Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit
Knowledge Base - International

Library Level	Number	Title
Shelf		Individual Outbound
Book	10	Foreign Tax Credit (Individual Outbound)
Chapter	10.2	Calculation of Amount of Allowable
Section		
Subsection		

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

Document Control Number (DCN)	FTC/C/10_02-01
Date of Last Update	04/12/17

Table of Contents

(View this PowerPoint in "Presentation View" to click on the links below)

General Overview

Categorization of Income and Taxes Into Proper Basket

This Practice Unit covers the appropriate identification of the types of foreign sourced income and taxes to determine assignment into their proper categories (informally also known as baskets).

The Foreign Tax Credit (FTC) calculation must be applied separately to each category of income, often 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 limitation must be calculated separately for different categories of foreign source income according to IRC 904(d). Prior to 2007, there were up to nine separate income baskets. The 2004 Jobs Act effective for taxable calendar years starting after 2006 reduced the number of income baskets from nine to five. Passive and general categories of income are the most common. IRC 901(j) income, treaty resourced income and retirement plan lump-sum distributions are additional separate categories. See Treas. Reg. 1.904-4(a). Pre-2007 rules are beyond the scope of this Practice Unit.

The limitation formula is based upon taxable income akin to how Form 1040 taxable income is calculated. It is necessary to determine foreign source taxable income (FSTI) 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)

Categorization of Income and Taxes Into Proper Basket

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 U.S. income tax on the taxable income in that category from all sources outside the United States.

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. In order 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.

- If more than one category exists, a separate Form 1116 will be prepared. Form 1116, Part IV, lines 23-27 is the summary of credits added from separate Form 1116 Parts 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 22 is the form used to combine totals.

Detailed Explanation of the Concept

Categorization of Income and Taxes Into Proper Basket
Income Categories

Analysis	Resources
<u>Income Category: Passive</u>	▪ IRC 904(d)(2)(A)(i)
This category includes passive income and specified passive category income.	▪ IRC 904(d)(2)(B)
▪ Passive income includes:	▪ Treas. Reg. 1.904-4(b)(2)
− Interest	
− Dividends	▪ IRC 1293
− Rents	▪ Treas. Reg. 1.904-4(b)(2)(i)(B)
− Royalties	
− Gains from sale and exchange	▪ Treas. Reg. 1.904-5
− Income inclusions relating to passive foreign investment companies (PFIC), which are qualifying electing funds (QEFs)	
▪ Look-through rules address income received by U.S. persons having ownership of a controlled foreign corporation and noncontrolled IRC 902 corporations, and treats this income as one of the separate categories.	▪ Treas. Reg. 1.904-5(h)(2)
▪ Participation of less than 10% in a flow-through entity can generally categorize income from that entity as passive.	

Detailed Explanation of the Concept (cont'd)

Categorization of Income and Taxes Into Proper Basket	
Analysis	**Resources**
<u>Income Category: Passive (cont'd)</u> ▪ 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.	▪ 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)

Detailed Explanation of the Concept (cont'd)

Categorization of Income and Taxes Into Proper Basket	
Analysis	**Resources**
<u>Income Category: Passive (cont'd)</u>	▪ IRC 904(d)(2)(B)(iii)
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 product of the highest applicable tax rate multiplied by the amount of 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)(F) ▪ Treas. Reg. 1.904-4(c)
▪ Passive Income generally does not include recharacterized passive income under the look-through rules. Recharacterized income is of a type that is usually passive income, but is treated as general category income due to the look-through rules of IRC 904(d)(3), (d)(4), and (d)(6)(C).	▪ Treas. Reg. 1.904-4(b)(2)(ii) ▪ IRC 904(d)(3) ▪ IRC 904(d)(4) ▪ IRC 904(d)(6)(C)

Detailed Explanation of the Concept (cont'd)

Categorization of Income and Taxes Into Proper Basket	
Analysis	**Resources**
Income Category: Passive (cont'd) ▪ Active rents and royalties are excluded from the passive income category, and are treated as general category income. ▪ 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 separate category income. ▪ Any income defined in another separate limit category is not passive income.	▪ Treas. Reg. 1.904-4(b)(2)(iii) ▪ IRC 904(d)(6)

Detailed Explanation of the Concept (cont'd)

Categorization of Income and Taxes Into Proper Basket	
Analysis	**Resources**
<u>Income Category: General Category Income</u> The Internal Revenue Code (IRC) defines general category income as income other than passive income. It also includes income that does not fall into one of the other additional separate categories. In effect, it is a general catch-all category. General category income generally 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 if it is derived by a financial services entity. ▪ High-taxed income that would otherwise be passive income. ▪ All other income that does not fall into one of the other separate limit categories (which in operation constitutes the majority of foreign income) falls into the general limitation category.	▪ IRC 904(d)(2)(A)(ii) ▪ IRC 904(d)(2)(C) ▪ IRC 904(d)(2)(D) ▪ IRC 904(d)(2)(F)

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Categorization of Income and Taxes Into Proper Basket</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>
<u>Income Category: 901(j)</u>

No foreign tax credit 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. The code contains several provisions that apply to designated countries for both tax and non-tax policy reasons. In addition, income earned from each sanctioned country is subject to a separate FTC limitation. Pub. 514 and periodic notices issued by the IRS identify 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.
</td><td>
▪ IRC 901(j)
▪ Treas. Reg. 1.904–4(m)
▪ IRM 4.61.10.3.4

▪ Pub. 514
</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Categorization of Income and Taxes Into Proper Basket</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Income Category: 901(j) (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.

$$\frac{\text{Number of Nonsanctioned Days in Year}}{\text{Number of Days in Year}}$$

Pub. 514 discusses the countries for which sanctions have ended or for which a Presidential waiver has been granted. For any of these countries, a foreign tax credit can be claimed for the taxes paid or accrued to that country on the income for the period that begins after the end date.</td><td>▪ Pub. 514
▪ Rev. Rul. 92-62 – Trade or Business Expenses</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

Categorization of Income and Taxes Into Proper Basket

Analysis	Resources
Income Category: 901(j) (cont'd) The following countries were impacted by either having the sanctions removed or by granting of Presidential waiver:	▪ Rev. Rul. 2016-8 - Countries Subject to IRC 901(j) and 952(a)(5)

Country	Beginning	Ending
Iraq	02/01/91	06/27/04
Libya	01/01/87	12/09/04
Cuba	01/01/87	12/21/15

Back to Table of Contents

Detailed Explanation of the Concept (cont'd)

Categorization of Income and Taxes Into Proper Basket	
Analysis	**Resources**
Income Category: 901(j) (cont'd) Example 1: A calendar year filer received $20,000 of income from country X in 2014 on which $4,500 of taxes were paid. Sanctions against country X ended on July 11, 2014. It cannot be determined how much of the income or tax is for the nonsanctioned period. Because the tax year starts on January 1, and the country X sanction ended on July 11, 2014, 173 days of the tax year are in the nonsanctioned period. Compute the income for the nonsanctioned period: 173/365 x $20,000 = $9,479 Figure the tax for the nonsanctioned period: 173/365 x $ 4,500 = $2,133 To figure the foreign tax credit, use $9,479 as the income from country X and $2,133 as the tax. Example 2: An individual lived and worked in Iran until August, when they were transferred to Italy. The taxpayer paid taxes to each country on the income earned in that country. The taxpayer cannot claim a foreign tax credit for the foreign taxes paid on the income earned in Iran. Because the income earned in Iran is a separate category of foreign income, a separate Form 1116 must be completed for that income. A credit for taxes paid on the income earned in Iran cannot be taken, but that income is taxable by the United States.	

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Categorization of Income and Taxes Into Proper Basket</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>Income Category: Income Resourced 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, Treaty- Based Return Position Disclosure Under Section 6114 or 7701(b), can be utilized by the taxpayer.

T TREATY IMPLICATION: Look to the applicable treaty which provides for any special sourcing rules.</td><td>▪ IRC 904(d)(6)

▪ Treas. Reg. 1.904-5(m)(7)
▪ Foreign Tax Credit - Special Issues: www.irs.gov/Individuals/International-Taxpayers/Foreign-Tax-Credit---Special-Issues
▪ United States Income Tax Treaties - A to Z: www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z
▪ Form 8833 - Treaty-Based Return Positon Disclosure Under Section 6114 or 7701(b)</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Categorization of Income and Taxes Into Proper Basket</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Income Category: Retirement Plan Lump-Sum Distributions</u>

▪ 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 e above Part I. Skip Part I. Complete Part II showing only foreign taxes that are attributable to the lump-sum distribution.</td><td>▪ Form 1116 Instructions
▪ Pub. 575

▪ Form 4972

▪ IRC 402(d)</td></tr>
</table>

Index of Referenced Resources

Categorization of Income and Taxes Into Proper Basket
Form 1116 Instructions
Form 4972
Form 8833
IRC 402
IRC 901
IRC 904
IRC 1293
IRM 4.61.10.3.4
Pub. 514
Pub. 575
Treas. Reg. 1.904
Rev. Rul. 92-62
Rev. Rul. 2016-8
Foreign Tax Credit - Special Issues
United States Income Tax Treaties - A to Z

Training and Additional Resources

Categorization of Income and Taxes Into Proper Basket	
Type of Resource	**Descriptions**
Saba Meeting Sessions	▪ *How To Audit FTC-Form 1116*, Part I-IIC, Lesson #2 – 2015 CPE Saba
White Papers / Guidance	▪ Pub. 570 ▪ Pub. 901 ▪ Form 1116 Instructions
Databases / Research Tools	▪ *BNA Tax Management Int'l Portfolio* 900-2nd Se.111

Glossary of Terms and Acronyms

Term/Acronym	Definition
Basket	Category
DISC	Domestic International Sales Corporation
EFI	Export Financing Interest
Foreign Source Income	Income determined by tax law to be earned outside the U.S.
FSC	Foreign Sales Corporation
FSTI	Foreign Source Taxable Income
FTC	Foreign Tax Credit
IRC	Internal Revenue Code
PFIC	Passive Foreign Investment Company
QEF	Qualifying Electing Funds
United States	United States (U.S.) when used in a geographical sense includes only the States and the District of Columbia
U.S. Source Income	Income determined by tax law to be from within the U.S.

Back to Table of Contents

Index of Related Practice Units

Associated UILs	Related Practice Unit	DCN
9432.01	FTC General Principles	FTC/C/10_1-05
9432.02	Sourcing of Income	FTC/C/10_02-05
9432.02	Sourcing of Salary and Compensation	FTC/P/10_02-02 (formerly FTC/9432.02_01(2014))