Foreign Tax Credit for Individuals

For use in preparing 2005 Returns

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What's New for 2005

Rate of exchange for foreign taxes. If you claim the credit for foreign taxes on an accrual basis, you must generally use the average exchange rate for the tax year to which taxes relate. However in tax years beginning in 2005 and later years, you can elect to use the exchange rate in effect on the date the taxes are paid if the foreign tax liability is denominated in a nonfunctional currency. See Foreign Currency and Exchange Rates.

Source of compensation for labor or personal services. In tax years beginning after July 13, 2005, new rules apply in determining the source of compensation for labor or personal services performed as an employee. If you file your tax returns on a calendar year basis, the new rules apply to your returns for 2006 and later years.

Under the new rules, compensation (other than fringe benefits) is sourced on a time basis. Fringe benefits (such as housing and education) are sourced on a geographical basis. For more information, see Regulations section 1.861-4.

Reminders

Change of address. If your address changes from the address shown on your last return, use Form 8822, Change of Address, to notify the Internal Revenue Service.

Get forms and other information faster and easier by:

Internet • www.irs.gov
Introduction
If you paid or accrued foreign taxes to a foreign country on foreign source income and are subject to U.S. tax on the same income, you may be able to take either a credit or an itemized deduction for those taxes. Taken as a deduction, foreign income taxes reduce your U.S. taxable income. Taken as a credit, foreign income taxes reduce your U.S. tax liability.

In most cases, it is to your advantage to take foreign income taxes as a tax credit. The major scope of this publication is the foreign tax credit. The publication discusses:

- How to choose to take the credit or the deduction,
- Who can take the credit,
- What foreign taxes qualify for the credit,
- How to figure the credit, and
- How to carry over unused foreign taxes to other tax years.

Unless you choose not to be subject to the foreign tax credit limit, you may claim the credit by filing Form 1116 with your U.S. income tax return. Two examples with filled-in Forms 1116 are provided at the end of this publication.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can write to us at the following address:

Internal Revenue Service
Individual Forms and Publications Branch
SE.W:CAR.MP-T1
1111 Constitution Ave. NW, IR-6406
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence. You can email us at “taxforms@irs.gov.” (The asterisk must be included in the address.) Please put “Publications Comment” on the subject line. Although we cannot respond individually to each email, we do appreciate your feedback and will consider your comments as we revise our tax products.

Tax questions. If you have a tax question, visit www.irs.gov or call 1-800-829-1040. We cannot answer tax questions at either of the addresses listed above.

Ordering forms and publications. Visit www.irs.gov/formspubs to download forms and publications, call 1-800-829-3676, or write to the National Distribution Center at the address shown under How To Get Tax Help in the back of this publication.

Useful Items
You may want to see:

Publication
- 54 Tax Guide for U.S. Citizens and Resident Aliens Abroad
- 519 U.S. Tax Guide for Aliens
- 570 Tax Guide for Individuals With Income From U.S. Possessions

Form (and Instruction)
- 1116 Foreign Tax Credit
See How To Get Tax Help near the end of this publication for information about getting these publications and this form.

Choosing To Take Credit or Deduction
You can choose each tax year to take the amount of any qualified foreign taxes paid or accrued during the year as a foreign tax credit or as an itemized deduction. You can change your choice for each year’s taxes.

To choose the foreign tax credit, you generally must complete Form 1116 and attach it to your U.S. tax return. However, you may qualify for the exception that allows you to claim the foreign tax credit without using Form 1116. See How To Figure the Credit, later. To claim the taxes as an itemized deduction, use Schedule A (Form 1040), Itemized Deductions.

Carrybacks and carryovers. There is a limit on the credit you can claim in a tax year. If your qualified foreign taxes exceed the credit limit, you may be able to carry over or carry back the excess to another tax year. If you deduct qualified foreign taxes in a tax year, you cannot use a carryback or carryover in that year. That is because you cannot take both a deduction and a credit for qualified foreign taxes in the same tax year.

For more information on the limit, see How To Figure the Credit, later. For more information on carrybacks and carryovers, see Carryback and Carryover, later.

Choice Applies to All Qualified Foreign Taxes
As a general rule, you must choose to take either a credit or a deduction for all qualified foreign taxes.

If you choose to take a credit for qualified foreign taxes, you must take the credit for all of them. You cannot deduct any of them. Conversely, if you choose to deduct qualified foreign taxes, you must deduct all of them. You cannot take a credit for any of them.

See What Foreign Taxes Qualify for the Credit, later, for the meaning of qualified foreign taxes.

There are exceptions to this general rule, which are described next.

Exceptions for foreign taxes not allowed as a credit. Even if you claim a credit for other foreign taxes, you can deduct any foreign tax that is not allowed as a credit if:

- You paid the tax to a country for which a credit is not allowed because it provides support for acts of international terrorism, or because the United States does not have diplomatic relations with it or recognizes its government,
- You paid withholding tax on dividends from foreign corporations whose stock you did not hold for the required period of time,
- You paid withholding tax on income or gain (other than dividends) from property you did not hold for the required period of time,
- You paid withholding tax on income or gain to the extent you had to make related payments on positions in similar or related property,
- You participated in or cooperated with an international boycott,
- You paid taxes in connection with the purchase or sale of oil or gas.

For more information on these items, see Taxes for Which You Can Only Take an Itemized Deduction later under Foreign Taxes for Which You Cannot Take a Credit.

Foreign taxes that are not income taxes. Generally, only foreign income taxes qualify for the foreign tax credit. Other taxes, such as foreign real and personal property taxes, do not qualify. But you may be able to deduct these other taxes even if you claim the foreign tax credit for foreign income taxes.

You generally can deduct these other taxes only if they are expenses incurred in a trade or business or in the production of income. However, you can deduct foreign real property taxes that are not trade or business expenses as an itemized deduction on Schedule A (Form 1040).

Making or Changing Your Choice
You can make or change your choice to claim a deduction or credit at any time during the period within 10 years from the regular due date for filing the return for the tax year for which you make the claim. You make or change your choice on your tax return (or on an amended return) for the year your choice is to be effective.

Example. You paid foreign taxes for the last 13 years and chose to deduct them on your U.S. income tax returns. You were timely in both filing your returns and paying your U.S. tax liability. In February 2005, you file an amended return for tax year 1994 choosing to take a credit for your 1994 foreign taxes because you now realize that the credit is more advantageous than the deduction for that year. Because the regular due date of your 1994 return was April 17 (April 15 was a Saturday in 1995), 1995, this choice is timely (within 10 years).
Because there is a limit on the credit for your 1994 foreign tax, you have used 1994 foreign taxes. Ordinarily, you first carry back unused foreign taxes arising in 1994 to, and claim them as a credit in, the 2 preceding tax years. If you are unable to claim all of them in those 2 years, you carry them forward to the 5 years following the year in which they arose.

Because you originally chose to deduct your foreign taxes and the 10-year period for changing the choice for 1992 and 1993 has passed, you cannot carry the unused 1994 foreign taxes back to tax years 1992 and 1993.

Because the 10-year periods have not passed for your 1995 through 1999 income tax returns, you can still choose to carry forward any unused 1994 foreign taxes. However, you must reduce the unused 1994 foreign taxes that you carry forward by the amount that would have been allowed for the tax year as you had timely carried back the foreign tax to tax years 1992 and 1993.

You cannot take a credit or a deduction for foreign taxes paid on income you exclude under the foreign earned income exclusion or the foreign housing exclusion.

Why Choose the Credit?

The foreign tax credit is intended to relieve you of the double tax burden when your foreign source income is taxed by both the United States and the foreign country. Generally, if the foreign tax rate is higher than the U.S. rate, there will be no U.S. tax on the foreign income. If the foreign tax rate is lower than the U.S. rate, U.S. tax on the foreign income will be limited to the difference between the rates. The foreign tax credit can only reduce U.S. taxes on foreign source income; it cannot reduce U.S. taxes on U.S. source income.

Although no one rule covers all situations, it is generally better to take a credit for qualified foreign taxes than to deduct them as an itemized deduction. This is because:

- A credit reduces your actual U.S. income tax on a dollar-for-dollar basis, while a deduction reduces only your income subject to tax.
- You can choose to take the foreign tax credit even if you do not itemize your deductions. You then are allowed the standard deduction in addition to the credit, and
- If you choose to take the foreign tax credit, and the taxes paid or accrued exceed the credit limit for the tax year, you may be able to carry over or carry back the excess to another tax year. (See Limit on the Credit under How To Figure the Credit, later.)

Example 1. For 2005, you and your spouse have adjusted gross income of $80,000, including $20,000 of dividend income from foreign sources. None of the dividends are qualified dividends. You file a joint return and can claim two $3,200 exemptions. You had to pay $2,000 in foreign income taxes on the dividend income. If you take the foreign taxes as an itemized deduction, your total itemized deductions are $12,000. Your taxable income then is $61,600 and your tax is $8,736.

If you take the credit instead, your itemized deductions are only $10,000. Your taxable income then is $63,600 and your tax before the credit is $7,236. After the credit, however, your tax is only $7,236. Therefore, your tax is $1,500 lower ($7,376 − $7,236) by taking the credit.

Example 2. In 2005, you receive investment income of $5,000 from a foreign country, which imposes a tax of $3,500 on that income. You report on your U.S. return this income as well as $56,000 of income from U.S. sources. You are single, entitled to only $3,200 exemption, and have other itemized deductions of $5,400. If you deduct the foreign tax on your U.S. return, your taxable income is $48,900 ($5,000 + $56,000 − $3,200 − $5,400) and your tax is $8,396.

If you take the credit instead, your taxable income is $52,400 ($5,000 + $56,000 − $3,200 − $5,400) and your tax before the credit is $9,771. You can take a credit of only $801 because of limits discussed later. Your tax after the credit is $8,970 ($9,771 − $801), which is $7 ($8,970 − $8,896) more than if you deduct the foreign tax. If you choose the credit, you will have unused foreign taxes of $2,699 ($3,500 − $801), when deciding whether to take the credit or the deduction this year, you will need to consider whether you can benefit from a carryback or carryover of that unused foreign tax.

Credit for Taxes Paid or Accrued

You can claim the credit for a qualified foreign tax in the tax year in which you pay it or accrue it, depending on your method of accounting. "Tax year" means the tax year for which your U.S. return is filed, not the tax year for which your foreign return is filed.

Accrual method of accounting. If you use an accrual method of accounting, you can claim the credit only in the year in which you accrue the tax. You are using an accrual method of accounting if you report income when you earn it, rather than when you receive it, and you deduct your expenses when you incur them, rather than when you pay them.

Foreign taxes generally accrue when all the events have taken place that fix the amount of the tax and your liability to pay it.

Contesting your foreign tax liability. If you are contesting your foreign tax liability, you cannot accrue it and take a credit until the amount of foreign tax due is finally determined. However, if you choose to pay the tax liability you are contesting, you can take a credit for the amount you pay before a final determination of foreign tax liability is made. Once your liability is determined, the foreign tax credit is allowable for the year to which the foreign tax relates. If the amount of foreign taxes taken as a credit differs from the final foreign tax liability, you may have to adjust the credit, as discussed later under Foreign Tax Redetermination.

You may have to post a bond. If you claim a credit for taxes accrued but not paid, you may have to post an income tax bond to ensure your payment of any tax due in the event the amount of foreign tax paid differs from the amount claimed.

The IRS can request this bond at any time without regard to the Time Limit on Tax Assessment, discussed later under Carryback and Carryover.

Cash method of accounting. If you use the cash method of accounting, you can choose to take the credit either in the year you pay the tax or in the year you accrue it. You are using the cash method of accounting if you report income in the year you actually or constructively receive it, and deduct expenses in the year you pay them.

Choosing to take in the year taxes accrue. Even if you use the cash method of accounting, you can choose to take a credit for foreign taxes in the year they accrue. You make the choice by checking the box in Part II of Form 1116. Once you make that choice, you must follow it in all later years and take a credit for foreign taxes in the year they accrue.

In addition, the choice to take the credit when foreign taxes accrue applies to all foreign taxes qualifying for the credit. You cannot take a credit for some foreign taxes when paid and take a credit for others when accrued.

If you make the choice to take the credit when foreign taxes accrue and pay them in a later year, you cannot claim a deduction for any part of the previously accrued taxes.

Credit based on taxes paid in earlier year. If, in earlier years, you took the credit based on taxes paid, and this year you choose to take the credit based on taxes accrued, you may be able to take the credit this year for taxes from more than one year.

Example. Last year you took the credit based on taxes paid. This year you chose to take the credit based on taxes accrued. During the year you paid foreign income taxes owed for last year. You also accrued foreign income taxes for this year that you did not pay by the end of the year. You can base the credit on your return for this year on both last year’s taxes that you paid and this year’s taxes that you accrued.

Foreign Currency and Exchange Rates

U.S. income tax is imposed on income expressed in U.S. dollars, while the foreign tax is imposed on income expressed in foreign currency. Therefore, the tax credit is affected when the foreign currency depreciates or appreciates in value in terms of U.S. dollars.

Translating foreign currency into U.S. dollars. If you receive all or part of your income or pay some or all of your expenses in foreign currency, you must translate the foreign currency into U.S. dollars. How you do this depends on your functional currency. Your functional currency generally is the U.S. dollar unless you are required to use the currency of a foreign country.

You must make all federal income tax determinations in your functional currency. The U.S. dollar is the functional currency for all taxpayers.
except some qualified business units. A qual- ified business unit is a separate and clearly iden- tified legal entity that maintains separate books and records. Unless you are self-employed, your functional currency is the U.S. dollar.

Even if you are self-employed and have a qualified business unit, your functional currency is the U.S. dollar if any of the following apply.

- You conduct the business primarily in dol- lars.
- The principal place of business is located in the United States.
- You choose to or are required to use the dollar as your functional currency.
- The business books and records are not kept in the currency of the economic envi- ronment in which a significant part of the business activities is conducted.

If your functional currency is the U.S. dollar, you must immediately translate into dollars all items of income, expense, etc., that you receive, pay, or accrue in a foreign currency and that will affect computation of your income tax. If there is more than one exchange rate, use the one that most properly reflects your income. You can generally get exchange rates from banks and U.S. Embassies. If your functional currency is not the U.S. dollar, make all income tax determinations in your functional currency. At the end of the year, translate the results, such as income or loss, into U.S. dollars to report on your income tax return.

For more information, write to:

Internal Revenue Service
International Section
P.O. Box 920
Bensalem, PA 19020-8518.

Rate of exchange for foreign taxes paid.

Use the rate of exchange in effect on the date you paid the foreign taxes to the foreign country unless you meet the exception discussed next. If your tax was withheld in foreign currency, you use the rate of exchange in effect for the date on which the tax was withheld. If you make foreign estimated tax payments, you use the rate of exchange in effect for the date on which you made the estimated tax payment.

**Exception.** If you claim the credit for foreign taxes on an accrual basis, you must generally use the average exchange rate for the tax year to which the taxes relate. This rule applies to accrued taxes relating to tax years beginning after 1997 and only under the following conditions:

1. The foreign taxes are paid on or after the first day of the tax year to which they relate.
2. The foreign taxes are paid not later than 2 years after the close of the tax year to which they relate.

For all other foreign taxes, you should use the exchange rate in effect on the date you paid them.

**Election to use exchange rate on date paid.** If you have accrued foreign taxes that you are otherwise required to convert using the average exchange rate, you may elect to use the exchange rate in effect on the date the foreign taxes are paid if the taxes are denominated in a foreign currency. You may make the election for all nonfunctional foreign income taxes or only those nonfunctional currency foreign income taxes that are attributable to qualified business units with a U.S. dollar functional currency. Once made, the election applies to the tax year for which made and all subsequent tax years unless revoked with the consent of the IRS. The election is available for tax years beginning after 2004. It must be made by the due date (including extensions) for filing the tax return for the first tax year to which the election applies. Makes the election by attaching a statement to the applica- ble tax return. The statement should identify whether the election is made for all foreign taxes or only for foreign taxes attributable to qualified business units with a U.S. dollar functional cur- rency.

**Foreign Tax Redetermination.**

A foreign tax redetermination is any change in your foreign tax liability that may affect your U.S. foreign tax credit claimed. The time of the credit remains the year to which the foreign taxes paid or accrued relate, even if the change in foreign tax liability occurs in a later year.

- If a foreign tax redetermination occurs, a redetermination of your U.S. tax liability is re- quired in the following situations:
  - Tax years beginning before 1998. For tax years beginning before 1998, a redetermination of your U.S. tax liability is required if:
    1. You pay additional foreign taxes.
    2. You receive a refund of foreign taxes paid, or
    3. There is a change in the dollar amount of your foreign tax credit because of differ- ences in the exchange rate at the time the foreign taxes were accrued and the time they were paid.
   See Rate of exchange for foreign taxes paid, earlier, under Foreign Currency and Exchange Rates.

When redetermination of tax is not re- quired. A redetermination is not required if the change is due solely to an exchange rate fluctu- ation and the change in foreign tax liability for the tax year is less than the smaller of:

1. $10,000, or
2. 2% of the total dollar amount of the foreign tax initially accrued for that foreign country.

In this case, you must adjust your U.S. tax in the tax year in which the accrued foreign taxes are paid.

**Tax years beginning after 1997.** For tax years beginning after 1997, a redetermination of your U.S. tax liability is required if:

1. The accrued taxes when paid differ from the amount you claimed as a credit.
2. The accrued taxes you claimed as a credit in one tax year are not paid within 2 years after the end of that tax year, or
3. The foreign taxes you paid are refunded in whole or in part.

If (2) above applies to you, you will not be able to claim a credit for the refunded amount. You must pay them. When you pay the accrued taxes, you must translate them into U.S. dollars using the exchange rate as of the date they were paid. The foreign tax credit is allowed for the year to which the foreign tax relates. See Rate of ex- change for foreign taxes paid, earlier, under Foreign Currency and Exchange Rates.

**Foreign Tax Redetermination.**

You must file Form 1040X, Amended U.S. Individual Income Tax Return, and a revised Form 1116 for the tax year affected by the redetermination. The IRS will redetermine your U.S. tax liability for the year or years affected.

If you pay foreign taxes that you originally claimed a credit for, you must file Form 1040X and a revised Form 1116 within 180 days after the redetermination occurred. There is no limit on the time the IRS has to redetermine and assess the correct U.S. tax due. If you pay more foreign tax than you originally claimed a credit for, you have 10 years to file a claim for refund of U.S. taxes. See Time Limit on Refund Claims, later.

**Failure-to-notify penalty.** If you fail to no- tify the IRS of a foreign tax redetermination and cannot show reasonable cause for the failure, you may have to pay a penalty.

For each month, or part of a month, that the failure continues, you pay a penalty of 5% of the tax due resulting from a redetermination of your U.S. tax. This penalty cannot be more than 25% of the tax due.

**Foreign tax refund.** If you receive a foreign tax refund without interest from the foreign gov- ernment, you will not have to pay interest on the amount of tax due resulting from the adjustment to your U.S. tax for the time before the date of the refund.

However, if you receive a foreign tax refund with interest, you must pay interest to the IRS up to the amount of the interest paid to you by the foreign government. The interest you must pay cannot be more than the interest you would have had to pay on taxes that were unpaid for any other reason for the same period.

**Foreign tax imposed on foreign refund.** If your foreign tax refund is taxed by the foreign country, you cannot take a separate credit or deduction for this additional foreign tax. How- ever, when you refigure the foreign tax credit taken for the original foreign tax, reduce the amount of the refund by the foreign tax paid on the refund.

**Example.** You paid a foreign income tax of $3,000 in 2003, and received a foreign tax re- fund of $500 in 2005 on which a foreign tax of $100 was imposed. When you refigure your credit for 2003, you must reduce the $3,000 you paid by $400.

**Time Limit on Refund Claims.**

You have 10 years to file a claim for refund of U.S. tax if you find that you paid or accrued a larger foreign tax than you claimed a credit for. The 10-year period begins the day after the
regular due date for filing the return for the year in which the taxes were actually paid or accrued. You have 10 years to file your claim regardless of whether you claim the credit for taxes paid or taxes accrued. The 10-year period applies to claims for refund or credit based on:

1. Fixing math errors in figuring qualified foreign taxes,
2. Reporting qualified foreign taxes not originally reported on the return, or
3. Any other change in the size of the credit (including one caused by correcting the foreign tax credit limit).

The special 10-year period also applies to making or changing your choice of whether to claim a deduction or credit for foreign taxes. See Making or Changing Your Choice discussed earlier under Choosing To Take Credit or Deduction.

Who Can Take the Credit?

U.S. citizens, resident aliens, and nonresident aliens who paid foreign income tax and are subject to U.S. tax on foreign source income may be able to take a foreign tax credit.

U.S. Citizens

If you are a U.S. citizen, you are taxed by the United States on your worldwide income wherever you live. You are normally entitled to take a credit for foreign taxes you pay or accrue. For information on alien status and effectively claim a credit for your share of foreign taxes paid, see Publication 519.

Resident Aliens

If you are a resident alien of the United States, you can take a credit for foreign taxes subject to the same general rules as U.S. citizens. If you are a bona fide resident of Puerto Rico for the entire tax year, you also come under the same rules.

Generally, you can take a credit only for those foreign taxes imposed on income you actually or constructively received while you had resident alien status.

For information on alien status, see Publication 519.

Nonresident Aliens

If you are a nonresident alien, you generally cannot take the credit. However, you may be able to take the credit if:

- You were a bona fide resident of Puerto Rico during your entire tax year.
- You pay or accrue tax to a foreign country or U.S. possession on income from foreign sources that is effectively connected with a trade or business in the United States. But if you must pay tax to a foreign country or U.S. possession on income from U.S. sources only because you are a citizen or a resident of that country or U.S. possession, do not use that tax in figuring the amount of your credit.

For information on alien status and effectively connected income, see Publication 519.

What Foreign Taxes Qualify for the Credit?

Generally, the following four tests must be met for any foreign tax to qualify for the credit.

1. The tax must be imposed on you.
2. You must have paid or accrued the tax.
3. The tax must be the legal and actual foreign tax liability.
4. The tax must be an income tax (or a tax in lieu of an income tax).

Certain foreign taxes do not qualify for the credit even if the four tests are met. See Foreign Taxes for Which You Cannot Take a Credit, later.

Tax Must Be Imposed on You

You qualify for the foreign tax credit only for foreign taxes that are imposed on you by a foreign country or U.S. possession. For example, a tax that is deducted from your wages is considered to be imposed on you. You cannot shift the right to claim the credit by contract or other means.

Foreign country. A foreign country includes any foreign state and its political subdivisions. Income, war profits, and excess profits taxes paid or accrued to a foreign city or province qualify for the foreign tax credit.

U.S. possessions. For foreign tax credit purposes, all qualified taxes paid to U.S. possessions are considered foreign taxes. For this purpose, U.S. possessions include Puerto Rico, Guam, the Northern Mariana Islands, and American Samoa.

When the term "foreign country" is used in this publication, it includes U.S. possessions unless otherwise stated.

You Must Have Paid or Accrued the Tax

Generally, you can claim the credit only if you paid or accrued the foreign tax to a foreign country or U.S. possession. However, the paragraphs that follow describe some instances in which you can claim the credit even if you did not directly pay or accrue the tax yourself.

Joint return. If you file a joint return, you can claim the credit based on the total foreign income taxes paid or accrued by you and your spouse.

Partner or S corporation shareholder. If you are a member of a partnership, or a shareholder in an S corporation, you can claim the credit based on your proportionate share of the foreign income taxes paid or accrued by the partnership or the S corporation. However, if you are a shareholder in an S corporation that in turn owns stock in a foreign corporation, you cannot claim a credit for your share of foreign taxes paid by the foreign corporation.

Beneficiary. If you are a beneficiary of an estate or trust, you may be able to claim the credit based on your proportionate share of foreign income taxes paid or accrued by the estate or trust. This amount will be shown on the Schedule K-1 you receive from the estate or trust. However, you must show that the tax was imposed on income of the estate and not on income received by the decedent.

Mutual fund shareholder. If you are a shareholder of a mutual fund, you may be able to claim the credit based on your share of foreign income taxes paid by the fund if it chooses to pass the credit on to its shareholders. You should receive from the mutual fund a Form 1099-DIV, or similar statement, showing the foreign country or U.S. possession, your share of the foreign income, and your share of the foreign taxes paid. If you do not receive this information, you will need to contact the fund.

Controlled foreign corporation shareholder. If you are a shareholder of a controlled foreign corporation and choose to be taxed at corporate rates on the amount you must include in gross income from that corporation, you can claim the credit based on your share of foreign taxes paid or accrued by the controlled foreign corporation. If you make this election, you must claim the credits by filing Form 1118, Foreign Tax Credit—Corporations.

Controlled foreign corporation. A controlled foreign corporation is a foreign corporation in which U.S. shareholders own more than 50% of the voting power or value of the stock. You are considered a U.S. shareholder if you own, directly or indirectly, 10% or more of the total voting power of all classes of the foreign corporation’s stock. See Internal Revenue Code sections 951(b) and 958(b) for more information.

Tax Must Be the Legal and Actual Foreign Tax Liability

The amount of foreign tax that qualifies is not necessarily the amount of tax withheld by the foreign country. Only the legal and actual foreign tax liability that you paid or accrued during the year qualifies for the credit.

Foreign tax refund. You cannot take a foreign tax credit for income taxes paid to a foreign country if it is reasonably certain the amount would be refunded, credited, rebated, abated, or forgiven if you made a claim.

For example, the United States has tax treaties with many countries allowing U.S. citizens and residents reductions in the rates of tax of those foreign countries. However, some treaty countries require U.S. citizens and residents to pay the tax figured without regard to the lower treaty rates and then claim a refund for the amount by which the tax actually paid is more than the amount of tax figured using the lower treaty rate. The qualified foreign tax is the amount figured using the lower treaty rate and not the amount actually paid, because the excess tax is refundable.

Subsidy received. Tax payments a foreign country returns to you in the form of a subsidy do not qualify for the foreign tax credit. This rule
applies even if the subsidy is given to a person related to you, or persons who participated with you in a transaction or a related transaction. A subsidy can be provided by any means but must be determined, directly or indirectly, in relation to the amount of tax, or to the base used to figure the tax. The term “subsidy” includes any type of benefit. Some ways of providing a subsidy are refunds, credits, deductions, payments, or discharges of obligations.

Shareholder receiving refund for corporate tax in integrated system. Under some foreign tax laws and treaties, a shareholder is considered to have paid part of the tax that is imposed on the corporation. You may be able to claim a refund of these taxes from the foreign government. You must include the refund (including any amount withheld) in your income in the year received. Any tax withheld from the refund is a qualified foreign tax.

Example. You are a shareholder of a French corporation. You receive a $100 refund of the tax paid to France by the corporation on the earnings distributed to you as a dividend. The French government imposes a 15% withholding tax ($15) on the refund you received. You receive a check for $85. You include $100 in your income. The $15 of tax withheld is a qualified foreign tax.

**Tax Must Be an Income Tax (or Tax in Lieu of Income Tax)**

Generally, only income, war profits, and excess profits taxes (income taxes) qualify for the foreign tax credit. Foreign taxes on wages, dividends, interest, and royalties generally qualify for the credit. Furthermore, foreign taxes on income can qualify even though they are not imposed under an income tax law if the tax in lieu of an income, war profits, or excess profits tax. See **Taxes in Lieu of Income Taxes**, later.

**Income Tax**

Simply because the levy is called an income tax by the foreign taxing authority does not make it an income tax for this purpose. A foreign levy is an income tax only if it meets both of the following tests.

1. It is a tax; that is, you have to pay it and you get a specific economic benefit (discussed below) from paying it.
2. The predominant character of the tax is that of an income tax in the U.S. sense.

A foreign levy may meet these requirements even if the foreign tax law differs from U.S. tax law. The foreign law may include in income items that U.S. law does not include, or it may allow certain exclusions or deductions that U.S. law does not allow.

**Specific economic benefit.** Generally, you get a specific economic benefit if you receive, or are considered to receive, an economic benefit from the foreign country imposing the levy, and:

1. If there is a generally imposed income tax, the economic benefit is not available on substantially the same terms to all persons subject to the income tax, or
2. If there is no generally imposed income tax, the economic benefit is not available on substantially the same terms to the population of the foreign country in general.

You are considered to receive a specific economic benefit if you have a business transaction with a person who receives a specific economic benefit from the foreign country and, under the terms and conditions of the transaction, you receive directly or indirectly all or part of the benefit.

However, see the exception discussed later under **Penalty and interest.**

**Economic benefits.** Economic benefits include the following.

- Goods
- Services
- Fees or other payments
- Rights to use, acquire, or extract resources, patents, or other property the foreign country owns or controls
- Discharges of contractual obligations

Generally, the right or privilege merely to engage in business is not an economic benefit.

**Dual-capacity taxpayers.** If you are subject to a foreign country’s levy and you also receive a specific economic benefit from that foreign country, you are a “dual-capacity taxpayer.” As a dual-capacity taxpayer, you cannot claim a credit for any part of the foreign levy, unless you establish that the amount paid under a distinct element of the foreign levy is a tax, rather than a compulsory payment for a direct or indirect specific economic benefit.

For more information on how to establish elements paid under separate elements of a levy, write to:

**Internal Revenue Service**

P.O. Box 920
Bensalem, PA 19020-8518.

**Pension, unemployment, and disability fund payments.** A foreign tax imposed on an individual to pay for retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for similar purposes, is not payment for a specific economic benefit if the amount of the tax does not depend on the age, life expectancy, or similar characteristics of that individual. No deduction or credit is allowed, however, for social security taxes paid or accrued to a foreign country with which the United States has a social security agreement. For more information about these agreements, see **Publication 54**.

**Soak-up taxes.** A foreign tax is not predomi-

nantly an income tax and does not qualify for credit to the extent it is a soak-up tax. A tax is a soak-up tax to the extent that liability for it depends on the availability of a credit for it against income tax imposed by another country. This rule applies only if and to the extent that the foreign tax would not be imposed if the credit were not available.

**Penalties and interest.** Amounts paid to a foreign government to satisfy a liability for interest, fines, penalties, or any similar obligation are not taxes and do not qualify for the credit.

**Taxes not based on income.** Foreign taxes based on gross receipts or the number of units produced, rather than on realized net income, do not qualify unless they are imposed in lieu of an income tax, as discussed next. Taxes based on assets, such as property taxes, do not qualify for the credit.

**Taxes in Lieu of Income Taxes**

A tax paid or accrued to a foreign country qualifies for the credit if it is imposed in lieu of an income tax otherwise generally imposed. A foreign levy is a tax in lieu of an income tax only if:

- It is not payment for a specific economic benefit as discussed earlier, and
- The tax is imposed in place of, and not in addition to, an income tax otherwise generally imposed.

A tax in lieu of an income tax does not have to be based on realized net income. A foreign tax imposed on gross income, gross receipts or sales, or the number of units produced or exported can qualify for the credit.

A soak-up tax (discussed earlier) generally does not qualify as a tax in lieu of an income tax. However, if the foreign country imposes a soak-up tax in lieu of an income tax, the amount that does not qualify for foreign tax credit is the lesser of the following amounts:

- The soak-up tax.
- The foreign tax you paid that is more than the amount you would have paid if you had been subject to the generally imposed income tax.

**Foreign Taxes for Which You Cannot Take a Credit**

This part discusses the foreign taxes for which you cannot take a credit. These are:

- Taxes on excluded income.
- Taxes for which you can only take an itemized deduction.
- Taxes on foreign oil related income.
- Taxes on foreign mineral income.
- Taxes from international boycott operations.
- Taxes of U.S. persons controlling foreign corporations or partnerships.
- Taxes on foreign oil and gas extraction income.
Taxes on Excluded Income

You cannot take a credit for foreign taxes paid or accrued on income excluded from U.S. gross income.

Foreign Earned Income and Housing Exclusions

You must reduce your foreign taxes available for the credit by the amount of those taxes paid or accrued on income that is excluded from U.S. income under the foreign earned income exclusion or the foreign housing exclusion. See Publication 54 for more information on the foreign earned income and housing exclusions.

Wages completely excluded. If your wages are completely excluded, you cannot take a credit for any of the foreign taxes paid or accrued on these wages.

Wages partly excluded. If only part of your wages is excluded, you cannot take a credit for the foreign income taxes allocable to the excluded part. You find the amount allocable to your excluded wages by multiplying the foreign earned income received or accrued during the tax year by a fraction.

The numerator of the fraction is the total amount of income unless a Presidential waiver is granted. Howver, see Internal Revenue Code section 901(j) for more information on the foreign tax credit.

Possession Exclusion

If you are a bona fide resident of American Samoa and cannot exclude income from sources in American Samoa, you cannot take a credit for the taxes you pay or accrue on the excluded income. For more information on this exclusion, see Publication 570.

Extraterritorial Income Exclusion

You cannot take a credit for taxes paid on foreign income that is taxable in the United States. For more information on this exclusion, see Form 8873, Extraterritorial Income Exclusion.

Taxes for Which You Can Only Take an Itemized Deduction

You cannot claim a foreign tax credit for foreign income taxes paid or accrued under the following circumstances. However, you can claim an itemized deduction for these taxes. See Choosing To Take Credit or Deduction, earlier.

Taxes Imposed By Sanctioned Countries (Section 901(j) Income)

You cannot claim a foreign tax credit for income taxes paid or accrued to any country if the income giving rise to the tax is for a period (the sanction period) during which:

The United States has severed or does not conduct diplomatic relations with the country, or

The United States does not recognize the country’s government, unless that government is eligible to purchase defense articles or services under the Arms Export Control Act.

The following countries meet this description for 2005. Income taxes paid or accrued to these countries in 2005 do not qualify for the credit.

- Cuba
- Iran
- Libya (but see Note below)
- North Korea
- Sudan
- Syria

Income that is paid through one or more entities is treated as coming from a foreign country listed above if the original source of the income is from one of the listed countries.

Waiver of denial of the credit. A waiver can be granted to a sanctioned country if the President of the United States determines that granting the waiver is in the national interest of the United States and will expand trade and investment opportunities for U.S. companies in the sanctioned country. The President must report to Congress his intentions to grant the waiver and his reasons for granting the waiver not less than 30 days before the date on which the waiver is granted.

Note. Effective December 10, 2004, the President granted a waiver to Libya. Income taxes arising on or after this date qualify for the credit if they meet the other requirements in this publication.

Limit on credit. In figuring the foreign tax credit limit, discussed later, income from a sanctioned country is a separate category of foreign income unless a Presidential waiver is granted. You must fill out Form 1116 for this income. This will prevent you from claiming a credit for foreign taxes paid or accrued to the sanctioned country.

Example. You lived and worked in Syria until August, when you were transferred to Italy. You paid taxes to each country on the income earned in that country. You cannot claim a foreign tax credit for the foreign income taxes paid on the income earned in Syria. Because the income earned in Syria is a separate category of foreign income, you must fill out a separate Form 1116 for that income. You cannot take a credit for taxes paid on the income earned in Syria, but that income is taxable in the United States.

Figuring the credit when a sanction ends. Table 1 lists the countries for which sanctions have ended or for which a Presidential waiver has been granted. For any of these countries, you can claim a foreign tax credit for the taxes paid or accrued to that country on the income for the period that begins after the end of the sanction period or the date the Presidential waiver was granted.
Example. The sanctions against Country X ended on July 31. On August 19, you receive a dividend from a mutual fund of Country X income. The fund paid Country X income tax for you on the distribution. Because the distribution was made after the sanction ended, you may include the foreign tax paid on the distribution to compute your foreign tax credit.

Amounts for the nonsanctioned period. If a sanction period ends (or a Presidential waiver is granted) during your tax year and you are not able to determine the actual income and taxes for that period, you can allocate amounts to that period based on the number of days in the period that fall in your tax year. Multiply the income or taxes for the year by the following fraction to determine the amounts allocable to that period:

\[
\text{Number of nonsanctioned days in year} \times \frac{\text{Income or taxes for the year}}{\text{Number of days in year}}
\]

Example. You are a calendar year filer and received $20,000 of income from Country X in 2005 on which you paid tax of $4,500. Sanctions against Country X ended on July 11, 2005. You are unable to determine how much of the income or tax is for the nonsanctioned period. Because your tax year starts on January 1, and the Country X sanction ended on July 11, 2005; 173 days of your tax year are in the nonsanctioned period. You would compute the income for the nonsanctioned period as follows:

\[
173 \times \frac{20,000}{365} = \$9,479
\]

You would figure the tax for the nonsanctioned period as follows:

\[
173 \times \frac{4,500}{365} = \$1,233
\]

To figure your foreign tax credit, you would use $9,479 as the income from Country X and $1,233 as the tax.

Further information. The rules for figuring the foreign tax credit after a country’s sanction period ends are more fully explained in Revenue Ruling 92-62, Cumulative Bulletin 1992-2, page 193. This Cumulative Bulletin can be found in many libraries and IRS offices.

Taxes Impose on Certain Dividends

You cannot claim a foreign tax credit for withholding tax (defined later) on dividends paid or accrued if either of the following applies to the dividends:

1. The dividends are on stock you held for less than 16 days during the 31-day period that begins 15 days before the ex-dividend date (defined later).
2. The dividends are for a period or periods totaling more than 366 days on preferred stock you held for less than 46 days during the 91-day period that begins 45 days before the ex-dividend date. If the dividend is not more than 366 days, rule (1) applies to the preferred stock.

When figuring how long you held the stock, count the day you sold it, but do not count the day you acquired it or any days on which you were protected from risk or loss.

Regardless of how long you held the stock, you cannot claim the credit to the extent you have an obligation under a short sale or otherwise to make payments related to the dividend for positions in substantially similar or related property.

Withholding tax. For this purpose, withholding tax includes any tax determined on a gross basis. It does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

Example. You bought common stock from a foreign corporation on November 3. You sold the stock on November 19. You received a dividend on this stock because you owned it on the ex-dividend date (defined later). For income or gain (other than dividends) paid or accrued to a foreign country in connection with the purchase or sale of oil or gas, you are not entitled to the credit.

To figure your foreign tax credit, you would use $2,133 as the tax.

When figuring how long you held the property, count the day you sold it, but do not count the day you acquired it or any days on which you were protected from risk or loss.

Withholding tax. For this purpose, withholding tax includes any tax determined on a gross basis. It does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

Example 2. The facts are the same as in Example 1 except that you sold the stock on November 14. You held the stock for only 11 days. You are not entitled to the credit.

Exception. If you own a securities dealer who actively conducts business in a foreign country, you may be able to claim a foreign tax credit for qualified taxes paid on dividends regardless of how long you held the stock or whether you were obligated to make payments for positions in substantially similar or related property. See section 901(k)(4) of the Internal Revenue Code for more information.

Taxes Withheld on Income or Gain (Other Than Dividends)

For income or gain (other than dividends) paid or accrued on property, you cannot claim a foreign tax credit for withholding tax (defined later):

• If you have not held the property for at least 16 days during the 31-day period that begins 15 days before the date on which the right to receive the payment arises, or
• To the extent you have to make related payments on positions in substantially similar or related property.

Example. The sanctions against Country X ended on July 31. On August 19, you receive a dividend from a mutual fund of Country X income. The fund paid Country X income tax for you on the distribution. Because the distribution was made after the sanction ended, you may include the foreign tax paid on the distribution to compute your foreign tax credit.

Amounts for the nonsanctioned period. If a sanction period ends (or a Presidential waiver is granted) during your tax year and you are not able to determine the actual income and taxes for that period, you can allocate amounts to that period based on the number of days in the period that fall in your tax year. Multiply the income or taxes for the year by the following fraction to determine the amounts allocable to that period:

\[
\text{Number of nonsanctioned days in year} \times \frac{\text{Income or taxes for the year}}{\text{Number of days in year}}
\]

Example. You are a calendar year filer and received $20,000 of income from Country X in 2005 on which you paid tax of $4,500. Sanctions against Country X ended on July 11, 2005. You are unable to determine how much of the income or tax is for the nonsanctioned period. Because your tax year starts on January 1, and the Country X sanction ended on July 11, 2005; 173 days of your tax year are in the nonsanctioned period. You would compute the income for the nonsanctioned period as follows:

\[
173 \times \frac{20,000}{365} = \$9,479
\]

You would figure the tax for the nonsanctioned period as follows:

\[
173 \times \frac{4,500}{365} = \$1,233
\]

To figure your foreign tax credit, you would use $9,479 as the income from Country X and $1,233 as the tax.

Further information. The rules for figuring the foreign tax credit after a country’s sanction period ends are more fully explained in Revenue Ruling 92-62, Cumulative Bulletin 1992-2, page 193. This Cumulative Bulletin can be found in many libraries and IRS offices.

Taxes Impose on Certain Dividends

You cannot claim a foreign tax credit for withholding tax (defined later) on dividends paid or accrued if either of the following applies to the dividends:

1. The dividends are on stock you held for less than 16 days during the 31-day period that begins 15 days before the ex-dividend date (defined later).
2. The dividends are for a period or periods totaling more than 366 days on preferred stock you held for less than 46 days during the 91-day period that begins 45 days before the ex-dividend date. If the dividend is not more than 366 days, rule (1) applies to the preferred stock.

When figuring how long you held the stock, count the day you sold it, but do not count the day you acquired it or any days on which you were protected from risk or loss.

Regardless of how long you held the stock, you cannot claim the credit to the extent you have an obligation under a short sale or otherwise to make payments related to the dividend for positions in substantially similar or related property.

Withholding tax. For this purpose, withholding tax includes any tax determined on a gross basis. It does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

Example 1. You bought common stock from a foreign corporation on November 3. You sold the stock on November 19. You received a dividend on this stock because you owned it on the ex-dividend date (defined later). For income or gain (other than dividends) paid or accrued to a foreign country in connection with the purchase or sale of oil or gas, you are not entitled to the credit.

To figure your foreign tax credit, you would use $2,133 as the tax.

When figuring how long you held the property, count the day you sold it, but do not count the day you acquired it or any days on which you were protected from risk or loss.

Withholding tax. For this purpose, withholding tax includes any tax determined on a gross basis. It does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

Exception. If you own a securities dealer who actively conducts business in a foreign country, you may be able to claim a foreign tax credit for qualified taxes paid on dividends regardless of how long you held the stock or whether you were obligated to make payments for positions in substantially similar or related property. See section 901(k)(4) of the Internal Revenue Code for more information.

Taxes in Connection With the Purchase or Sale of Oil or Gas

You cannot claim a foreign tax credit for taxes paid or accrued to a foreign country in connection with the purchase or sale of oil or gas extracted in that country if you do not have an economic interest in the oil or gas, and the purchase price or sales price is different from the fair market value of the oil or gas at the time of purchase or sale.

Taxes on Foreign Oil Related Income

You must reduce foreign taxes paid or accrued on foreign oil related income to the extent that the tax imposed by the foreign country on such income is considered to be materially greater than the tax imposed by that country on income other than foreign oil related income or foreign oil and gas extraction income (discussed later). See Regulations section 1.907(b)-1. The amount of tax not allowed as a credit under this rule is allowed as a business expense deduction.

Taxes on Foreign Mineral Income

You must reduce any taxes paid or accrued to a foreign country or possession on mineral income from that country or possession if you were allowed a deduction for percentage depletion for any part of the mineral income.
Taxes From International Boycott Operations

If you participate in or cooperate with an interna-
tional boycott during the tax year, your foreign
taxes resulting from boycott activities will reduce
the total taxes available for credit. See the in-
structions for line 12 in the Form 1116 instruc-
tions to figure this reduction.

This rule generally does not apply to employ-
eses with wages who are working and living in
boycotting countries, or to retirees with pensions
who are living in these countries.

List of boycotting countries. A list of the
countries which may require participation in or
cooperation with an international boycott is pub-
blished by the Department of the Treasury each
calendar quarter. As of December 2004, the follow-
ing countries are listed.

- Bahrain.
- Kuwait.
- Lebanon.
- Libya.
- Oman.
- Qatar.
- Saudi Arabia.
- Syria.
- United Arab Emirates.
- Republic of Yemen.

For information concerning changes to the
list, write to:

Internal Revenue Service
International Section
P.O. Box 920
Bensalem, PA 19020-8518

Determinations of whether the boycott rule
applies. You may request a determination from
the Internal Revenue Service as to whether a
particular operation constitutes participation in
or cooperation with an international boycott. The
procedures for obtaining a determination from
the Service are outlined in Revenue Procedure
77-9 in Cumulative Bulletin 1977-1. You can buy
the Cumulative Bulletin from the Government
Printing Office. Copies are also available in most
IRS offices and you are welcome to read them
there.

Public inspection. A determination and
any related background file is open to public
inspection. However, your identity and certain
other information will remain confidential.

Reporting requirements. You must file a re-
port with the IRS if you or any of the following
persons have operations in or related to a boy-
cotting country or with the government, a com-
pany, or national of a boycotting country.

- A foreign corporation in which you own
10% or more of the voting power of all
voting stock but only if you own the stock
of the foreign corporation directly or
through foreign entities.

- A partnership in which you are a partner.

- A trust you are treated as owning.

Form 5713 required. If you have to file a
report, you must use Form 5713, International
Boycott Report, and attach all supporting sched-
ules.

You must file the form in duplicate when your
tax return is due, including extensions. Send
one copy to the Internal Revenue Service
Center, Philadelphia, PA 19255. You may send the
other copy to your income tax return that you file
with your usual Internal Revenue Service Center.

Penalty for failure to file. If you willfully fail
to make a report, in addition to other penalties,
you may be fined $25,000 or imprisoned for no
more than one year, or both.

Taxes on Foreign Oil and Gas Extraction income

You must reduce your foreign taxes by a portion
of any foreign taxes imposed on foreign oil and
gas extraction income. The amount of the reduc-
tion is the amount by which your foreign oil and
gas extraction taxes exceed the amount of your
foreign oil and gas extraction income multiplied
by a fraction equal to your pre-credit U.S. tax lia-

ability (Form 1040, line 44) divided by your
worldwide income. You may be entitled to carry
over to other years taxes reduced under this
rule. See Internal Revenue Code section 907(f).

Taxes of U.S. Persons Controlling Foreign Corporations and Partnerships

If you had control of a foreign corporation or a
foreign partnership for the annual accounting
period of that corporation or partnership that
dated with or within your tax year, you may have
had to file an annual information return. If you do not
file the required information return, you may have
reduce the foreign taxes that may be
used for the foreign tax credit. See Penalty for
not filing Form 5471 or Form 8865, later.

U.S. persons controlling foreign corpora-
tions. If you are a U.S. citizen or resident who
had control of a foreign corporation for an unin-
terrupted period of at least 30 days during the
annual accounting period of that corporation,
you may have to file an annual information re-
turn on Form 5471, Information Return of U.S.
Persons With Respect To Certain Foreign Corpo-
rations. Under this rule, you generally had
control of a foreign corporation if at any time
during the corporation’s tax year you owned:

- Stock possessing more than 50% of the
total combined voting power of all classes
of stock entitled to vote, or

- More than 50% of the total value of shares
of all classes of stock of the foreign corpo-
ration.

U.S. persons controlling foreign partner-
ships. If you are a U.S. citizen or resident who
had control of a foreign partnership at any time
during the partnership’s tax year, you may have
to file an annual information return on Form
8865, Return of U.S. Persons With Respect To
Certain Foreign Partnerships. Under this rule,
you generally had control of the partnership if
you owned more than 50% of the capital or
profits or interest, or an interest to which 50% of
the deductions or losses were allocated.

You also may have to file Form 8865 if at any
time during the tax year of the partnership, you
owned a 10% or greater interest in the partner-
ship while the partnership was controlled by
U.S. persons owning at least a 10% interest. See
the Instructions for Form 8865 for more
information.

Penalty for not filing Form 5471 or Form
8865. Generally, there is a dollar penalty of
$10,000 for each annual accounting period for
which you fail to furnish information. Additional
penalties apply if the failure continues for more
than 90 days after the day on which notice of the
failure to furnish the information is mailed.

If you file to file either Form 5471 or Form
8865 when due, you may also be required to
reduce by 10% all foreign taxes that may be
used for the foreign tax credit. This 10% reduc-
tion shall not exceed the greater of $10,000 or
the income of the foreign corporation for the
foreign partnership for the accounting period for
which the failure occurs. This foreign tax credit penalty
is also reduced by the amount of the dollar
penalty imposed.

How To Figure the Credit

As already indicated, you can claim a foreign tax
credit only for foreign taxes on income, war
profits, or excess profits, or taxes in lieu of those
taxes. In addition, there is a limit on the amount
of the credit that you can claim. You figure this
limit and your credit on Form 1116. Your credit is
the amount of foreign tax you paid or accrued or,
if smaller, the limit.

If you have foreign taxes available for credit
but you cannot use them because of the limit,
you may be able to carry them back 1 tax year
and forward to the next 10 tax years. See Car-
ryback and Carryover, later.

Also, certain tax treaties have special rules
that you must consider when figuring your for-
ereign tax credit. See Tax Treaties, later.

Exemption from foreign tax credit limit.
You will not be subject to this limit and will be
able to claim the credit without using Form 1116
if the following requirements are met.

- Your only foreign source gross income for
the tax year is passive income. Passive
income is defined later under Separate
Limit Income. However, for purposes of
this rule, high taxed income and export
financing interest are also passive income.

Passive income also includes income that
would be passive except that it is also
described in another income category.

- Your qualified foreign taxes for the tax
year are not more than $300 ($600 if mar-
ried filing a joint return).

- All of your gross foreign income and the
foreign taxes are reported to you on a
payee statement (such as a Form 1099-DIV or 1099-INT).

- You elect this procedure for the tax year.

If you make this election, you cannot carry back or carry over any unused foreign tax to or from this tax year.

This election exempts you only from the limit figured on Form 1116 and not from the other requirements described in this publication. For example, the election does not exempt you from the requirements discussed earlier under What Foreign Taxes Qualify for the Credit.

Limit on the Credit

Your foreign tax credit cannot be more than your total U.S. tax liability (line 44 Form 1040) multiplied by a fraction. The numerator of the fraction is your taxable income from sources outside the United States. The denominator is your total taxable income from U.S. and foreign sources.

To determine the limit, you must separate your foreign source income into categories, as discussed under Separate Limit Income. The limit treats all foreign income and expenses in each separate category as a single unit and limits the credit to the U.S. income tax on the taxable income in that category from all sources outside the United States.

Separate Limit Income

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

- Passive income.
- High withholding tax interest.
- Financial services income.
- Shipping income.
- Certain dividends from a domestic international sales corporation (DISC) or former DISC.
- Certain distributions from a foreign sales corporation (FSC) or former FSC.
- Any lump sum distributions from employer benefit plans for which the special averaging treatment is used to determine your tax.
- Section 901(j) income.
- Income re-sourced by treaty.
- General limitation income. This is all other income not included in the above categories.

In figuring your separate limits, you must combine the income (and losses) in each category from all foreign sources, and then apply the limit.

Income from controlled foreign corporations. As a U.S. shareholder, certain income that you receive or accrue from a controlled foreign corporation (CFC) is treated as separate limit income. You are considered a U.S. shareholder in a CFC if you own 10% or more of the total voting power of all classes of the corporation’s voting stock.

Subpart F inclusions, interest, rents, and royalties from a CFC are generally treated as separate limit income if they are attributable to the separate limit income of the CFC. A dividend paid or accrued out of the earnings and profits of a CFC is treated as separate limit income in the same proportion that the part of earnings and profits attributable to income in the separate category bears to the total earnings and profits of the CFC. For more information, see section 904(d)(3) of the Internal Revenue Code and Regulations section 1.904-5.

Partnership distributive share. In general, a partner’s distributive share of partnership income is treated as separate limit income if it is from the separate limit income of the partnership. However, if the partner owns less than a 10% interest in the partnership, the income is generally treated as passive income. For more information, see Regulations section 1.904-5(h).

Passive Income

Except as described earlier under Income from controlled foreign corporations and Partnership distributive share, passive income generally includes the following:

- Dividends.
- Interest.
- Rents.
- Royalties.
- Annuities.
- Net gain from commodities transactions, except for hedging and active business gains or losses of producers, processors, merchants, or handlers of commodities.
- Amounts you must include as foreign personal holding company income under section 551(a) or 551(a) of the Internal Revenue Code.
- Amounts includible in income under section 1293 of the Internal Revenue Code (relating to certain passive foreign investment companies).

If you receive foreign source distributions from a mutual fund that elects to pass through to you the foreign tax credit, the income is generally considered passive. The mutual fund will need to provide you with a written statement showing the amount of foreign taxes it elected to pass through to you.

What is not passive income. Passive income does not include any of the following:

- Gains or losses from the sale of inventory property or property held mainly for sale to customers in the ordinary course of your trade or business.
- Export financing interest.
- High-taxed income.
- Active business rents and royalties.
- Any income that is defined in another separate limit category.

Export financing interest. This is interest derived from financing the sale or other disposition of property for use outside the United States if:

- The property is manufactured, produced, grown, or extracted in the United States, and
- 50% or less of the value of the property is due to imports into the United States.

High-taxed income. This is passive income subject to foreign taxes that are higher than the highest U.S. tax rate that can be imposed on the income. The high-taxed income and the taxes imposed on it are moved from the passive income category into the general limitation income category. See Regulations section 1.904-4(c) for more information.

High Withholding Tax Interest

High withholding tax interest is interest (except export financing interest) that is subject to a foreign or U.S. possession withholding tax or other tax determined on a gross basis of at least 5%. If interest is not high withholding tax interest because it is export financing interest, it is usually general limitation income. However, if it is received by a financial services entity, it is financial services income.

Financial Services Income

Financial services income generally is income received or accrued by a financial services entity. This is an entity predominantly engaged in the active conduct of a banking, financing, insurance, or similar business. If you qualify as a financial services entity, financial services income includes income from the active conduct of that business, passive income, high-taxed income, certain incidental income, and export financing interest which is subject to a foreign or U.S. possession withholding tax or gross-basis tax of at least 5%.

Shipping Income

This is income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce or income derived from space or ocean activities. It also includes income from the sale or other disposition of these aircraft or vessels. Shipping income that is also financial services income is treated as financial services income.

DISC Dividends

This dividend income generally consists of dividends from an interest charge domestic international sales corporation (DISC) or former DISC that are treated as foreign source income.

FSC Distributions

These are:
- Distributions from a foreign sales corporation (FSC) or former FSC out of earnings.
The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

and profits attributable to foreign trade in-
come, or

• Interest and carrying charges incurred by
an FSC or former FSC from a transaction
that results in foreign trade income.

Lump-Sum Distribution
If you receive a foreign source lump-sum distri-
bution (LSD) from a retirement plan, and you
figure the tax on it using the special averaging
treatment for LSDs, you must make a special
computation. Follow the Form 1116 instructions
and complete the worksheet in those instruc-
tions to determine your foreign tax credit on the
LSD.

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

Section 901(j) Income
This is income earned from activities conducted
in sanctioned countries. Income derived from
each sanctioned country is subject to a separate
foreign tax credit limitation. Therefore, you
must use a separate Form 1116 for income earned
from each such country. See Taxes Imposed By
Sanctioned Countries (Section 901(j) Income),
under Taxes for Which You Can Only Take an
Itemized Deduction, earlier.

Income Re-Sourced By Treaty
If a sourcing rule in an applicable income tax
treaty treats any of the income described below
as foreign source, and you elect to apply
the treaty, the income will be treated as foreign
income.

• Certain gains (section 865(h)).
• Certain income from a U.S.-owned foreign
corporation (section 904(g)(10)). See Reg-
ulations section 1.904-5(m)(7) for an ex-
ample.

You must compute a separate foreign tax
credit limitation for any such income for which
you claim benefits under a treaty, using a sepa-
rate Form 1116 for each amount of re-sourced
income from a treaty country.

General Limitation Income
This is income from sources outside the United
States that does not fall into one of the other
separate limit categories. It generally includes
active business income that does not fall into
one of the other separate categories. It also
includes wages, salaries, and overseas al-
lowances of an individual as an employee.

Allocation of Foreign Taxes
If you paid or accrued foreign income tax for a
tax year on income in more than one separate
limit income category, allocate the tax to the income
category to which the tax specifically
relates. If the tax is not specifically related to any
one category, you must allocate the tax to each
category of income.

You do this by multiplying the foreign income
tax related to more than one category by a
fraction. The numerator of the fraction is the net
income in a separate category. The denomina-
tor is the total net foreign income.

You figure net income by deducting from the
gross income in each category and from the total
foreign income any expenses, losses, and other
deductions definitely related to them under
the laws of the foreign country or U.S. possession. If
the expenses, losses, and other deductions are
not definitely related to a category of income
under foreign law, they are apportioned under
the principles of the foreign law. If the foreign law
does not provide for apportionment, use the
principles covered in the U.S. Internal Revenue
Code.

Example. You paid foreign income taxes of
$3,200 to Country A on wages of $80,000 and
interest income of $3,000. These were the only
taxable items of income on your foreign return. You
also have deductions of $4,400 that, under foreign
tax law, are not definitely related to either the wages
or interest income. Your total net income is
$78,600 ($83,000 – $4,400).

Because the foreign tax is not specifically for
either item of income, you must allocate the tax
between the wages and the interest under the
tax laws of Country A. For purposes of this
example, assume that the laws of Country A do
this in a manner similar to the U.S. Internal Revenue
Code. First figure the income in each category by allocating those expenses that
are not definitely related to either category of income.

You figure the expenses allocable to wages
(general limitation income) as follows.

$80,000 (wages) × 4,400 = $3,084
$83,000 (total income)

The net wages are $75,759 ($80,000 – $4,241).

You figure the expenses allocable to interest
(passive income) as follows.

$3,000 (interest) × 4,400 = $159
$83,000 (total income)

The net interest is $2,841 ($3,000 – $159).

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

$75,759 (net wages) × 3,084 = $3,084
$77,600 (total net income)

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

$2,841 (net interest) × 3,200 =$116
$77,600 (total net income)

Foreign Taxes From a Partnership or an S Corporation
If foreign taxes were paid or accrued on your
behalf by a partnership or an S corporation, you
will figure your credit using certain information
from the Schedule K-1 you received from the
partnership or S Corporation. If you received a
2005 Schedule K-1 from a partnership or an S
corporation that includes foreign tax information,
see your Form 1116 instructions for how to re-
port that information.

Figuring the Limit
Before you can determine the limit on your
credit, you must first figure your total taxable
income from all sources before the deduction for
foreign taxes. The result, entered on line 41 of Form
1040 (minus any amount of Form 8914, line 2). Then for each category of
income, you must figure your taxable income
from sources outside the United States.

Determining Source of Income
Before you can figure your taxable income in
each category from sources outside the United
States, you must first determine whether your
gross income in each category is from U.S.
sources or foreign sources. Some of the general
rules for figuring the source of income are out-
lined in Table 2.

Income from sources in U.S. possessions.
The rules for determining whether income is
from sources in a U.S. possession are generally
the same as those for determining whether in-
come is from U.S. sources. But exceptions ap-
ply. See Publication 570 for more information.

Sales or exchanges of certain personal
property. Generally, if personal property is
sold by a U.S. resident, the gain or loss from the
sale is treated as U.S. source. If personal prop-
erty is sold by a nonresident, the gain or loss is
treated as foreign source.

This rule does not apply to the sale of inven-
tory, intangible property, or depreciable prop-
erty, or property sold through a foreign office
or fixed place of business. The rules for these
types of property are discussed later.

U.S. resident. The term “U.S. resident,” for
this purpose, means a U.S. citizen or resident alien
who does not have a tax home in a foreign
country. The term also includes a nonresident
alien who has a tax home in the United States.
Generally, your tax home is the general area of
your main place of business, employment, or
post of duty, regardless of where you maintain
your family home. Your tax home is the place
where you are permanently or indefinitely en-
gaged in your profession as an employee or self-
employed individual. If you do not have a regular or main
place of business because of the nature of your
work, then your tax home is the place where you
regularly live. If you do not fit either of these
categories, you are considered an itinerant and
your tax home is wherever you work.

Nonresident. A nonresident is any person
who is not a U.S. resident.

U.S. citizens and resident aliens with a for-
egn tax home will be treated as nonresidents for
a sale of personal property only if an income tax
of at least 10% of the gain on the sale is paid to a
foreign country.

This rule also applies to losses recognized after January 7, 2002, if the foreign country
would have imposed a 10% or higher tax had the
sale resulted in a gain. You can choose to apply
this rule to losses recognized in tax years begin-
ning after 1986. For details about making this
choice, see Regulations section 1.865-1(f)(2).
For stock losses, see Regulations section 1.865-2(e).

Income. Income from the sale of inventory that you purchased is sourced where the property is sold. Generally, this is where title to the property passes to the buyer.

Income from the sale of inventory that you purchased is sourced where the property is sold. Generally, this is where title to the property passes to the buyer.

Sources Outside the United States

For more information, see Regulations section 1.865-1(f)(2).

Intangibles. Intangibles include patents, copyrights, trademarks, and goodwill. The gain from the sale of amortizable or depreciable intangible property, up to the previously allowable amortization or depreciation deductions, is sourced in the same way as the original deduction was sourced. Thus, it is the same as the source rule for gain from the sale of depreciable property. See Depreciable property, next, for details how to apply this rule.

Gain in excess of the amortization or depreciation deduction is sourced in the country where the property is used if the income from the sale is contingent on the productivity, use, or disposition of that property. If the income is not contingent on the productivity, use, or disposition of the property, the income is sourced according to the seller’s tax home as discussed earlier. Payments for goodwill are sourced in the country where the goodwill was generated if the payments are not contingent on the productivity, use, or disposition of the property.

Depreciable property. The gain from the sale of depreciable personal property, up to the amount of the previously allowable depreciation, is sourced in the same way as the original deductions were sourced. Thus, to the extent the previous deductions for depreciation were allocable to U.S. source income, the gain is U.S. source. To the extent the depreciation deductions were allocable to foreign sources, the gain is foreign source income. Gain in excess of the depreciation deductions is sourced the same as inventory.

A loss recognized after January 7, 2002, is sourced in the same way as the depreciation deductions were sourced. However, if the property was used predominantly outside the United States, the entire loss reduces foreign source income. You can choose to apply this rule to losses recognized in tax years beginning after 1986. For details on making this choice, see Regulations section 1.865-1(f)(2).

Depreciation includes amortization and any other allowable deduction for a capital expense that is treated as a deductible expense.

Sales through foreign office or fixed place of business. Income earned by U.S. residents from the sale of personal property through an office or other fixed place of business outside the United States is generally treated as foreign source if:

- The income from the sale is from the business operations located outside the United States, and
- At least 10% of the income is paid as tax to the foreign country.

If less than 10% is paid as tax, the income is U.S. source.

This rule also applies to losses recognized after January 7, 2002, if the foreign country would have imposed a 10% or higher tax had the sale resulted in a gain. You can choose to apply this rule to losses recognized in tax years beginning after 1986. For details about making this choice, see Regulations section 1.865-1(f)(2).

Determine Taxable Income From Sources Outside the United States

To figure your taxable income in each category from sources outside the United States, you first allocate to specific classes (kinds) of gross income the expenses, losses, and other deductions (including the deduction for foreign housing costs) that are definitely related to that income.

Definitely related. A deduction is definitely related to a specific class of gross income if it is incurred either:

- As a result of, or incident to, an activity from which that income is derived, or
- In connection with property from which that income is derived.

Classes of gross income. You must determine which of the following classes of gross income your deductions are definitely related to:

- Compensation for services, including wages, salaries, fees, and commissions.
- Gross income from business.
- Gains from dealings in property.
- Interest.
- Rents.
- Royalties.
- Dividends.
- Alimony and separate maintenance.
- Annuities.
- Pensions.
- Income from life insurance and endowment contracts.
- Income from cancelled debts.
- Your share of partnership gross income.
- Income in respect of a decedent.
- Income from an estate or trust.

Exempt income. When you allocate deductions that are definitely related to one or more classes of gross income, you take exempt income into account for the allocation. However, do not take exempt income into account to ap-

Table 2. Source of Income

<table>
<thead>
<tr>
<th>Item of Income</th>
<th>Factor Determining Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries, wages, other compensation</td>
<td>Where services performed</td>
</tr>
<tr>
<td>Business income:</td>
<td>Where services performed</td>
</tr>
<tr>
<td>Personal services</td>
<td>Where sold</td>
</tr>
<tr>
<td>Sale of inventory—purchased</td>
<td>Allocation</td>
</tr>
<tr>
<td>Sale of inventory—produced</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>Residence of payer</td>
</tr>
<tr>
<td>Dividends</td>
<td>Whether a U.S. or foreign corporation*</td>
</tr>
<tr>
<td>Rents</td>
<td>Location of property</td>
</tr>
<tr>
<td>Royalties:</td>
<td>Location of property</td>
</tr>
<tr>
<td>Natural resources</td>
<td>Where property is used</td>
</tr>
<tr>
<td>Patent, copyrights, etc.</td>
<td></td>
</tr>
<tr>
<td>Sale of real property</td>
<td></td>
</tr>
<tr>
<td>Sale of personal property</td>
<td></td>
</tr>
<tr>
<td>Seller’s tax home (but see Sales or exchanges of certain personal property, later, for exceptions)</td>
<td></td>
</tr>
<tr>
<td>Pensions</td>
<td>Where services were performed that earned the pension</td>
</tr>
<tr>
<td>Sale of natural resources</td>
<td>Allocation based on fair market value of product at export terminal</td>
</tr>
</tbody>
</table>

*Exceptions include:

- Dividends paid by a U.S. corporation are foreign source if the corporation elects the Puerto Rico economic activity or possessions tax credit.
- Part of a dividend paid by a foreign corporation is U.S. source if at least 25% of the corporation’s gross income is effectively connected with a U.S. trade or business for the 3 tax years before the year in which the dividends are declared.
Interest expense and state income taxes. You must allocate and apportion your interest expense and state income taxes under the special rules discussed later under Interest expense and State income taxes.

Class of gross income that includes more than one separate limit category. If the class of gross income to which a deduction definitely relates includes either:

- More than one separate limit category, or
- At least one separate limit category and U.S. source income,

you must apportion the definitely related deductions within that class of gross income.

To apportion, you can use any method that reflects a reasonable relationship between the deduction and the income in each separate limit category. One method that is widely acceptable is the fair market value method. Fair market value is based on a comparison of the gross income in a class of gross income to the gross income in a separate limit category.

Use the following formula to figure the amount of the definitely related deduction apportioned to the income in the separate limit category:

\[
\text{Gross income in separate limit category} \times \frac{\text{Total gross income in the class}}{\text{Deduction}}
\]

Do not take exempt income into account when you apportion the deduction. However, income excluded under the foreign earned income exclusion is not considered exempt. You must, therefore, apportion deductions to that income.

Interest expense. Generally, you apportion your interest expense on the basis of your investment assets. Under the asset method, you must apportion the deduction. However, income excluded under the foreign earned income exclusion is not considered exempt. You must, therefore, apportion deductions to that income.

State income taxes. You must allocate and apportion your interest expense under the rules for those categories by taking into account their distributive share of partnership capital and share of partnership income or loss. For special rules that may apply, see Regulations section 1.861-9T(e).

Home mortgage interest. This is your deductible home mortgage interest from Schedule A (Form 1040). Apportion it under a gross income method, taking into account all income (including business, passive activity, and investment income). You can take a mortgage interest deduction if your adjusted gross income in the year of the deduction is less than $145,950 ($72,975 if married filing separately). This deduction does not reduce your itemized deductions on Schedule A (Form 1040).

Example. Your adjusted gross income is $60,000, and your interest expense is $6,000. You have stocks with an adjusted basis of $60,000. You have a bank loan in the amount of $40,000. The proceeds from the bank loan were divided equally between your business and your investment assets. You have stocks with an adjusted basis of $60,000. You have a bank loan in the amount of $40,000. The proceeds from the bank loan were divided equally between your business and your investment assets. You have stocks with an adjusted basis of $60,000. You have a bank loan in the amount of $40,000. The proceeds from the bank loan were divided equally between your business and your investment assets. You have stocks with an adjusted basis of $60,000. You have a bank loan in the amount of $40,000. The proceeds from the bank loan were divided equally between your business and your investment assets.
Capital Gains and Losses

Qualified Dividends

Treatment of personal exemptions. Do not take the deduction for personal exemptions, including exemptions for dependents, in figuring taxable income from sources outside the United States. However, you can take the deduction for additional exemptions for housing Hurricane Katrina displaced individuals from Form 8914, line 2. These exemptions are not definitely related to a specific class of income as explained earlier under Deductions not definitely related.

Qualified Dividends

Capital Gains and Losses

Note: Your foreign source net capital gain is the excess of your net long-term capital gain from foreign sources over your net short-term capital loss (if any) from foreign sources. Ignore any long-term capital gains you elected to include on Form 4952, line 4g, in determining your foreign source net capital gain. Ignore any qualified dividends you elected to include on Form 4952, line 4g, in determining the amount of your foreign source qualified dividends.

If you have any qualified dividends, you may be required to make adjustments to the amount of those qualified dividends before you take them into account on line 1 or line 17 of Form 1116. See Foreign Qualified Dividends and Capital Gains (Losses) in the Form 1116 instructions to determine the adjustments you may be required to make before taking foreign qualified dividends into account on line 1 of Form 1116. See the instructions for line 17 in the Form 1116 instructions to determine the adjustments you may be required to make before taking U.S. or foreign qualified dividends into account on line 17 of Form 1116.

Capital Gains and Losses

Apply to medical and dental expenses, casualty and theft losses (other than losses of employee property), gambling losses, and investment interest.

You figure the reduction by using the itemized deductions worksheet in the instructions for Schedule A (Form 1040). Line 3 of the worksheet shows the total itemized deductions subject to the reduction. Line 9 shows the amount of the reduction.

To determine your taxable income from sources outside the United States, you must first divide the reduction (line 9 of the worksheet) by the itemized deductions subject to the reduction (line 3 of the worksheet). This is your reduction percentage (expressed as a decimal rounded to at least four places). Then, multiply each itemized deduction subject to the reduction by your reduction percentage. Subtract the result from the itemized deduction to determine the amount you can allocate to income from sources outside the United States.

Example. You are single and have an adjusted gross income of $153,250. This is the amount on line 5 of the worksheet. Your itemized deductions subject to the reduction total $20,000. This is the amount on line 3 of the worksheet. Reduce your adjusted gross income (line 5) by $145,950. Enter the result ($7,300) on line 7. The amount on line 8 is $219 ($7,300 × 3%). This amount is also entered on line 9.

You have a real estate tax deduction of $12,000 shown on Schedule A (Form 1040) that is subject to the reduction. Your reduction percentage is 1.095% (219 ÷ $20,000). You must reduce your $12,000 deduction by $131 (1.095% × $12,000). The reduced deduction, $11,869 ($12,000 − $131), is used to determine your taxable income from sources outside the United States.

Adjustments to Foreign Source Capital Gains and Losses

If you have foreign source capital gains or losses in less than 3 separate categories and one of the following applies to you.

You figured your tax using the Qualified Dividends and Capital Gains Tax Worksheet in the instructions for Form 1040 and either line 3 or line 7 of that worksheet is zero or line 17 of that worksheet is equal to or greater than line 18.

You figured your tax using the Schedule D Tax Worksheet in the instructions for Schedule D (Form 1040) or in the instructions for Form 1041 and (1) line 17 is zero, (2) line 9 is zero or a loss, or (3) line 33 is equal to or greater than line 34.

You figured your tax using the Schedule D Tax Worksheet in the instructions for Schedule D (Form 1040) and the reduction (line 9 of the worksheet) by Section 1250 Gain Worksheet in the instructions for Schedule D and you did not complete the 28% Rate Gain Worksheet in the instructions for Schedule D.

If you use the instructions in this publication, see Adjustments to Foreign Source Capital Gains and Losses below to determine the adjustments you must make.

Line 17 (Form 1116). If you have U.S. or foreign qualified dividends into account on line 17 of Form 1116 to determine whether you are required to take the adjustment. See the instructions under this publication to determine the amount of the adjustment.

Adjustments to Foreign Source Capital Gains and Losses

You may have to make the following adjustments to your foreign source capital gains and losses:

• U.S. capital loss adjustment.
• Capital gain rate differential adjustment.

Before you make these adjustments, you must reduce your net capital gain by the amount of any gain you elected to include in investment income on line 4g of Form 4952. Investment Interest Expense Deduction. Your foreign source net capital gain is the excess of your net long-term capital gain for the year over any net short-term capital loss for the year.

U.S. capital loss adjustment. You must adjust the amount of your foreign source capital gains to the extent that your foreign source capital gain exceeds the amount of your worldwide capital gain (the “U.S. capital loss adjustment”).

Your foreign source capital gain is the amount of your foreign source capital gains in excess of your foreign source capital losses. If your foreign source capital gains do not exceed your foreign source capital losses, you do not have a foreign source capital gain and you do not need to make the U.S. capital loss adjustment. See Capital gain rate differential adjustment later for adjustments you must make to your foreign source capital gains or losses.

Your worldwide capital gain is the amount of your worldwide (U.S. and foreign) capital gains in excess of your worldwide (U.S. and foreign) capital losses. If your worldwide capital losses equal or exceed your worldwide capital gains, your “worldwide capital gain” is zero.

Your U.S. capital loss adjustment is the amount of your foreign source capital gains in excess of your worldwide capital gain. (If the amount of your foreign source capital gain does
not exceed the amount of your worldwide capital gain, you do not have a U.S. capital loss adjustment.) See Capital gain rate differential adjustment later for adjustments you must make to your foreign source capital gains or losses. If you have a U.S. capital loss adjustment, you must reduce your foreign source capital gains by the amount of the U.S. capital loss adjustment. To make this adjustment, you must allocate the total amount of the U.S. capital loss adjustment among your foreign source capital gains using the following steps.

**Step 1.** You must apportion the U.S. capital loss adjustment among your separate categories that have a net capital gain. A separate category has a net capital gain if the amount of foreign source capital gains in the separate category exceeds the amount of foreign source capital losses in the separate category. You must apportion the U.S. capital loss adjustment pro rata based on the amount of net capital gain in each separate category.

**Example 1.** Alfie has a $300 foreign source capital gain in the passive category, a $1,000 foreign source capital gain in the general limitation category, a $400 foreign source capital loss in the general limitation category, and a $150 U.S. source capital loss. He figures his net gains and U.S. capital loss adjustment as follows.

- **Foreign source capital gain = $900**
  - $1,000 − $100 − $400 − $150
- **Worldwide capital gain = $750**
  - ($1,000 + $300) − ($400 + $150)
- **U.S. capital loss adjustment = $150**
  - ($900 − $750)

Alfie must then apportion the U.S. capital loss adjustment ($150) between the passive category and the general limitation category based on the amount of net capital gain in each separate category. $50 apportioned to passive category ($150 × $300/$900).

Alfie reduces his $300 net capital gain in the passive category by $50 and includes the resulting $250 on line 1 of the Form 1116 for the passive category.

$100 apportioned to general limitation category ($150 × $600/$900).

Alfie reduces his $600 net capital gain in the general limitation category by $100 and includes the resulting $500 on line 1 of the Form 1116 for the general limitation category.

**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 15% rate group, and the long-term rate groups. Table 3 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 gain. Dennis also has foreign source capital gains and losses in the following categories.

- **Foreign source capital gain = $900**
  - ($1,000 + $300) − ($400 + $150)
- **U.S. capital loss adjustment = $150**
  - ($900 − $750)

Dennis has net capital gain in more than one group that must be adjusted. Long term rate groups.

**Table 3. Rate Groups**

<table>
<thead>
<tr>
<th>Rate group</th>
<th>A capital gain or loss is in the...</th>
<th>IF...</th>
</tr>
</thead>
<tbody>
<tr>
<td>28% rate group</td>
<td>It is included on the 28% Rate Gain Worksheet in the instructions for Schedule D.</td>
<td></td>
</tr>
<tr>
<td>25% rate group</td>
<td>It is included on line 1 through line 13 of the Unrecaptured Section 1250 Gain Worksheet in the instructions for Schedule D.</td>
<td></td>
</tr>
<tr>
<td>15% rate group</td>
<td>It is a long-term capital gain or loss and is not in the 28% or 25% rate group.</td>
<td></td>
</tr>
<tr>
<td>Short-term rate group</td>
<td>It is a short-term capital gain or loss.</td>
<td></td>
</tr>
</tbody>
</table>

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 in the passive category, $66.67 of foreign source short-term capital gain in the passive category, $133.33 of foreign source 28% gain in the passive category, and $200 of foreign source 15% capital gain in the general limitation category, as shown in the following table.

<table>
<thead>
<tr>
<th>Income category</th>
<th>28% rate</th>
<th>15% rate</th>
<th>Short-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passive</td>
<td>$200.00</td>
<td>$300.00</td>
<td>$750.00</td>
</tr>
<tr>
<td>General limitation</td>
<td>$700.00</td>
<td>$100.00</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>He figures his U.S. capital loss adjustment as follows.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dennis' foreign source capital gain is $900.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dennis' worldwide capital gain is $150.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dennis' U.S. capital loss adjustment is $150.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dennis must apportion his $300 U.S. capital loss adjustment between the passive category and the general limitation category based on the amount of net capital gain in each separate category.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Dennis' net capital gain in the passive category is $200.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Dennis' net capital gain in the general limitation category is $400.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Dennis has net capital gain in more than one rate group in the passive category. Therefore, the $100 apportioned to the passive category 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.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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)

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 rules 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 group. Mary does not have a U.S. capital loss adjustment because her foreign source capital gain ($450) does not exceed her worldwide capital gain ($500).

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 the passive category.

Example 4. Beth has $200 of capital gains in the 28% rate group in the general limitation category and no other items of capital gain or loss. Beth must adjust the capital gain before she includes it on line 1 as follows.

Step 1. First determine the rate group of the capital gain offset by the net capital gain 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 rules 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 group. If you have a net capital loss in a short-term rate group. Include the amount of net capital gain in each separate category long-term rate group on line 1 of the applicable Form 1116 without adjustment.

Example 4. Beth has $200 of capital gains in the 28% rate group in the general limitation category and no other items of capital gain or loss. Beth must adjust the capital gain before she includes it on line 1 as follows.

Step 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 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 rate category 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 rate category 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, and finally against any net capital gain in the 15% rate group.
   b. A foreign source net capital gain in the 28% rate group is netted first against

### Table: Capital Gain Rate Differential Adjustment for Net Capital Gains

<table>
<thead>
<tr>
<th>Income category</th>
<th>28% rate</th>
<th>15% rate</th>
<th>short-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passive</td>
<td>$133.33</td>
<td>$100</td>
<td>$66.67</td>
</tr>
<tr>
<td>General limitation</td>
<td>$200</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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. His U.S. long-term loss adjustment amount is $333.33 ($300 – $266.67). Dennis must allocate this amount between the $133.33 of net capital gain remaining in the 28% rate group, the $100 of net capital gain remaining in the 15% rate group in the general limitation category.

Dennis allocates $133.33 ($33.33 × 2 + $33.33) to the 28% rate group in the general limitation category.

Dennis allocates $100 of net capital gain remaining in the 15% rate group in the general limitation category. Therefore, Dennis must adjust $120 ($133.33 – $100) of net capital gain remaining in the 15% rate group in the general limitation category.
any net capital gain in the 25% rate group, and then against any net capital gain in the 15% rate group.  

c. A foreign source net capital loss in the 15% rate group is netted first against any net capital gain in the 28% rate group, and then 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 15% rate group, multiply the capital loss by 0.4286.
- 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 0.7143.
- 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 capital loss by 0.8. 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 gains. 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 Example 2. Dennis has a $100 foreign source 15% capital loss in the passive category. This loss is netted against the $200 foreign source 15% capital gain in the general limitation category according to Step 1.

Dennis includes $42.86 of the capital loss on line 5 of the Form 1116 for the general limitation category. ($100 × 0.4286)

**Example 8.** Dawn has a $20 net capital loss in the 15% rate group in the passive category, a $40 net capital loss in the 15% rate group in the general limitation category, a $50 U.S. source net capital gain in the 15% rate group, and a $50 net capital gain in the 28% rate group in the passive category, as shown in the following table.

<table>
<thead>
<tr>
<th>Income category</th>
<th>28% rate</th>
<th>15% rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Passive</td>
<td>$50</td>
<td>($20)</td>
</tr>
<tr>
<td>Foreign General Limitation</td>
<td></td>
<td>($40)</td>
</tr>
<tr>
<td>U.S. Source</td>
<td>$50</td>
<td></td>
</tr>
</tbody>
</table>

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 the passive category. ($50 × 0.3333)

$33.33 of the $50 is treated as coming from the general limitation category. ($50 × 0.6667)

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

$3.33 is treated as coming from the passive category. ($10 × 0.3333)

$6.67 is treated as coming from the general limitation category. ($10 × 0.6667)

Dawn includes $9.80 of the capital loss in the amount she enters on line 5 of Form 1116 for the passive category.

This is $7.14 ($16.67 × 0.4286) plus $2.66. ($3.33 × 0.8)

Dawn also includes $40.00 ($50 × 0.8) of capital gain in the amount she enters on line 1 of Form 1116 for the passive category.

**Allocation of Foreign and U.S. Losses**

You must allocate foreign losses for any taxable year and U.S. losses for any taxable 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 ForeignSource Capital Gains and Losses earlier under Capital Gains and Losses.

**Example.** You have $10,000 of income in the passive income category and incur a loss of $5,000 in the general limitation income category. You must use the $5,000 loss to offset $5,000 of the income in the passive category.

**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 in the general limitation income category, $3,000 of passive income, and $2,000 in distributions from a FSC. 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 income and 40% ($2,000/$5,000) or $800 reduces FSC distributions.

**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 Foreign Losses.

**Recharacterization of subsequent income in a loss category.** If you use a loss in one separate limit category (category A) to reduce the amount of income in another category or categories (category B and/or category C) and, in a later year you have income in category A, you must, in that later year, recharacterize some or all of the income from category A as income from category B and/or category C.

Do not recharacterize the tax.

**Example.** The facts are the same as in the previous example. However, in the next year you have $4,000 of passive income, $1,000 in FSC distributions, and $5,000 of general limitation income. Because $1,200 of the general limitation loss was used to reduce your passive income in the previous year, $1,200 of the current year’s general limitation income of $5,000 must be recharacterized as passive income. This makes the current year’s total passive income $5,200 ($4,000 + $1,200). Similarly, $800 of the general limitation income must be recharacterized as FSC distributions, making the current year’s total of FSC distributions $1,800 ($1,000 + $800). The total income in the general limitation category is $3,000 ($5,000 – $1,200 – $800).

**U.S. Losses**

Allocate any net loss from sources in the United States among the different categories of foreign income after:

1. Allocating all foreign losses as described earlier,
2. Recapturing any prior year overall foreign loss as described below, and
3. Recharacterizing foreign source income as described above.

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 over (2) the amount of taxable income you enter on Form 1116, line 17.

Recapture of Foreign Losses
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 foreign income from 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 $10,000 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 $100,000, and your share of its expenses is $115,000. Your only foreign source income is your share of partnership income which is in the general limitation income category. You are a bona fide resident of a foreign country and you elect to exclude your foreign earned income. You exclude the maximum $80,000. You also have itemized deductions of $6,100 that are not definitely related to any item of income.

In figuring your overall foreign loss in the general limitation category for the year, you must allocate a ratable part of the $6,100 in itemized deductions to the foreign source income. You figure the ratable part of the $6,100 that is for foreign source income, based on gross income, as follows:

\[
\text{Foreign source income} = \frac{\text{Foreign source income}}{100,000} \times 6,100
\]

Therefore, your overall foreign loss for the year is $8,545, figured as follows:

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign gross income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Foreign earned income</td>
<td>$80,000</td>
</tr>
<tr>
<td>Allowed definitely related expenses ($20,000 + $15,000)</td>
<td>$105,000</td>
</tr>
<tr>
<td>Ratable part of itemized deductions</td>
<td>5,945</td>
</tr>
<tr>
<td>Overall foreign loss</td>
<td>$8,545</td>
</tr>
</tbody>
</table>

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 smallest of:

1. The balance in the applicable overall foreign loss account,
2. 50% (or a larger percentage that you can choose) of your total foreign source taxable income for the succeeding tax year, or
3. The foreign source taxable income for the succeeding tax year which is in the same separate limit category as the loss after the allocation of foreign losses (discussed earlier).

Example. During 2004 and 2005, 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 2004, the partnership had a loss and your share was $20,000, consisting of $100,000 gross income less $120,000 expenses. Your net loss from the partnership was $4,000, after deducting the foreign earned income exclusion and definitely related allowable expenses. This loss is related to income in the general limitation category. Your U.S. dividend income was $20,000. Your itemized deductions totaled $5,000 and were not definitely related to any item of income. In figuring your taxable income for 2004, you deducted your share of the partnership loss from Country X from your U.S. source income.

During 2005, the partnership had net income from Country X. Your share of the net income was $40,000, consisting of $100,000 gross income less $60,000 expenses. Your net income from the partnership was $8,000, after deducting the foreign earned income exclusion and the definitely related allowable expenses. This is income in the general limitation category. You also received dividend income of $20,000 from U.S. sources. Your itemized deductions were $6,000, which are not definitely related to any item of income. You paid income taxes of $4,000 to Country X on your share of the partnership income.

When figuring your foreign tax credit for 2005, you must find the foreign source taxable income that you must treat as U.S. source income because of the foreign loss recapture provision. You figure the foreign taxable income that you must recapture as follows:

A. Determination of 2004 Overall Foreign Loss
1. Partnership loss from Country X . . . . $4,000
2. Add: Part of itemized deductions allocable to gross income from Country X
   $100,000 × $5,000 = $4,167
3. Overall foreign loss for 2004 . . . . $8,167

B. Amount of Recapture for 2005
1. Balance in general limitation category foreign loss account . . . . $8,167
2. Foreign source net income . . . . $8,000
   Less: Itemized deductions allocable to foreign source net income ($100,000/$120,000) × $6,000 . . . . $3,000
3. 50% of foreign source taxable income subject to recapture . . . . $1,500
4. Taxable income in general limitation category after allocation of foreign losses—
   General limitation income . . . . $8,000
   Less: Itemized deductions allocable to that income ($100,000/$120,000) × $6,000 . . . . $3,000
   General limitation taxable income less allocated foreign losses ($3,000 − 0) . . . . $3,000
5. Recapture for 2005 (smallest of (1), (3), or (4)) . . . . $1,500

The amount of the recapture is shown on line 15, Form 1116.

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 1040X.

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 before you disposed of it, the disposition generally 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. Generally, 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 fair market value 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 Recapture 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.

This rule also generally applies to a gain on the disposition of stock in a controlled foreign corporation (CFC) if you owned more than 50 percent (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.

The foreign source taxable income that you are considered to recognize is generally subject to recapture as U.S. source income in an amount equal to the lesser of:

1. Your foreign source taxable income in the same separate limit category as the overall foreign loss, or

2. 100% of your total foreign source taxable income for the year.

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 recapture. 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 by the amount of gain you are required to recapture in the overall foreign source taxable income in the overall foreign loss category and subject to recapture. 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 recapture.

**Predominant use outside United States.** Property is used predominantly outside the United States if it was owned outside the United States more than 50% of the time during the 3-year period ending on the date of disposition. If you owned 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 controlled foreign corporation (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 recaptured. 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.

**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 allow an additional credit for part of the tax imposed by the treaty partner on U.S. source income. It is separate from, and in addition to, your foreign tax credit for foreign taxes paid or accrued on foreign source income. The treaties that provide for this additional credit include those with Australia, Austria, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Portugal, Slovenia, South Africa, Sweden, Switzerland, and the United Kingdom. There is a worksheet at the end of this publication to help you figure the additional credit. But do not use this worksheet to figure the additional credit under the treaties with Australia and New Zealand. Also, do not use this worksheet for income that is in the “Income Re-Sourced By Treaty” category discussed earlier under Separate Limit Income.

You can get more information, and the worksheet to figure the additional credit under the Australia and New Zealand treaties, by writing to:

Internal Revenue Service
International Section
P.O. Box 900
Bensalem, PA 19020-8518.

You can also contact the United States Tax Attaché at the U.S. Embassies in London and Paris, as appropriate, for assistance.

**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).

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 (discussed previously).

### 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 mechanics of the carryback and carryover are illustrated by the following examples.
**Example 1.** All your foreign income is in the general limitation income category. The limit on your credit and the qualified foreign taxes paid on the income are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax Limit</th>
<th>Tax Paid</th>
<th>Unused Foreign Tax (+)</th>
<th>Excess Limit (-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>$200</td>
<td>$100</td>
<td>$100</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>$300</td>
<td>$500</td>
<td>$200</td>
<td></td>
</tr>
</tbody>
</table>

In 2005, you had unused foreign tax of $200 to carry to other years. You are considered to have paid this unused foreign tax first in 2004 (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 in the general limitation income category. In 2001, you had an unused foreign tax of $200. Because you had no foreign income in 1999 and 2000, you cannot carry back the unused foreign tax to those years. (The carryback period for unused foreign taxes arising in tax years beginning before October 23, 2004, is 2 years.) 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 limitation income for 2001–2006 are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax Limit</th>
<th>Tax Paid</th>
<th>Unused Foreign Tax (+)</th>
<th>Excess Limit (-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$600</td>
<td>$800</td>
<td>$200</td>
<td>$100</td>
</tr>
<tr>
<td>2002</td>
<td>$600</td>
<td>$700</td>
<td>$100</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>$500</td>
<td>$700</td>
<td>$200</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>$550</td>
<td>$400</td>
<td>$150</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>$800</td>
<td>$700</td>
<td>$100</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>$500</td>
<td>$550</td>
<td>$50</td>
<td></td>
</tr>
</tbody>
</table>

You cannot carry the $200 of unused foreign tax from 2001 to 2002 or 2003 because you have no excess limit in either of those years. Therefore, you carry the tax forward to 2004, 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 2001 can be carried to 2005. At this point, you have fully absorbed the unused foreign tax from 2001 and can carry it no further. You can also carry forward the unused foreign tax from 2002 and 2003.

**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 Publication 908, Bankruptcy Tax Guide.

**Time Limit on Tax Assessment.** When you carry back an unused foreign tax, IRS is given additional time to assess any tax resulting from the carryback. An assessment can be made up to the end of one 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 1040X 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 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 reverse your choice from deducting the taxes to claiming the credit. You have 10 years from the 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 2005, you paid foreign taxes of $600 on income in the general limitation income category. You have a foreign tax credit carryover of $200 from the same category from 2004. For 2005, your foreign tax credit limit is $700. If you choose to claim a credit for your foreign taxes in 2005, you would be allowed a credit of $700, consisting of $600 paid in 2005 and $100 of the $200 carried over from 2004. You will have a credit carryover to 2006 of $100, which is your unused 2004 foreign tax credit carryover.

If you choose to deduct your foreign taxes in 2005, your deduction will be limited to $600, which is the amount of taxes paid in 2005. You are not allowed a deduction for any part of the carryover from 2004. However, you must treat $100 of the credit carryover as used in 2005, because you have an unused credit limit of $100 ($700 limit minus $600 of foreign taxes paid in 2005). This reduces your carryover to later years.

If you claimed the deduction for 2005 and later decided you wanted to receive a benefit for that $100 part of the 2004 carryover, you could reverse the choice of a deduction for 2005. You would have to claim a credit for those taxes by filing an amended return for 2005 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 Husband and Wife, 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 Husband and Wife.
You must allocate the unused foreign tax or the excess excess limit for your separate income categories.

### Method of allocation.

For a tax year in which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return.

#### You and your spouse file separate returns for the current tax year (2005), to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return.

- 2004 (Joint return—Unused foreign tax year)
- 2005 (Separate return—Excess limit year)

#### You and your spouse file separate returns for the current tax year (2005), 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.

- 2004 (Joint return—Excess limit year)
- 2005 (Separate return—Excess limit year)

#### You and your spouse file a joint return for the current tax year (2005), 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.

- 2003 (Joint return—Unused foreign tax year)
- 2004 (Separate return—Excess limit year)
- 2005 (Joint return—Excess limit year)

### Allocations Between Husband and Wife

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 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.***

### 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.

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.**

2. **Apply each percentage to its category's excess limit (figured in (1)), with the foreign taxes paid or accrued for that category.**

3. **General limitation income category only**

### Example.

A Husband (H) and Wife (W) filed joint returns for 2001, 2003, and 2004, and separate returns for 2002 and 2005. Neither H nor W had any unused foreign tax or excess limit for any year before 2001. For the tax years involved, the income, unused foreign tax, excess limits, and carrybacks and carryovers are in the general limitation income category and are shown in Table 4.

W's allocated part of the unused foreign tax from 2001 ($30) is partly absorbed by her separate excess limit of $20 for 2002, and then fully absorbed by her allocated part of the joint excess limit for 2003 ($20). H's allocated part of the unused foreign tax from 2001 ($50) is fully absorbed by his allocated part of the joint excess limit ($65) for 2003.

H's separate unused foreign tax from 2002 ($25) is partly absorbed (up to $15) by his remaining excess limit in 2003, and then fully absorbed by W's remaining part of the joint excess limit for 2003 ($10). Each spouse's excess limit on the 2003 joint return is reduced by:

1. Each spouse's carryover from earlier years (W's carryover of $10 from 2001 and H's carryovers of $50 from 2001 and $15 from 2002).

### Table 4. Carryback/Carryover

<table>
<thead>
<tr>
<th>Tax year</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return</td>
<td>Joint</td>
<td>Separate</td>
<td>Joint</td>
<td>Joint</td>
<td>Separate</td>
</tr>
<tr>
<td>H's unused foreign tax to be carried back or over, or excess limit* (enclosed in parentheses)</td>
<td>$50</td>
<td>$25</td>
<td>($65)</td>
<td>$104</td>
<td>($50)</td>
</tr>
<tr>
<td>W's unused foreign tax to be carried back or over, or excess limit* (enclosed in parentheses)</td>
<td>$30</td>
<td>($20)</td>
<td>($20)</td>
<td>$69</td>
<td>($10)</td>
</tr>
<tr>
<td>Carryover absorbed:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>W's from 2001</td>
<td>20W</td>
<td>10W</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>H's from 2001</td>
<td></td>
<td></td>
<td>50H</td>
<td></td>
<td></td>
</tr>
<tr>
<td>H's from 2002</td>
<td></td>
<td></td>
<td>15H</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>10W</td>
<td></td>
<td></td>
</tr>
<tr>
<td>W's from 2004</td>
<td></td>
<td></td>
<td></td>
<td>10W</td>
<td></td>
</tr>
<tr>
<td>H's from 2004</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>50H</td>
</tr>
</tbody>
</table>

*General limitation income category only

### Allocation of the carryback and carryover.

The mechanics of the carryback and carryover, when allocations between husband and wife are needed, are illustrated by the following example.

### 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.

- 2004 (Joint return—Excess limit year)
- 2005 (Separate return—Excess limit year)
2. The other spouse’s carryover. (His carry-over of $10 from 2002 is absorbed by W's remaining excess limit.)

W’s allocated part of the unused foreign tax of $69 from 2004 is partly absorbed by her excess limit in 2005 ($10), and the remaining $59 will be a carryover to the general limitation income category for 2006 and the following 8 years unless absorbed sooner. H’s allocated part of the unused foreign tax of $104 from 2004 is partly absorbed by his excess limit in 2005 ($50), and the remaining $54 will be a carryover to 2006 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 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 Form 1040, line 47.

If you are a shareholder of a controlled foreign corporation and choose to be taxed at corporate rates on the amount you must include in gross income from that corporation, use Form 1116 to claim the credit. See Controlled foreign corporation 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. You must file a separate Form 1116 for each of the following categories of income for which you claim a foreign tax credit.

• Passive income.
• High withholding tax interest.
• Financial services income.
• Shipping income.
• Dividends from a DISC or former DISC.
• Certain distributions from an FSC or former FSC.
• Lump-sum distributions.
• Section 901(j) income.

• Income re-sourced by treaty.
• General limitation income—all other income from sources outside the United States.

A Form 1116 consists of four parts as explained next.

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 possession source income in the separate limit category for which you are completing the return. Do not include income you excluded from Form 2555 or Form 2555-EZ. From these, subtract the deductions that are definitely related to the separate limit income, and a negligible share of the deductions not definitely related to that income. If, in a separate limit category, you received foreign income from more than one foreign country or U.S. possession, complete a separate column for each.

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 on more than one foreign country or U.S. possession, complete a separate line for each.

3. Part III—Figuring the Credit. You use this part to figure the foreign tax credit that is allowable.

4. Part IV—Summary of Credits From Separate Parts III. You use this part on one Form 1116 to summarize the foreign tax credits figured on separate Form 1116.

Records To Keep
You should keep the following records in case you are later asked to verify the taxes shown on your Form 1116 or Form 1040. You do not have to attach these records to your Form 1040.

• A receipt for each foreign tax payment.
• The foreign tax return if you claim a credit for taxes accrued.
• Any payee statement (such as Form 1099-DIV or Form 1099-INT) showing foreign taxes reported to you.

The receipt or return you keep as proof should be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. If the receipt or return is in a foreign language, you also should have a certified translation of it. Revenue Ruling 97-308 in Cumulative Bulletin 1967-2 discusses in detail the requirements of the certified translation. You can buy the Cumulative Bulletin from the Government Printing Office. Issues of the Cumulative Bulletin are also available in most IRS offices and you are welcome to read them there.

Alternative Minimum Tax
In addition to your regular income tax, you may be liable for the alternative minimum tax. A foreign tax credit may be allowed in figuring this tax. See the instructions for Form 6251, Alternative Minimum Tax—Individuals, for a discussion of the alternative minimum tax foreign tax credit.

Simple Example — Filled-In Form 1116
Betsy Wilson is single, under 65, and is a U.S. citizen. She earned $21,000 working as a night auditor in Pittsburgh. She owns 200 shares in XYZ mutual fund that invests in Country Z corporation. She received a dividend of $620 from XYZ, which withheld and paid tax of $93 to Country Z on her dividend. XYZ reported this information to her on Form 1099-DIV.

Betsy elects to be exempt from the foreign tax credit limit because her only foreign taxable income is passive income (dividend of $620) and the amount of taxes paid ($93) is not more than $300. To claim the $93 as a credit, Betsy enters $93 on Form 1040, line 47. (She can claim her total taxes paid of $93 because it is less than her "regular tax," shown on Form 1040 line 44.) She does not file Form 1116. However, she cannot carry any unused foreign taxes to this tax year.

If Betsy does not elect to be exempt from the foreign tax credit limit, she will need to complete a Form 1116 as follows.

Betsy fills in her name and social security number, and checks the box for passive income.

Part I—Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)
Betsy enters the name of the foreign country in column A and shows on line 1 the amount of income ($620) and type of income (dividends) she received from XYZ. None of the dividends are qualified dividends. Next, because Betsy does not itemize her deductions, she puts her standard deduction ($5,000) on line 3a and completes 3b and 3c. Her gross foreign source income (line 3d) is $620 and gross income from all sources (line 3e) is $21,620. She enters $144 on line 6. Line 7 is $478, the difference between lines 1 and 6.

Part II—Foreign Taxes Paid or Accrued
Betsy checks the “Paid” box and enters $93 on line A, column (f) and (x), and on line B.

Because the income was reported to Betsy in U.S. dollars on Form 1099-DIV, she does not have to convert the amount shown into foreign currency. She enters "1099 taxes" on line A, column (a).

Part III—Figuring the Credit
Betsy figures her credit as shown on the completed form. The computation shows that she may take only $47 of the amount paid to Country Z as a credit against her U.S. income tax. The remaining $46 is available for a carryback and carryover.
Part IV—Summary of Credits From Separate Parts III

Because this is the only Form 1116 that Betsy must complete, she does not need to fill in lines 22 through 30 of Part IV

Comprehensive Example — Filled-In Form 1116

Robert Smith, a U.S. citizen, is a salesman who lived and worked in Country X for all of 2005, except for one week he spent in the United States on business. He is single and under 65. He is a cash-basis taxpayer who uses the calendar year as his tax year.

During the year, Robert received income from sources within Country X and the United States.

Income from United States. Robert received wages of $4,200 for services performed during the one week in the United States. He also received dividend income of $3,000 from sources within the United States. None of the dividends are qualified dividends.

Income from Country X. Robert received the following income from Country X during the year and paid tax on the income to Country X on December 31. The conversion rate throughout the year was 2 pesos to each U.S. dollar (2:1).

Income Tax

Robert enters $2,400 on line 4a, his employee business expense deduction is $672. This is the difference between his business expenses of $1,480 ($480 + $1,000 from U.S. business trip) and the 2%-of-adjusted-gross-income limit ($608).

Forms 1116

Robert must use two Forms 1116 to figure his allowable foreign tax credit. On one Form 1116, he will mark the box to the left of General limitation income. and figure his foreign tax credit on the wages of $20,000 (Country X wages minus excluded wages). On the other Form 1116, he will mark the block to the left of Passive income, and figure his foreign tax credit on his interest income of $1,000 and dividend income of $4,000.

Under the later discussions for each part on Form 1116, Robert’s computations are explained for each Form 1116 that must be completed. Both Forms 1116 are illustrated near the end of this publication.

Computation of Taxable Income

Before making any entries on Form 1116, Robert must figure his taxable income on Form 1040.

His taxable income is $22,028 figured as follows:

- **Gross Income**
  - Wages (Country X) ........... $100,000
  - Dividend income (Country X) ........... $3,000

- **Less: Foreign earned income exclusion** ........... $80,000
  - Income tax credit on foreign income (Form 1116, line 7) ........... $20,000

- **Less: Foreign earned income category (line 3d)** to his gross income from all sources.

- **Total (Adjusted gross income)** ........... $30,400

- **Less: Total Itemized Deductions** ........... $5,172
  - Taxable income before the personal exemption ........... $25,228
  - Less: Personal Exemption ........... $2,900

- **Taxable Income** ........... $22,328

On each Form 1116, Robert enters $25,228 (his taxable income before the personal exemption) on line 17 of Part III.

Part I—Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)

In figuring the limit on both Forms 1116, Robert must separately determine his taxable income from Country X (Form 1116, line 7).

Form 1116—General limitation income. On this Form 1116, Robert figures his taxable income from Country X for income in the general limitation income category only. He does not include his passive income of interest and dividends.

- **Line 1.** Robert enters the wages earned in Country X of $20,000 on line 1.

- **Line 2.** The unreimbursed employee business expenses related to these foreign source wages included in income are $480, as shown earlier. Robert must determine which part of the 2%-of-adjusted-gross-income limit ($608) is allocable to these employee business expenses. He figures this as follows:

  \[ \frac{480}{197} \times 608 = 197 \]

The denominator ($1,480) is the total allowable unreimbursed business expenses ($1,000 + $480). The amount of deductible expenses definitely related to $20,000 of taxable foreign wages is $283 ($480 – $197). He enters $283 on line 2. He attaches this explanation to his Form 1116 that he files with his tax return.

- **Line 3a–g.** Robert enters $940 on line 3a. This is his real estate tax which is not definitely related to income from any source. He does not apportion his charitable contributions to foreign source income. Robert must prorate this itemized deduction by using the ratio of gross income from Country X in the general limitation category (line 3d) to his gross income from all sources (line 3e). For this purpose, gross income from Country X and gross income from all sources include the $80,000 of wages that qualify for the foreign earned income exclusion. He figures the ratable part of deductions, $851, as follows and enters it on line 3g.

  \[ \frac{100,000}{171,420} \times 940 = 851 \]

- **Line 4a.** Robert prorates his qualified home mortgage interest, $2,900, to general limitation income as follows:
  1. Enter gross foreign source income of the type shown on Form 1116. **Do not enter income excluded on Form 2555** ........... $20,000
  2. Enter gross income from all sources. **Do not enter income excluded on Form 2555** ........... $30,400
  3. Divide line 1 by line 2 and enter the result as a decimal ........... 0.6579
  4. Enter deductible home mortgage interest (from Schedule A (Form 1040)) ........... $2,900
  5. Multiply line 4 by line 3. Enter the result here and on Form 1116, line 4a ........... $1,908

Robert enters this amount, $1,908 on line 4a.
Robert uses Part II, Form 1116, to report the foreign tax paid or accrued on income from foreign sources.

Form 1116—General limitation income. On this Form 1116, Robert enters the amount of foreign taxes paid, in foreign currency and in U.S. dollars, on the wages from Country X.

Form 1116—Passive income. On this Form 1116, Robert enters the amount of foreign taxes paid in the interest and dividend income.

Part III—Figuring the Credit

Robert figures the amount of foreign tax credit in Part III on each Form 1116.

Form 1116—General limitation income. On this Form 1116, Robert figures the amount of foreign tax credit allowable for the foreign taxes paid on his wages from Country X.

Line 10. He has a carryover of $200 for unused foreign taxes paid in 2004 and enters that amount on line 10. He attaches a schedule showing how he figured his $200 carryover to 2005 after carrying back the unused $350 tax in 2004 to the 2 preceding tax years. (This schedule is shown in Table 5.) The unused foreign tax in 2004 and the excess limits in 2002 and 2003 are in the general limitation income category. The unused foreign tax of $200 is carried over to the general limitation income category in 2005.

Note. The carryback period for unused foreign taxes arising in tax years beginning before October 23, 2002 is 2 years.

Line 12. On line 12, Robert must reduce the total foreign taxes paid by the amount related to the wages he excludes as foreign earned income. To do this, he multiplies the $27,400 foreign tax he paid on his wages by a fraction. The numerator of the fraction is his foreign earned income exclusion ($80,000) minus his definitely related business expenses ($2,400). The denominator of the fraction is his total foreign wages ($100,000) minus his definitely related business expenses ($2,400).

$27,400 × $80,000 – $2,400 = $21,920

He enters the result, $21,920, on line 12.

Line 13. His total foreign taxes available for credit are $5,680 ($200 carryover from 2004 + $5,480 paid in 2005 ($27,400 – $21,920)).

Robert now determines if he has any unused foreign taxes of $3,504 ($5,480 – $1,976), shown on line 33. He also enters this amount on Form 1040, line 47.

Part IV—Summary of Credits From Separate Parts III

Robert summarizes his foreign tax credits for the two types of income on Part IV of Form 1116. He uses the Form IV of Form 1116—General limitation income.

Robert leaves line 32 blank because he did not participate in or cooperate with an international boycott during the tax year. The allowable foreign tax credit is $2,476 ($500 + $1,976), shown on line 33. He also enters this amount on Form 1040, line 47.

Unused Foreign Taxes

Robert now determines if he has any unused foreign taxes that can be used as a carryback or carryover to other tax years.

General limitation income. Robert has 2005 unused foreign taxes of $5,504 ($5,480 – $1,976) and $200 of 2004 unused foreign taxes available as a carryover to 2006 and later years. (The foreign taxes related to his foreign earned income exclusion are not available for carryover.) He cannot carry back any part of the 2005 unused taxes to 2004 as shown in Table 5.

Passive income. Because the foreign tax Robert paid on his interest and dividend income is less than the amount for which he could have claimed a credit in 2005 under the limit for this separate income category, he has no unused foreign tax and therefore no carryback or carryover to other tax years.

<table>
<thead>
<tr>
<th>Table 5. Robert’s Schedule Showing Computation of His Carryover</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>Maximum credit allowable under limit</td>
</tr>
<tr>
<td>Foreign tax paid in tax year</td>
</tr>
<tr>
<td>Unused foreign tax (+) to be carried over or excess of limit (-) over tax</td>
</tr>
<tr>
<td>Tax credit carried back from 2004</td>
</tr>
<tr>
<td>Net excess tax to be carried over to 2005</td>
</tr>
<tr>
<td>Less carrybacks to 2002 and 2003</td>
</tr>
<tr>
<td>Amount carried over to 2005</td>
</tr>
</tbody>
</table>

The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.
### Part I: Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)

<table>
<thead>
<tr>
<th>Foreign Country or U.S. Possession</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country Z</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Deductions and losses (Caution: See pages 13 and 14 of the instructions):**

2. Expenses definitely related to the income on line 1 (attach statement).

3. Pro rata share of other deductions not definitely related:
   - Certain itemized deductions or standard deduction (see instructions).
   - Other deductions (attach statement).
   
   4. Pro rata share of interest expense (see instructions):
      - Home mortgage interest (use worksheet on page 13 of the instructions).
      - Other interest expense.

5. Losses from foreign sources.

6. Add lines 2, 3a, 3b, 4a, 4b, and 5.

7. Subtract line 6 from line 1. Enter the result here and on line 14, page 2.

### Part II: Foreign Taxes Paid or Accrued (see page 14 of the instructions)

- **Foreign taxes paid or accrued**
  - Credits claimed in foreign currency: Tax withheld at source on:
    - Dividends
    - Rents and royalties
    - Interest
  - Taxes withheld at source on:
    - Dividends
    - Rents and royalties
    - Interest
  - Other foreign taxes paid or accrued
  - Total foreign taxes paid or accrued added cols. (m) through (w)

<table>
<thead>
<tr>
<th>Country</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>1099 Taxes</td>
<td>93</td>
<td>93</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

8. Add lines A through C, column (x). Enter the total here and on line 9, page 2.
### Form 1116 (2005) Page 26

#### Part III  | Figuring the Credit
---|---
9 | Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I.  
9 | 93
10 | Carryback or carryover (attach detailed computation).  
10 | -0-
11 | Add lines 9 and 10.  
11 | 93
12 | Reduction in foreign taxes (see page 15 of the instructions).  
12 | -0-
13 | Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit.  
13 | 93
14 | Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I (see page 15 of the instructions).  
14 | 476
15 | Adjustments to line 14 (see page 16 of the instructions).  
15 | -0-
16 | Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.)  
16 | 476
17 | Caution: If you figured your tax using the lower rates on qualified dividends or capital gains, see page 17 of the instructions.

#### Part IV  | Summary of Credits From Separate Parts III (see page 18 of the instructions)
---|---
22 | Credit for taxes on passive income.  
22 |
23 | Credit for taxes on high withholding tax interest.  
23 |
24 | Credit for taxes on financial services income.  
24 |
25 | Credit for taxes on shipping income.  
25 |
26 | Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC.  
26 |
27 | Credit for taxes on lump-sum distributions.  
27 |
28 | Credit for taxes on certain income re-sourced by treaty.  
28 |
29 | Credit for taxes on general limitation income.  
29 |
30 | Add lines 22 through 29.  
30 |
31 | Enter the smaller of line 19 or line 30.  
31 | 47
32 | Reduction of credit for international boycott operations. See instructions for line 12 on page 15.  
32 |
33 | Subtract line 32 from line 31. This is your foreign tax credit. Enter here and on Form 1040, line 47; Form 1040NR, line 44; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a.  
33 | 47

---

*Caution:* If you are completing line 19 for separate category (lump-sum distributions), see page 18 of the instructions.
Form 1116
Foreign Tax Credit
(Individual, Estate, or Trust)

Use a separate Form 1116 for each category of income listed below. See Categories of Income on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>Passive income</td>
</tr>
<tr>
<td>b</td>
<td>High withholding tax interest</td>
</tr>
<tr>
<td>c</td>
<td>Financial services income</td>
</tr>
<tr>
<td>d</td>
<td>Shipping income</td>
</tr>
<tr>
<td>e</td>
<td>Dividends from a DISC or former DISC</td>
</tr>
<tr>
<td>f</td>
<td>Certain distributions from a foreign sales corporation (FSC) or former FSC</td>
</tr>
<tr>
<td>g</td>
<td>Lump-sum distributions</td>
</tr>
<tr>
<td>h</td>
<td>Section 901(j) income</td>
</tr>
<tr>
<td>i</td>
<td>Certain income re-sourced by treaty</td>
</tr>
<tr>
<td>j</td>
<td>General limitation income</td>
</tr>
</tbody>
</table>

k | Resident of (name of country) | Country X |

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)

<table>
<thead>
<tr>
<th>Country Foreign Country or U.S. Possession</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enter the name of the foreign country or U.S. possession</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>20,000</td>
<td>1</td>
<td>20,000</td>
<td></td>
</tr>
</tbody>
</table>

Deductions and losses (Caution: See pages 13 and 14 of the instructions):

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Expenses definitely related to the income on line 1 (attach statement)</td>
</tr>
<tr>
<td>3</td>
<td>Pro rata share of other deductions not definitely related:</td>
</tr>
<tr>
<td>a</td>
<td>Certain itemized deductions or standard deduction (see instructions)</td>
</tr>
<tr>
<td>b</td>
<td>Other deductions (attach statement)</td>
</tr>
<tr>
<td>c</td>
<td>Add lines 3a and 3b</td>
</tr>
<tr>
<td>d</td>
<td>Gross foreign source income (see instructions)</td>
</tr>
<tr>
<td>e</td>
<td>Gross income from all sources (see instructions)</td>
</tr>
<tr>
<td>f</td>
<td>Divide line 3d by line 3e</td>
</tr>
<tr>
<td>g</td>
<td>Multiply line 3c by line 3f</td>
</tr>
<tr>
<td>4</td>
<td>Pro rata share of interest expense (see instructions):</td>
</tr>
<tr>
<td>a</td>
<td>Home mortgage interest (use worksheet on page 13 of the instructions)</td>
</tr>
<tr>
<td>b</td>
<td>Other interest expense</td>
</tr>
<tr>
<td>5</td>
<td>Losses from foreign sources</td>
</tr>
<tr>
<td>6</td>
<td>Add lines 2 through 5</td>
</tr>
<tr>
<td>7</td>
<td>Subtract line 6 from line 1. Enter the result here and on line 14, page 2</td>
</tr>
</tbody>
</table>

Part II
Foreign Taxes Paid or Accrued (see page 14 of the instructions)

<table>
<thead>
<tr>
<th>Country</th>
<th>Foreign Tax paid or accrued</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>12-31-05</td>
</tr>
<tr>
<td>B</td>
<td>54,200</td>
</tr>
<tr>
<td>C</td>
<td>27,400</td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see page 18 of the instructions.
## Figuring the Credit

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I</td>
<td>27,400</td>
</tr>
<tr>
<td>10</td>
<td>Carryback or carryover (attach detailed computation)</td>
<td>200</td>
</tr>
<tr>
<td>11</td>
<td>Add lines 9 and 10</td>
<td>27,600</td>
</tr>
<tr>
<td>12</td>
<td>Reduction in foreign taxes (see page 15 of the instructions)</td>
<td>21,920</td>
</tr>
<tr>
<td>13</td>
<td>Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit</td>
<td>5,680</td>
</tr>
<tr>
<td>14</td>
<td>Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I</td>
<td>16,958</td>
</tr>
<tr>
<td>15</td>
<td>Adjustments to line 14 (see page 16 of the instructions)</td>
<td>0</td>
</tr>
<tr>
<td>16</td>
<td>Combine the amounts on lines 14 and 15. This is your net foreign source taxable income (if the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I). Skip lines 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.</td>
<td>25,228</td>
</tr>
</tbody>
</table>

**Part III Summary of Credits From Separate Parts III (see page 18 of the instructions)**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>Credit for taxes on passive income</td>
<td>500</td>
</tr>
<tr>
<td>23</td>
<td>Credit for taxes on high withholding tax interest</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Credit for taxes on financial services income</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Credit for taxes on shipping income</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC</td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Credit for taxes on lump-sum distributions</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Credit for taxes on certain income re-sourced by treaty</td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>Credit for taxes on general limitation income</td>
<td>1,376</td>
</tr>
<tr>
<td>30</td>
<td>Add lines 22 through 29</td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>Enter the smaller of line 19 or line 30</td>
<td></td>
</tr>
<tr>
<td>32</td>
<td>Reduction of credit for international boycott operations. See instructions for line 12 on page 15</td>
<td></td>
</tr>
<tr>
<td>33</td>
<td>Subtract line 32 from line 31. This is your foreign tax credit. Enter here and on Form 1040, line 47; Form 1040NR, line 44; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a</td>
<td>2,476</td>
</tr>
</tbody>
</table>

**Caution:** If you figured your tax using the lower rates on qualified dividends or capital gains, see page 17 of the instructions.

**Caution:** If you are completing line 19 for separate category g (lump-sum distributions), see page 18 of the instructions.

Form 1116 (2005)
Form 1116

Foreign Tax Credit

(Individual, Estate, or Trust)

Use a separate Form 1116 for each category of income listed below. See Categories of Income on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

| a | Passive income |
| b | High withholding tax interest |
| c | Financial services income |
| d | Shipping income |
| e | Dividends from a DISC or former DISC |
| f | Certain distributions from a foreign sales corporation (FSC) or former FSC |
| g | Lump-sum distributions |
| h | Section 901(j) income |
| i | Certain income re-sourced by treaty |
| j | General limitation income |

**Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)**

<table>
<thead>
<tr>
<th>Foreign Country or U.S. Possession</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(Add cols. A, B, and C.)</td>
</tr>
<tr>
<td>1 Gross income from sources within country shown above and of the type checked above (see page 13 of the instructions):</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend interest:</td>
<td></td>
<td></td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5,000</td>
</tr>
</tbody>
</table>

Deductions and losses (Caution: See pages 13 and 14 of the instructions):

| Expenses definitely related to the income on line 1 (attach statement): |   |
| Pro rata share of other deductions not definitely related: |
| Certain itemized deductions or standard deduction (see instructions): |   |
| Other deductions (attach statement): | 940 |
| Add lines 3a and 3b: | 940 |
| Gross foreign source income (see instructions): | 5,000 |
| Gross income from all sources (see instructions): | 10,400 |
| Multiply line 3c by line 3f: | 0.0435 |
| 4 Pro rata share of interest expense (see instructions): |
| Home mortgage interest (use worksheet on page 13 of the instructions): | 477 |
| Other interest expense: |   |
| Add lines 2, 3g, 4a, 4b, and 5: | 520 |

Part II Foreign Taxes Paid or Accrued (see page 14 of the instructions)

<table>
<thead>
<tr>
<th>Country</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>d</th>
<th>e</th>
<th>f</th>
<th>g</th>
<th>h</th>
<th>i</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>12-31-05</td>
<td>300</td>
<td>100</td>
<td>450</td>
<td>50</td>
<td>500</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Add lines A through C, column (a). Enter the total here and on line 9, page 2.
## Form 1116 (2005) Page 2

### Part III Figuring the Credit

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I.</td>
<td>500</td>
</tr>
<tr>
<td>10</td>
<td>Carryback or carryover (attach detailed computation).</td>
<td>-0-</td>
</tr>
<tr>
<td>11</td>
<td>Add lines 9 and 10.</td>
<td>500</td>
</tr>
<tr>
<td>12</td>
<td>Reduction in foreign taxes (see page 15 of the instructions).</td>
<td>-0-</td>
</tr>
<tr>
<td>13</td>
<td>Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit.</td>
<td>500</td>
</tr>
<tr>
<td>14</td>
<td>Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I (see page 15 of the instructions).</td>
<td>4,480</td>
</tr>
<tr>
<td>15</td>
<td>Adjustments to line 14 (see page 16 of the instructions).</td>
<td>-0-</td>
</tr>
<tr>
<td>16</td>
<td>Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.</td>
<td>4,480</td>
</tr>
<tr>
<td>17</td>
<td>Caution: If you figured your tax using the lower rates on qualified dividends or capital gains, see page 17 of the instructions.</td>
<td>25,228</td>
</tr>
<tr>
<td>18</td>
<td>Divide line 16 by line 17. If line 16 is more than line 17, enter “1”.</td>
<td>1776</td>
</tr>
<tr>
<td>19</td>
<td>Caution: If you are completing line 19 for separate category (lump-sum distributions), see page 18 of the instructions.</td>
<td>2,333</td>
</tr>
<tr>
<td>20</td>
<td>Multiply line 18 by line 19 (maximum amount of credit).</td>
<td>522</td>
</tr>
<tr>
<td>21</td>
<td>Enter the smaller of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 18 of the instructions).</td>
<td>500</td>
</tr>
</tbody>
</table>

### Part IV Summary of Credits From Separate Parts III (see page 18 of the instructions)

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>Credit for taxes on passive income</td>
</tr>
<tr>
<td>23</td>
<td>Credit for taxes on high withholding tax interest</td>
</tr>
<tr>
<td>24</td>
<td>Credit for taxes on financial services income</td>
</tr>
<tr>
<td>25</td>
<td>Credit for taxes on shipping income</td>
</tr>
<tr>
<td>26</td>
<td>Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC</td>
</tr>
<tr>
<td>27</td>
<td>Credit for taxes on lump-sum distributions</td>
</tr>
<tr>
<td>28</td>
<td>Credit for taxes on certain income re-sourced by treaty</td>
</tr>
<tr>
<td>29</td>
<td>Credit for taxes on general limitation income</td>
</tr>
<tr>
<td>30</td>
<td>Add lines 22 through 29</td>
</tr>
<tr>
<td>31</td>
<td>Enter the smaller of line 19 or line 30</td>
</tr>
<tr>
<td>32</td>
<td>Reduction of credit for international boycott operations. See instructions for line 12 on page 15.</td>
</tr>
<tr>
<td>33</td>
<td>Subtract line 32 from line 31. This is your foreign tax credit. Enter here and on Form 1040, line 47; Form 1040NR, line 44; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a.</td>
</tr>
</tbody>
</table>
How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that result from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:
- Call the Taxpayer Advocate toll free at 1-877-777-4778.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call 1-800-829-4059 if you are a TTY/TDD user.

For more information, see Publication 1546, How To Get Help With Unresolved Tax Problems (now available in Chinese, Korean, Russian, and Vietnamese, in addition to English and Spanish).

Free tax services. To find out what services are available, get Publication 910, IRS Guide to Free Tax Services. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Internet. You can access the IRS website 24 hours a day, 7 days a week, at www.irs.gov to:
- E-file your return. Find out about commercial tax preparation and e-file services available free to eligible taxpayers.
- Check the status of your 2005 refund. Click on Where's My Refund. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2005 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using our Form W-4 calculator.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.
- Ordering forms, instructions, and publications. Call 1-800-829-3676 to order current-year forms, instructions, and publications and prior-year forms and instructions. You should receive your order within 10 days.
- Asking tax questions. Call the IRS with your tax questions at 1-800-829-1040.
- Solving problems. You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.
- TTY/TDD equipment. If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- TeleTax topics. Call 1-800-829-4477 and press 2 to listen to pre-recorded messages covering various tax topics.
- Order IRS products online.
- Request adjustments to your tax account. A CD that is released twice so you have 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2005 tax return available because you will need to know your social security number, your filing status, and the exact whole dollar amount of your refund.
- Evaluate the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.
- Products. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- Services. You can walk in to your local Taxpayer Assistance Center every business day for personal, face-to-face tax help. An employee can explain IRS letters, request adjustments to your tax account, or help you set up a payment plan. If you need to resolve a tax problem, have questions about how the tax law applies to your individual tax return, or you’re more comfortable talking with someone in person, visit your local Taxpayer Assistance Center where you can spread out your records and talk with an IRS representative face-to-face. No appointment is necessary, but if you prefer, you can call the local Center and leave a message requesting an appointment to resolve a tax account issue. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.
- Mail. You can send your order for forms, instructions, and publications to the address below and receive a response within 10 business days after your request is received.

National Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903

CD-ROM for tax products. You can order Publication 1796, IRS Tax Products CD-ROM, and obtain:
- A CD that is released twice so you have the latest products. The first release ships in late December and the final re-release ships in late February.
- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Tax law frequently asked questions (FAQs).
- Tax Topics from the IRS telephone response system.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
Buy the CD-ROM from National Technical Information Service (NTIS) at www.ntis.gov/or call 1-877-233-6767 toll free to buy the CD-ROM for $25 (plus a $5 handling fee).

CD-ROM for small businesses. Publication 3207, The Small Business Resource Guide CD-ROM for 2005, has a new look and enhanced navigation features. This year’s CD includes:
- Helpful information, such as how to prepare a business plan, find financing for your business, and much more.
• All the business tax forms, instructions, and publications needed to successfully manage a business.
• Tax law changes for 2005.
• IRS Tax Map to help you find forms, instructions, and publications by searching on a keyword or topic.

• Web links to various government agencies, business associations, and IRS organizations.
• “Rate the Product” survey—your opportunity to suggest changes for future editions.

An updated version of this CD is available each year in early April. You can get a free copy by calling 1-800-829-3676 or by visiting www.irs.gov/smallbiz.
Worksheet.  **Additional Foreign Tax Credit on U.S. income**

**I. U.S. tax on U.S. source income**

<table>
<thead>
<tr>
<th>(U.S. source rules)</th>
<th>COL. A</th>
<th>COL. B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Dividends</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Interest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Royalties</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Capital gain</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Gross earned income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Allocable employee business expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Net compensation. Subtract line 5b from line 5a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Gross rent, real property</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Direct expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Net rent. Subtract line 6b from line 6a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Add lines 1–5a, 6a and 7 in columns A and lines 1–4, 5c, 6c and 7 in column B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Enter tax from Form 1040 (see instructions)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Enter adjusted gross income (AGI) from line 37, Form 1040</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Divide line 9 by line 10. Enter the result as a decimal. This is the average tax rate on your AGI.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Multiply line 11 by line 8 (column B). This is your estimated U.S. tax on your U.S. source income</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**II. Tax at source allowable under treaty**

**A. Items fully taxable by U.S.**

| 13. a. Identify | |
| b. Multiply line 13a by line 11 | |

**B. Items partly taxable by U.S.**

| 14. a. Identify | |
| b. Treaty rate | |
| c. Allowable tax at source (Multiply line 14a by 14b) | |

| 15. a. Identify | |
| b. Treaty rate | |
| c. Allowable tax at source (Multiply line 15a by 15b) | |

| 16. Total (Add line 13b, 14c, and 15c) | |

**C. Identify each item of U.S. source income from Col. A, Step I, on which the U.S. may not, under treaty, tax residents of the other country who are not U.S. citizens**

**III. Additional credit**

| 17. Residence country tax on U.S. source income before foreign tax credit | |
| 18. Foreign tax credit allowed by residence country for U.S. income tax paid | |
| 19. Maximum credit. Subtract the greater of line 16 or line 18 from line 12 | |
| 20. a. Enter the amount from line 17 | |
| b. Enter the greater of line 16 or line 18 | |
| c. Subtract line 20b from line 20a | |
| 21. Additional credit. Enter the smaller of line 19 or line 20c. Add this amount to line 33 of Part IV Form 1116 | |

*See the discussion on Tax Treaties for information on when you should use this worksheet.*
Worksheet Instructions. **Additional Foreign Tax Credit on U.S. Income**

<table>
<thead>
<tr>
<th><strong>STEP I</strong></th>
<th>Figure the estimated tax on U.S. source income using U.S. source rules.</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Lines 1 – 7 —</td>
<td>Enter the gross amount for each type of income in Column A, and the net amount in column B.</td>
<td></td>
</tr>
<tr>
<td>Line 9 —</td>
<td>Enter the amount from Form 1040, line 44.</td>
<td></td>
</tr>
</tbody>
</table>

| **STEP II** | Determine the amount of tax that the United States is allowed to collect at source under the treaty on income of residents of the other country who are not U.S. citizens. |  |
| PART A — | Income fully taxable by the United States. Identify the type and amount on line 13a. |  |
| PART B — | Income for which treaty limits U.S. tax at source. |  |
| Lines 14 – 15 — | Identify each type and amount of income. Use the specified treaty rate. (See Publication 901, U.S. Tax Treaties.) |  |
| PART C — | Identify the items not taxable at source by the United States under the treaty. |  |

| **STEP III** | Figure the amount of the additional credit for foreign taxes paid or accrued on U.S. source income. The additional credit is limited to the difference between the estimated U.S. tax (Step 1) and the greater of the allowable U.S. tax at source (Step II) or the foreign tax credit allowed by the residence country (line 18). |  |
| Line 17 — | Enter the amount of the residence country tax on your U.S. source income before reduction for foreign tax credits. If possible, use the fraction of the pre-credit residence country tax which U.S. source taxable income bears to total taxable income. Otherwise, report that fraction of the pre-credit foreign tax which gross U.S. income bears to total gross income for foreign tax purposes. |  |
| Line 21 — | This amount may be claimed as a foreign tax credit on Form 1116. Complete Form 1116 according to the instructions. Add the additional credit to line 33, Part IV, of Form 1116 and report that total on your Form 1040. File this worksheet with your Form 1040 as an attachment to Form 1116. |  |
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To help us develop a more useful index, please let us know if you have ideas for index entries. See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

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