principles*
9432	*Sourcing of Salary and Compensation*
9470	*Overview of Qualified Business Units (QBUs)*