What’s New for 2007

Income categories eliminated. The following categories of income have been eliminated for purposes of computing the foreign tax credit limit. Income that previously fell in these categories is either passive category income or general category income.

- High withholding tax interest.
- Financial services income.
- Shipping income.
- Dividends from a domestic international sales corporation (DISC) or former DISC.
- Certain distributions from a foreign sales corporation (FSC) or former FSC.

High withholding tax interest and shipping income are passive category income or general category income depending on the circumstances. Financial services income is general category income if you are predominantly engaged in the active conduct of a banking, insurance, financing or similar business. Dividends from a DISC or former DISC, and certain distributions from a former FSC, are passive category income.

See Separate Limit Income under How To Figure the Credit.

Carryforward and carryback of unused foreign taxes. Special rules apply to carrybacks of unused foreign taxes to 2006 and carryforwards of unused foreign taxes to 2007 and later years. See Special rules for carryforwards and carrybacks of pre-2007 and post-2006 unused foreign taxes under Carryback and Carryover.

Recharacterization of overall domestic loss. If you have an overall domestic loss for any tax
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 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.

Separate income categories have changed. See Allocation of Foreign and U.S. Losses.

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.

Photographs of missing children.

The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

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 choose to claim the taxes as an itemized deduction, use Schedule A (Form 1040), Itemized Deductions.

You can choose to take a credit for qualified foreign taxes 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, or
You paid taxes in connection with the purchase or sale of oil or gas.

For more information on these items, see the instructions for Schedule A (Form 1040).

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 on property foreign real property taxes, do not qualify.

Example 1. In February 2007, you file an amended return for the year your choice is to be effective.

Example 2. In 2007, 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 $56,000 of income from U.S. sources. You are able to deduct the foreign tax on your U.S. return, your taxable income is $48,700 ($5,000 + $56,000 − $3,500), and your tax is $8,605.

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.

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 2007, you file an amended return for tax year 1996 choosing to take a credit for your 1996 foreign taxes because you now realize that amount of foreign tax due is finally determined.

Accrual method of accounting.

If you use an accrual method of accounting, you can claim the credit in the year you earn the foreign income and the 10-year period for changing the choice for 1994 and 1995 has passed, you cannot carry the unused 1996 foreign taxes back to tax years 1994 and 1995.

Because the 10-year periods have not passed for your 1997 through 2001 income tax returns, you can still choose to carry forward any unused 1996 foreign taxes. However, you must reduce the unused 1996 foreign taxes that you carry forward by the amount that would have been allowed as a carryback if you had timely carried back the foreign tax to tax years 1994 and 1995.

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. See Foreign Earned Income and Housing Exclusions under Foreign Taxes for Which You Cannot Take a Credit, later.

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 2007, 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 $3,400 exemptions. You had to pay $2,000 in foreign income taxes on the dividend income.

If you take the credit instead, your itemized deductions are only $13,000. Your taxable income in that year is $56,200 and your tax is $7,951.

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 guarantee 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 credit 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 you pay or accrue in foreign currency. 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, fluctuations in the value of the foreign currency relative to the U.S. dollar will affect the foreign tax credit.

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 qualified business unit is a separate and clearly identified unit of a trade or business 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 dollars.
- 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 environment in which the business activities are 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 recompute 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, 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 currency 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. Make the election by attaching a statement to the applicable 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 currency.

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 required 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:

- You made an overpayment of foreign taxes.
- You receive a refund of foreign taxes paid, or
- There is a change in the dollar amount of your foreign tax credit because of differences 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 required.

A redetermination is not required if the change is due solely to an exchange rate fluctuation 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 any of the following conditions apply.

1. The accrued taxes when paid differ from the amounts 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.

If this applies to you, you must reduce the credit previously claimed by the amount of the unpaid taxes. You will not be allowed a credit for the unpaid taxes until you 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 exchange for foreign taxes paid, earlier, Under Foreign Currency and Exchange Rates.

3. The foreign taxes you paid are refunded in whole or in part.

4. For taxes taken into account when accrued but translated into dollars on the date of payment, the dollar value of the accrued tax differs from the dollar value of the tax paid because of fluctuations in the exchange rate between the date of accrual and the date of payment. However, no redetermination is required if the change in foreign tax liability for each foreign country is less than the smaller of:
   a. $10,000, or
   b. 2% of the total dollar amount of the foreign tax initially accrued for that foreign country for the U.S. tax year.

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

Notice to the Internal Revenue Service (IRS) of Redetermination

The notification requirements discussed here apply to foreign tax redeterminations occurring in:

1. 2008 and later tax years.
2. 2005, 2006, and 2007 if:
   a. The redetermination reduced the amount of foreign taxes you paid or accrued for any tax year, and
   b. As of November 7, 2007, you had not notified the IRS of the redetermination.

If you are required to notify the IRS about a redetermination of your U.S. tax liability for each tax year affected by the redetermination, you generally must file Form 1040X, Amended U.S. Individual Income Tax Return, with a revised Form 1116 and a statement that contains information sufficient for the IRS to redetermine your U.S. tax liability for the year or years affected. See Contents of statement later.

You are not required to attach Form 1116 for a tax year affected by a redetermination if:

1. The amount of your creditable taxes paid or accrued during the tax year is not more than $300 ($600 if married filing a joint return) as a result of the foreign tax redetermination, and
2. You meet the requirements listed under Exemption from foreign tax credit limit under How To Figure the Credit, later.

There are other exceptions to this requirement. They are discussed later under Due date of notification to IRS.

Contents of statement. The statement must include all of the following.

- Your name, address, and taxpayer identification number.
- The tax year or years that are affected by the foreign tax redetermination.
- The date or dates the foreign taxes were accrued, if applicable.
- The date or dates the foreign taxes were paid.
- The amount of foreign taxes paid or accrued on each date (in foreign currency) and the exchange rate used to translate each amount.
- Information sufficient to determine any interest due from or owing to you, including the amount of any interest paid to you by the foreign government and the dates received.

In the case of any foreign taxes that were not paid before the date two years after the close of the tax year to which those taxes relate, you must provide the amount of those taxes in foreign currency and the exchange rate that was used to translate that amount when initially claimed as a credit.

If any foreign tax was refunded in whole or in part, you must provide the date and amount (in foreign currency) of each refund, the exchange rate that was used to translate each amount when originally claimed as a credit, and the exchange rate for the date the refund was received (for purposes of computing foreign currency gain or loss under Internal Revenue Code section 988).

Due date of notification to IRS. If you pay less foreign tax than you originally claimed a credit for, you must file a notification by the due date (with extensions) of your original return for your tax year in which the foreign tax redetermination occurred. There is no limit on the time the IRS has to redetermine and assess the correct U.S. tax liability. 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.

Exceptions to this due date are explained in the next three paragraphs.

Redeterminations occurring in 2005, 2006, and 2007. If the redetermination occurred in 2005, 2006, or 2007, you must file the notification by the due date (with extensions) of your 2009 Form 1040 or Form 1040NR.

Multiple redeterminations of U.S. tax liability for same tax year. Where more than one foreign tax redetermination requires a redetermination of U.S. tax liability for the same tax year and those redeterminations occur in the same tax year or within two consecutive tax years, you can file for that tax year one notification (Form 1040X with a Form 1116 and the required statement) that reflects all those tax redeterminations. If you choose to file one notification, the due date for that notification is the due date of the original return (with extensions) for the year in which the first foreign tax redetermination that reduced your foreign tax liability occurred. However, foreign tax redeterminations with respect to the tax year for which a redetermination of U.S. tax liability is required may occur after the due date for providing that notification. In this situation, you may have to file more than one Form 1040X for that tax year.

Additional U.S. tax due eliminated by foreign tax credit carryback or carryover. If a foreign tax redetermination requires a redetermination of U.S. tax liability that would otherwise result in an additional amount of U.S. tax due, but the additional tax is eliminated by a carryback or carryover of an unused foreign tax, you do not have to amend your tax return for the year affected by the redetermination. Instead, you can notify the IRS by attaching a statement to the original return for the tax year in which the foreign tax redetermination occurred. You must file the statement by the due date (with extensions) of that return. The statement must show the amount of the unused foreign taxes paid or accrued and a detailed schedule showing the computation of the carryback or carryover (including the amounts carried back or over to the year for which a redetermination on U.S. tax liability is required).

Failure-to-notify penalty. If you fail to notify 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 government, 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 period. Interest also is owed from the time you receive a refund until you pay the additional tax due.

Foreign tax imposed on refund claim. If your foreign tax refund is taxed by the foreign country, you cannot take a separate credit or deduction for this additional foreign tax. However, when you refigure the foreign tax credit taken for the foreign original 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 2005, and received a foreign tax refund of $500 in 2007 on which a foreign tax of $100 was imposed. When you refigure your credit for 2005, 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
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 Impounded on You

You can claim a 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. 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. These amounts will be shown on the Schedule K-1 you receive from the partnership or 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 income 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 from that corporation, you can claim the credit based on your share of foreign income taxes paid or accrued by the controlled foreign corporation. If you make this election, you must claim the credit 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 851(b) and 956(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. You cannot claim the legal and actual foreign tax liability that you paid or accrued during the year for which you qualify.

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, 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

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.

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.

Usually, 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, or
• 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.
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 refund, credits, deductions, payments, or discharge 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 corporate income. 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 is 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 no 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 Pension, unemployment, and disability fund payments.

Economic benefits. Economic benefits include the following.

• Goods.
• Services.
• Fees or other payments.
• Rights to use, acquire, or extract resources, patents, or other property for which you do not pay for in the foreign country.
• 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 amounts paid under separate elements of a levy, write to: Internal Revenue Service International Section 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 or against income taxed 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 on foreign oil and gas extraction income.
• Taxes of U.S. persons controlling foreign corporations and partnerships.
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 tax paid or accrued on foreign earned income received or accrued during the tax year by a fraction.

The fraction of the numerator is your foreign earned income and housing amounts excluded under the foreign earned income and housing exclusions for the tax year minus the deductible expenses definitely related and properly apportioned to that income. Deductible expenses do not include the foreign housing deduction.

The denominator is your total foreign earned income and housing amounts excluded under the foreign earned income and housing exclusions for the tax year minus all deductible expenses allocable to that income (including the foreign housing deduction). If the foreign tax is foreign earned income and some other income (for example, earned income from U.S. sources or a type of income not subject to U.S. tax), and the taxes on the other income cannot be segregated, the denominator of the fraction is the total amount of income subject to the foreign tax minus deductible expenses allocable to that income.

Example. You are a U.S. citizen and a cash basis taxpayer, employed by Company X and living in Country A. Your records show the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign earned income received</td>
<td>$120,000</td>
</tr>
<tr>
<td>Unreimbursed business travel</td>
<td></td>
</tr>
<tr>
<td>expenses</td>
<td>$20,000</td>
</tr>
<tr>
<td>Income tax paid to Country A</td>
<td>$30,000</td>
</tr>
<tr>
<td>Exclusion of foreign earned income and housing allowance</td>
<td>87,225</td>
</tr>
</tbody>
</table>

Because you can exclude part of your wages, you cannot claim a credit for part of the foreign taxes. To find that part, do the following:

First, find the amount of business expenses allocable to excluded wages and therefore not deductible. To do this, multiply the otherwise deductible expenses by a fraction. That fraction is the excluded wages over your foreign earned income.

Next, find the numerator of the fraction by which you will multiply the foreign taxes paid. To do this, subtract business expenses allocable to excluded wages from foreign income taxes paid. The result is $72,225. Then, find the denominator of the fraction by subtracting all your deductible expenses from all your foreign earned income. Finally, multiply the foreign tax you paid by the resulting fraction.

Table 1. Countries Removed From the Sanction List or Granted Presidential Waiver

<table>
<thead>
<tr>
<th>Country</th>
<th>Sanction Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iraq</td>
<td>February 1, 1991 - June 27, 2004</td>
</tr>
<tr>
<td>Libya</td>
<td>January 1, 1987 - December 9, 2004</td>
</tr>
</tbody>
</table>

*Final list includes presidential waiver granted for qualified income taxes arising after December 9, 2004.*

Taxes on Income From Puerto Rico Exempt From U.S. Tax

If you have income from Puerto Rican sources that is not taxable, you must reduce your foreign taxes paid or accrued by the tax allocable to the exempt income. For information on figuring the reduction, see Publication 570.

Possession Exclusion

If you are a bona fide resident of American Samoa and 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 you pay on qualifying foreign trade income excluded on Form 8873, Extraterritorial Income Exclusion. However, see Internal Revenue Code section 943(d) for an exception for certain withholding taxes.

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 Secretary of State has designated the country as one that repeatedly provides support for acts of international terrorism.
- 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 2007. Income taxes paid or accrued to these countries in 2007 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 a separate 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 un-
til August, when you were transferred to Italy. You paid taxes to each country on the income earned in that country. You cannot claim a for-
eign tax credit for the foreign 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 sanc-
tion 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 distribution 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 non-sanctioned 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 pe-
tiod 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.

Number of nonsanctioned days in year.

Number of days in year.

Example. You are a calendar year filer and received $20,000 of income from Country X in 2007 on which you paid tax of $4,500. Sanctions against Country X ended on July 11, 2007. You are unable to determine how much of the in-
come or tax is for the non-sanctioned period. Because your tax year starts on January 1, and the Country X sanction ended on July 11, 2007, 173 days of your tax year are in the nonsan-
c tioned period. You would compute the income for the non-sanctioned period as follows:

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

You would figure the tax for the non-sanctioned period as follows:

\[
\frac{173}{365} \times \$4,500 = \$2,133
\]

To figure your foreign tax credit, you would use $9,479 as the income from Country X and $2,133 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 Imposed on Certain Dividends

You cannot claim a foreign tax credit for with-
holding 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.

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 31-day period that begins 45 days before the ex-dividend date. If the dividend period is not for 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.

Withholding tax. For this purpose, withhold-
ing 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 divi-
dend on this stock because you owned it on the ex-dividend date of November 5. To claim the credit, you must have held the stock for at least 16 days within the 31-day period that began on October 21 (15 days before the ex-dividend date). Because you held the stock for 16 days, from November 4 until November 19, you are entitled to the credit.

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 are a securities dealer who actively conducts business in a foreign country, you may be able to claim a foreign tax credit for qualified taxes withheld on foreign oil and gas extraction income (discussed later). For any part of the mineral income.

Example. The 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.

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, withhold-
ing 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.

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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 31-day period that begins 45 days before the ex-dividend date. If the dividend period is not for 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.

Withholding tax. For this purpose, withhold-
ing 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 for dealers. If you are a dealer in property who actively conducts business in a foreign country, you may be able to claim a foreign tax credit for qualified taxes withheld on income or gain from that property regardless of how long you held it or whether you have to make related payments on position in similar or related property. See section 901(l)(2) of the Internal Revenue Code for more information.

Taxes on Foreign Mineral 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 deduc-

Taxes on Foreign Mineral Income

You must reduce any taxes paid or accrued to a foreign country or possession on mineral in-
come from that country or possession if you were allowed a deduction for percentage deple-
tion 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-
ees 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-
lished by the Department of the Treasury. As of
December 2007, the following countries are listed.

• Kuwait.
• Lebanon.
• Libya.
• Qatar.
• Saudi Arabia.
• Syria.
• United Arab Emirates.
• Republic of Yemen.

Iraq is not included in this list, but its status with
respect to future lists remains under review by
the Department of Treasury.

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-
ocotting country or with the government, a com-
pany, or a 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. See the Instructions for Form 5713 for
information on when and where to file the form.

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
liability (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
ended with or within your tax year, you may have
to file an annual information return. If you do not
file the required information return, you may
have to 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 Cor-
porations. Under this rule, you generally 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-
ratio.

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 informa-

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 no
more than 90 days after the day on which notice of the
failure to furnish the information is mailed.

If you fail 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 or 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-

gain 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 category income.

Passive category income is defined later
under Separate Limit Income. However,
for purposes of this rule, high taxed in-
come and export financing interest are
also passive category income.

• 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 on 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 category income.
- General category income.
- Section 901(j) income.
- Certain income re-sourced by treaty.
- Any lump sum distribution from an employer benefit plan for which the special averaging treatment is used to determine your tax.

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 in each 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 Category Income
Passive category income consists of passive income and specified passive category income.

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 the sale of non-income-producing investment property or property that generates passive income.
- 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 if the Internal Revenue Code (relating to certain passive foreign investment companies).

If you receive foreign source distributions from a mutual fund or other regulated investment company that elects to pass through to you the foreign tax credit, the income is generally considered passive. The mutual fund will provide you with a Form 1099-DIV or substitute 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 of 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 fair market 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 passive category income into general category income. See Regulations section 1.904-4(c) for more information.

Specified passive category income. Specified passive income consists of:
1. Dividends from a DISC (domestic international sales corporation) or former DISC to the extent the dividends are treated as foreign source income, and
2. Distributions from a former FSC (foreign sales corporation) out of earnings and profits that are attributable to:
   a. Foreign trade income, or
   b. Interest and carrying charges derived from a transaction that results in foreign trade income.

General Category Income
General category income includes income from sources outside the United States that is not passive category income or does not fall into one of the other separate limit categories discussed later. It generally includes active business income and wages, salaries, and overseas allowances of an individual as an employee. General category income includes high-taxed income that would otherwise be passive income. See High-taxed income earlier under What is not passive income.

Financial services income. In general, financial services income is treated as general category income if it is derived by a financial services entity. You are a financial services entity if you are predominantly engaged in the active conduct of a banking, insurance, financing, or similar business for any taxable year. Financial services income of a financial services entity generally includes income derived in the active conduct of a banking, financing, insurance or similar business. Financial services income of a financial services entity also includes passive income and certain incidental income.

If you qualify as a financial services entity because you treat certain items of income as active financing income under Regulations section 1.904-4(c)(2)(i)(Y), you must show the type and amount of each item on an attachment to Form 1116.

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 Remzed Deduction, earlier.

Certain 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 source.
- Certain gains (section 865(h)).
Certain income from a U.S.-owned foreign corporation (section 904(h)(10)). See Reg-ulation 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.

**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 8972, Tax on Lump-Sum Distributions.

**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 items of income on your foreign return. You also have deductions of $4,400, that, under foreign 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 net 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 category income) as follows.

\[
\text{Net wages} = \frac{\text{Wages}}{\text{Total net income}} \times \text{Total net income} = \frac{\$80,000}{\$78,600} \times \$78,600 = \$80,000 - \$4,400 = \$75,600
\]

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

\[
\text{Net interest} = \frac{\text{Interest}}{\text{Total net income}} \times \text{Total net income} = \frac{\$3,000}{\$78,600} \times \$78,600 = \$3,000 - \$159 = \$2,841
\]

**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 2007 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 personal exemptions. This is the amount shown on line 41 of Form 1040. Then for each category of income, you must figure your taxable income from sources outside the United States.

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.

**Determining the Source of Compensation for Labor or Personal Services**

If you are an employee and receive compensa-tion for labor or personal services performed both inside and outside the United States, spe-cial rules apply in determining the source of the income.

**Determining the Source of Income From the Sale of Certain Personal Property**

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compensation. Compensation (other than cer-
tain fringe benefits) is sourced on a time basis. Certain fringe benefits (such as housing and education) are sourced on a geographical basis.

Or, you may be permitted to use an alterna-
tive basis to determine the source of compensa-
tion. See Alternative basis later.

If you are self-employed, you determine the source of compensation for labor or personal services from employment on the basis that most correctly reflects the proper source of that income under the facts and circumstances of your case. For example, an amount of compensation that specifically relates to a period of time that includes several calendar years is attributable to the entire multi-year pe-
riod.

The amount of compensation treated as from foreign sources is figured by multiplying the total multi-year compensation by a fraction. The nu-
merator of the fraction is the number of days (or unit of time less than a day, if appropriate) that you performed labor or personal services in the foreign country in connection with the project. The denominator of the fraction is the total num-
ber of days (or unit of time less than a day if appropriate) that you performed labor or per-
sonal services in connection with the project.

Geographical basis. Compensation you re-
eceive as an employee in the form of the following fringe benefits is sourced on a geographical basis,

- Housing.
- Education.
- Local transportation.
- Tax reimbursement.
- Hazardous or hardship duty pay.
- Moving expense reimbursement.

The amount of fringe benefits must be reasona-
ble and you must substantiate them by ade-
quate records or by sufficient evidence. Table 3
summarizes the factors used for determining the source of these fringe benefits.

Housing. The source of a housing fringe benefit is determined based on the location of your principal place of work. A housing fringe benefit includes payments to or on your behalf and your family if your family resides with you only for the following:

- Rent.
- Utilities (except telephone charges).
- Real and personal property insurance.
- Occupancy taxes not deductible under section 164 or 216(a).
- Nonrefundable fees for securing a lease-
hold.
- Rental of furniture and accessories.

Multi-year compensation. The source of multi-year compensation is generally deter-
mined on a time basis over the period to which the compensation is attributable.

Example 1. Christina Brooks, a U.S. citizen, worked 240 days for a U.S. company during the tax year. She received $80,000 in compensa-
tion. None of it was for fringe benefits. Christina

Example 2. Rob Waters, a U.S. citizen, is employed by a U.S. corporation. His principal place of work is in the United States. His annual salary is $100,000. None of it is for fringe bene-
fits. During the first quarter of the year he worked entirely within the United States. On April 1, Rob was transferred to Singapore for the remainder of the year. Rob is able to establish that the first quarter of the year and the last 3 quarters of the year are two separate, distinct, and continuous periods of time. Accordingly, $25,000 of Rob's annual salary is attributable to the first quarter of the year ($25 × $100,000). All of it is U.S. source income because he worked entirely within the United States during that quarter. The remaining

$75,000 is attributable to the last three quarters of the year. During those quarters, he worked 150 days in Singapore and 30 days in the United States. His periodic performance of services in the United States did not result in distinct, separate, and continuous periods of time. Of his

$75,000 salary, $62,500 ($75,000 × 8/3) is foreign source income for the year.

Multi-year compensation is generally deter-
mixed on a time basis over the period to which the compensation is attributable.
and the fair rental value of any em-
ployer-provided vehicle used predominantly by
you or your spouse or dependents for local transpor-
tation. Actual expenses do not include the
(cost including interest) of any vehicle pur-
chased by you on your behalf.

**Tax reimbursement.** The source of a for-
egign tax reimbursement fringe benefit is deter-
dined based on the location of the jurisdiction
that imposed the tax for which you are reim-
bursted.

**Hazardous or hardship duty pay.** The source
of hazardous or hardship duty pay and
benefit is determined based on the location of
the hazardous or hardship duty zone for which
the hazardous or hardship duty pay fringe bene-
fit is paid. A hazardous or hardship duty zone
is any place in a foreign country which meets ei-
ther of the following conditions:

- The zone is designated by the Secretary of
  State as a place where living conditions are
  extraordinarily difficult, notably un-
  healthy, or where excessive physical hard-
  ships exist, and for which a post
differential of 15 percent or more would be
  provided under section 5925(b) of Title 5
  of the U.S. Code to any officer or em-
  ployee of the U.S. government at that
  place.
- The zone is where civil insurrection, civil
  war, terrorism, or wartime conditions
  threaten physical harm or imminent dan-
gers to your health and well-being.

Compensation is treated as a hazardous or
hardship duty pay fringe benefit only if your
employer provides the hazardous or hardship
duty pay fringe benefit only to employees per-
forming labor or personal services in a hazard-
ous or hardship duty zone.

The amount of compensation treated as a
hazardous or hardship duty pay fringe benefit
cannot exceed the maximum amount that the
U.S. government would allow its officers or em-
ployees present at that location.

**Moving expense reimbursement.** The source
of a moving expense reimbursement is generally based on the location of your
new principal place of work. However, the source is
determined based on the location of your former
principal place of work if you have sufficient
evidence that such determination of source is
more appropriate under the facts and circum-
stances of your case. Sufficient evidence gener-
ally should include an agreement between you
and your employer, or a written statement of com-
pany policy, which is reduced to writing before
the move and which is entered into or estab-
lished to induce you or other employees to move
to another country. The written statement or
agreement must state that your employer will
reimburse you for moving expenses that you
incur to return to your principal place of work
regardless of whether you continue to work for
your employer after returning to that location. It
may contain certain conditions upon which the
right to reimbursement is determined as long as
those conditions set forth standards that are
definitely ascertainable and can only be fulfilled
prior to, or through completion of, your return
move to your former principal place of work.

**Alternative basis.** If you are an employee,
you can determine the source of your compen-
sation under an alternative basis if you establish
the satisfaction of the IRS that, under the facts
and circumstances of your case, the alternative
basis more properly determines the source of
your compensation than the time or geographi-
cal basis. If you use an alternative basis, you
must keep (and have available for inspection)
the document why the alternative basis more
properly determines the source of your
compensation. Also, if your total compensation
was $250,000 or more, you must make the
attachment to your tax return that sets forth all
of the following:

1. Your name and social security number
   (written across the top of the statement).
2. The specific compensation income, or the
   specific fringe benefit, for which you are
   using the alternative basis,
3. For each item in (2), the alternative basis
   of allocation of source used,
4. For each item in (2), a computation show-
   ing how the alternative allocation was com-
   puted, and
5. A comparison of the dollar amount of the
   U.S. compensation and foreign compensa-
   tion sourced under both the alternative ba-
   sis and the time or geographical basis
   discussed earlier.

**Determining the Source of Income**

**From the 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 property is sold by a
nonresident, the gain or loss is treated as foreign
source.

A rule does not apply to the sale of inven-
tory, intangible property, or depreciable prop-
etry, 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 to work 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-
egign 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-
ing after 1986. For details about making this
choice, see Regulations section 1.865-5(a2).

For stock losses, see Regulations section 1.865-2(e).

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

Income from the sale of inventory that you
produced in the United States and sold outside
the United States (or vice versa) is sourced
based on an allocation. For information on mak-
ing the allocation, see Regulations section
1.863-3.

**Intangibles.** Intangibles include patents,
copyrights, trademarks, and goodwill. The gain
from the sale of amortizable or depreciable in-
tagibles property, up to the amount allocable
amortization or depreciation deductions, is
sourced in the same way as the original deduc-
tions were sourced. This rule is the same as the
source rule for gain from the sale of depreciable
property. See Depreciable property, next, for
details on how to apply this rule to losses.

Gain in excess of the amortization or depre-
ciation 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 disposi-
tion of the property, the income is sourced ac-
cording 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 property's allocable depreciation, is
sourced in the same way as the original de-
ductions were sourced. Thus, to the extent the
previous deductions for depreciation were allo-
cable to U.S. source income, the gain is U.S.
source. To the extent the depreciation deduc-
tions were allocable to foreign sources, the gain
is foreign source income. Gain in excess of the
depreciation deductions is sourced the same as
inventory.

If personal property is used predominantly in
the United States, treat the gain from the sale,
up to the amount of the allowable depreciation
deductions, entirely as U.S. source income.
If the property is used predominantly outside the
United States, treat the gain, up to the amount of the
depreciation deductions, entirely as foreign source
income.

A loss recognized after January 7, 2002, is
sourced in the same way as the depreciation
deductions were sourced. However, if the prop-
erty 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 about 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). For stock losses, see Regulations section 1.865-2(e).

This rule does not apply to income sourced under the rules for inventory property, depreciable personal property, intangible property (when payments in consideration for the sale are contingent on the productivity, use, or disposition of the property), or goodwill.

Determining 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 apportion deductions that are not definitely related to a separate limit category.

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 acceptable method for many individuals is based on a comparison of the gross income in a class of income to the gross income in a separate limit income category.

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

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

Do not take exempt income into account when you apportion the deduction. However, income exempt because the foreign earned income exclusion is not considered exempt expenses, losses, and other deductions to that income.

Interest expense. Generally, you apportion your interest expense on the basis of your assets. However, certain special rules apply. If you have gross foreign source income (including income from an interest in the foreign entity income exclusion) of $5,000 or less, your interest expense can be allocated entirely to U.S. source income.

Business interest. Apportion interest incurred in a trade or business using the asset method based on your business assets.

Under the asset method, you apportion the interest expense to your separate limit categories based on the value of the assets that produced the income. You can value assets at fair market value, the tax book value, or the alternative book value. For more information about the asset method, see Temporary Regulations section 1.861-9T(e).

If you use the tax book value method, you can elect to change to the fair market value method at any time without IRS approval. If you elect to use the fair market value method, you must continue to use that method unless you have IRS approval to change methods.

Investment interest. Apportion this interest on the basis of your investment assets.

Passive activity interest. Apportion interest incurred in a passive activity on the basis of your passive activity assets.

Partnership interest. General partners and limited partners with partnership interests of 10% or more must classify their distributive share as exempt income that is not definitely related to one of the three categories listed above. They must apportion the interest expense according to the rules for those categories by taking into account their distributive share of partnership gross income or pro rata share of partnership assets. For special rules that may apply, see Regulations section 1.861-9T(e).

Home mortgage interest. This is your deductible home mortgage interest (including points and qualified mortgage insurance premi- ums) from Schedule A (Form 1040). Apportion this interest under a gross income method, taking into account all income (including business, passive activity, and investment income) that is exempt under the foreign earned income exclusion. The gross interest method is based on a comparison of the gross income in a separate limit category with total gross income.

The Instructions for Form 1116 have a worksheet for apportioning your deductible home mortgage interest expense.

For this purpose, however, any qualified residence that is rented is considered a business asset for the period in which it is rented. You therefore apportion this interest under the rules for passive activity or business interest.

Example. You are operating a business as a sole proprietor. Your business generates only U.S. source income. Your investment portfolio consists of several less-than-10% stock investments. You have stocks with an adjusted basis of $100,000. Some of your stocks (with an adjusted basis of $40,000) generate U.S. source income. Your other stocks (with an adjusted basis of $60,000) generate foreign passive income. You own your main home, which is subject to a mortgage of $20,000. Interest on this loan is home mortgage interest. You also 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 portfolio. Your gross income from your business is $50,000. Your investment portfolio generated $4,000 in U.S. source income and $6,000 in foreign source passive income. All of your debts bear interest at the annual rate of 10%.

The interest expense for your business is $2,000. It is apportioned on the basis of the business assets. All of your business assets generate U.S. source income; therefore, they are U.S. assets. This $2,000 is interest expense allocable to U.S. source income.

The interest expense for your investments is also $2,000. It is apportioned on the basis of investment assets. $800 ($400,000/$100,000 × $2,000) of your investment interest is apportioned to U.S. source income, and $1,200 ($60,000/$100,000 × $2,000) is apportioned to foreign source passive income.

Your home mortgage interest expense is $12,000. It is apportioned on the basis of your gross income. Your gross income is $60,000, $54,000 of which is U.S. source income and $6,000 of which is foreign source income.
Deductions not definitely related. Thus, $1,200 ($6,000/$50,000 × $1,000 of the home mortgage interest is apportioned to foreign source passive income. The total state tax is imposed in part on foreign source income, the part of your state tax imposed on the foreign source income is definitely related and allocable to foreign source income.

Foreign income not exempt from state tax. If the state does not specifically exempt foreign income from tax, the following rules apply:

- If the total income taxed by the state is greater than the amount of the U.S. source income for federal tax purposes, then the state tax is allocable to both U.S. source and foreign source income.
- If the total income taxed by the state is less than the U.S. source income for federal tax purposes, none of the state tax is allocable to foreign source income.

Foreign income exempt from state tax. If the state specifically exempts foreign income from tax, the state taxes are allocable to the U.S. source income.

Example. Your total income for federal tax purposes, before deducting state tax, is $100,000. Of this amount, $25,000 is foreign source income and $75,000 is U.S. source income. Your total income for state tax purposes is $90,000, on which you pay state income tax of $6,000. The state does not specifically exempt foreign source income from tax. The total state income of $90,000 is greater than the U.S. foreign income for federal tax purposes. Therefore, the $6,000 is definitely related and allocable to both U.S. and foreign source income.

Assuming that $15,000 ($90,000 – $75,000) is the foreign source income taxed by the state, $1,000 of the state income is apportioned to foreign source income, figured as follows:

\[
\frac{15,000}{90,000} \times 6,000 = 1,000
\]

Deductions not definitely related. You must apportion to your foreign income in each separate limit category a fraction of your other deductions that are not definitely related to a specific class of gross income. If you itemize these deductions are medical expenses, general sales taxes, and real estate taxes for your home. If you do not itemize, this is your standard deduction. You should also apportion any other deductions that are not definitely related to a specific class of income, including deductions shown on Form 1040, lines 23-25.

The numerator of the fraction is your gross foreign income in the separate limit category, and the denominator is your total gross income from all sources. For this purpose, gross income includes income that is excluded under the foreign earned income provisions but does not include any other exempt income.

Itemized deduction limit. For 2007, you may have to reduce your itemized deductions on Schedule A (Form 1040) if your adjusted gross income is more than $156,400 ($78,200 if married filing separately). This reduction does not apply to medical and dental expenses, casualty and theft losses (other than losses of employee property), gambling losses, and investment interest.

You figure the deduction 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 11 shows the amount of the reduction.

To determine your taxable income from foreign source income, you must first divide the reduction (line 11 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 $216,400. Your itemized deductions subject to the overall reduction (line 3 of the worksheet) total $20,000. Of these deductions are definitely related to the income on Form 1116, line 1a. The other $12,000 ($20,000 – $8,000) are real estate taxes, which are not definitely related.

The amount of the overall reduction on line 11 of the worksheet is $1,200. To figure the amount of the real estate taxes to include in the total for line 3a of Form 1116, divide the amount on line 11 ($1,200) by the amount on line 3 ($20,000). This is your reduction percentage (6%). You must reduce your $12,000 deduction by $720 ($12,000 × 6%). The reduced deduction of $11,280 ($12,000 – $720) is the amount to enter on line 3a of Form 1116. Make a similar computation to figure the amount of definitely related itemized deductions ($7,520) to enter on line 2.

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.

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 1a 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 1a 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

If you have capital gains (including any capital gain distributions) or capital losses, you may be required to make certain adjustments to those gains or losses before taking them into account on line 1a (gains), line 5 (losses), or line 17 (taxable income before subtracting exemptions) of Form 1116.

Lines 1a and 5. If you have foreign source capital gains or losses, you may be required to make certain adjustments to those foreign source capital gains or losses before you take them into account on line 1a or line 5 of Form 1116. Use the instructions under Foreign Qualified Dividends and Capital Gains (and Losses) in the Instructions for Form 1116 to determine if you can use those instructions to make adjustments or if you must use the instructions in this publication to make adjustments.

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 source capital gains, you may be required to adjust the amount you enter on line 17 of Form 1116. Use the instructions for line 17 in the Instructions for Form 1116 to determine whether you are required to make an adjustment and 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 or loss you elected to include in investment income on line 4g of Form 4952. Investment Interest Expense Deduction. Your net gain is the excess of your net long-term capital gain for the year over any net short-term capital loss for the year. Foreign source capital gain you elected to include on line 4g of Form 4952 must be entered directly on line 1a of Form 1116 without adjustment.

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").

If 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 gain 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 that is passive category income, a $1,000 foreign source capital gain that is general category income, a $400 foreign source capital loss that is general category income, and a $150 U.S. source capital loss. He figures his net gains and U.S. capital loss adjustment as follows.

<table>
<thead>
<tr>
<th>Foreign source capital gain</th>
<th>$300</th>
<th>Passive category income</th>
<th>$300</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. capital loss adjustment</td>
<td>$150</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Alfie reduces his $300 net capital gain that is passive category income by $50 and includes the resulting $250 on line 1a of the Form 1116 for the passive category income. Alfie's U.S. capital loss adjustment is $300.

Example 2. Dennis has a $300 U.S. source long-term capital loss. Dennis also has foreign source capital gains and losses in the following categories.

<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</td>
<td>$100</td>
<td>$150</td>
</tr>
<tr>
<td>General</td>
<td>$700</td>
<td>$300</td>
<td></td>
</tr>
</tbody>
</table>

He figures his U.S. capital loss adjustment as follows.

Dennis' foreign source capital gain is $600. ($200 + $700 + $100) - ($150 + $300)

Dennis' worldwide capital gain is $300. ($200 + $700 + $100) - ($100 + $300 + $300)

Dennis' U.S. capital loss adjustment is $300. ($600 - $300)

Dennis must apportion his $300 U.S. capital loss adjustment between passive category income and general category income based on the amount of net capital gain in each separate category.

Dennis' net capital gain, passive category income is $200. ($100 + $200) - $150

Dennis apportions $100 to passive category income. ($300 - $200 + $600)

Dennis' net capital gain, general category income is $400. ($700 - $300)

Dennis apportions $200 to general category income. ($300 + $400 + $600)

Dennis has net capital gain in more than one rate group that is passive category income. Therefore, the $100 apportioned to passive category income must be further apportioned between the short-term rate group and the 25% rate group based on the amount of net capital gain in each rate group.

Table 4. Rate Groups

<table>
<thead>
<tr>
<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>
</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>
</tr>
<tr>
<td>15% rate group</td>
<td>it is a long-term capital gain that is not in the 28% or 25% rate group and is taxed at a 15% rate or if it is a long-term capital loss that is not in the 28% or 25% rate group.</td>
</tr>
<tr>
<td>5% rate group</td>
<td>it is a long-term capital gain that is not in the 25% or 25% rate group and is taxed at a rate of 5%.</td>
</tr>
<tr>
<td>Short-term rate group</td>
<td>it is a short-term capital gain or loss.</td>
</tr>
</tbody>
</table>
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 for net capital gains, later.

How to determine the amount of net capital gain that must be adjusted. You must adjust the net capital gain in each separate category long-term rate group that remains after the U.S. capital loss adjustment. You must adjust the entire amount of that remaining net capital gain if you do not have a net long-term capital loss from U.S. sources or you do not have any short-term capital gains. If you have a net long-term capital loss from U.S. sources and you have any short-term capital gains, you only need to adjust a portion of the remaining net capital gain in each separate category long-term rate group. In that case, the portion you must adjust is limited to the portion of the remaining net capital gain in the separate category long-term rate group in excess of the U.S. long-term loss adjustment amount (if any) allocated to that separate category long-term rate group. You have a net long-term capital loss from U.S. sources if your long-term capital losses from U.S. sources exceed your long-term capital gains from U.S. sources.

The U.S. long-term loss adjustment amount is the excess of your net long-term capital loss from U.S. sources over the amount by which you reduced your long-term capital gains from foreign sources under U.S. capital loss adjustment earlier. If only one separate category long-term rate group has a net capital gain after the U.S. capital loss adjustment, you must allocate the U.S. long-term loss adjustment amount among the separate category long-term rate groups pro rata based on the amount of the remaining net capital gain in each separate category long-term rate group.

You must adjust the portion of your net capital gain in a separate category long-term rate group in excess of the U.S. long-term loss adjustment amount among the separate category long-term rate group. See the instructions below under Capital gain rate differential adjustment for net capital gains. The remaining portion of your net capital gain in the separate category long-term rate group must be entered on line 1a of Form 1116 without adjustment.

Example 3. Mary has a $200 15% capital gain from U.S. sources, a $50 15% capital gain from foreign sources, and a $200 short-term capital gain from U.S. sources. Mary also has a $300 28% capital gain and a $150 15% capital gain from foreign sources that are passive category income.

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

Mary’s net long-term capital loss from U.S. sources is $150 ($200 - $50). Her U.S. long-term loss adjustment amount is $150 ($150 - $0). Mary allocates the $150 between the 28% rate group and the 15% rate group as follows:

- Mary allocates $100 ($150 x $300/$450) to the 28% rate group that is passive category income. Therefore, $200 ($300 - $100) of her $300 28% capital gain must be adjusted before it is included on line 1a. The remaining $100 of 28% capital gain is included on line 1a without adjustment.
- Mary allocates $50 ($150 x $150/$450) to the 15% rate group that is passive category income. Therefore, only $100 ($150 - $50) of her $150 15% capital gain must be adjusted before it is included on line 1a. The remaining $50 of 15% capital gain is included on line 1a without adjustment.

Capital gain rate differential adjustment for net capital gains. Adjust your net capital gain (or the applicable portion of your net capital gain) in each separate category long-term rate group as follows:

- For each separate category that has a net capital gain in the 5% rate group, multiply the applicable amount of the net capital gain by 0.1429.
- For each separate category that has a net capital gain in the 15% rate group, multiply the applicable amount of the net capital gain by 0.4286.
- For each separate category that has a net capital gain in the 25% rate group, multiply the applicable amount of the net capital gain by 0.7143.
- For each separate category that has a net capital gain in the 28% rate group, multiply the applicable amount of the foreign source net capital gain by 0.8. Add each result to any net capital gain in the same long-term separate category rate group that you were not required to adjust and include the combined amounts on line 1a of the applicable Form 1116.

No adjustment is required if you have a net capital gain in a short-term rate group. Include the amount of net capital gain in any short-term rate group on line 1a of the applicable Form 1116 without adjustment.

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

Beth includes $160 of capital gain on line 1a of Form 1116 for the general category income.

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

Mary includes $260 of the 28% capital gain ($200 x 0.8) + $100
Mary includes $92.86 of the 15% capital gain ($500 x 0.1429) + $50

Example 6. The facts are the same as Example 2. After making the U.S. capital loss adjustment, Dennis has the following:

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 $33.33 ($300 - $266.67). Dennis must allocate this amount between the $133.33 of net capital gain remaining in the 28% rate group that is passive category income and the $200 of net capital gain remaining in the 15% rate group that is general category income.

Dennis allocates $133.33 ($33.33 x $133.33 - $33.33) of the U.S. long-term loss adjustment to passive category income in the 28% rate group. Therefore, Dennis must adjust $120 ($133.33 - $11.11) of the $133.33 net capital gain remaining in the 28% rate group that is passive category income. Dennis includes
Step 1

First determine the rate group of the capital gain offset by that net capital loss. To do this, determine the rate group of the capital gain offset by the net capital loss, next.

.net capital loss in a separate category rate group. If you have a net capital loss in a separate category rate group, you must do the following:

1. First determine the rate group of the capital gain offset by that net capital loss. See How to determine the rate group of the capital gain offset by the net capital loss, next.

2. Then make the capital gain rate differential adjustment. See Capital gain rate differential adjustment for net capital loss, later.

How to determine the rate group of the capital gain offset by the net capital loss, later.

Use the following ordering rules to determine the rate group of the capital gain offset by the net capital loss. Determinations under the following ordering rules are made after you have taken into account any U.S. capital loss adjustment. However, determinations under the following ordering rules do not take into account any capital gain rate differential adjustments that you made to any net capital gain in a separate category rate group.

Step 1. Net capital losses from each separate category rate group are netted against net capital gains in the same rate group in other separate categories.

Step 2. U.S. source capital losses are netted against U.S. source capital gains in the same rate group.

Step 3. Net capital losses from each separate category rate group in excess of the amount netted against foreign source net capital gains in Step 1 are netted against your remaining foreign source net capital gains and your U.S. source net capital gains as follows.

1. First, against U.S. source net capital gains in the same rate group, and

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 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 to offset capital gain net income in the 5% rate group.

- A foreign source net capital loss in the 28% rate group is netted first against any net capital gain in the 25% rate group, then against any net capital gain in the 15% rate group, and finally to offset capital gain net income in the 5% rate group.

- A foreign source net capital loss in the 15% rate group is netted first against any net capital gain in the 5% rate group, then any net capital gain in the 28% rate group, and finally against any net capital gain in the 25% rate group.

The net capital losses in any separate category rate group are treated as coming pro rata from each separate category that contains a net capital loss in that rate group to the extent netted against:

- Net capital gains in any other separate category under Step 1,

- Any U.S. source net capital gain under Step 3(1), or

- Net capital gains in any other rate group under Step 3(2).

Capital gain rate differential adjustment for net capital loss, later.

After you have determined the rate group of the capital gain offset by the net capital loss, you may 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 5% rate group, multiply the net capital loss by 0.4286.

- To the extent a net capital loss in a separate category rate group offsets capital gain in the 15% rate group, multiply the capital gain offset by 0.8.

- To the extent that a net capital loss in a separate category rate group offsets capital gain in the 28% rate group, multiply that amount of the net capital loss by 0.7143.

- 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 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 that is passive category income. This loss is netted against the $200 foreign source 15% capital gain that is general category income according to Step 1.

Dennis includes $42.86 of the capital loss on line 5 of the Form 1116 for general category income.

($100 × 0.4286)

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

<table>
<thead>
<tr>
<th>Income category</th>
<th>28% rate</th>
<th>15% rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Passive</td>
<td>$90</td>
<td>$50</td>
</tr>
<tr>
<td>Foreign General</td>
<td>($40)</td>
<td>$50</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 passive category income. ($50 × $0.3333)

$33.33 of the $50 is treated as coming from general category income. ($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 passive category income. ($10 × $0.3333)

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

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

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

Dawn includes $19.63 of the capital loss in the amount she enters on line 5 of Form 1116 for general category income.

This is $14.29 ($33.33 × 0.4286) plus $5.34 ($6.67 × 0.8)

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

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 Foreign Source Capital Gains and Losses earlier under Capital Gains and Losses.

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

How to allocate. You must allocate foreign losses among the separate limit income categories in the same proportion as each category’s income bears to total foreign income.

Example. You have a $2,000 loss that is general category income, $3,000 of passive category income, and $2,000 of income re-sourced by treaty. You must allocate the $2,000 loss to the income in the other separate categories, 60% ($3,000/$5,000) of the $2,000 loss (or $1,200) reduces passive category income and 40% ($2,000/$5,000) or $800 reduces the income re-sourced by treaty.

Loss more than foreign income. If you have a loss remaining after reducing the income in other separate limit categories, use the remaining loss to reduce U.S. source income. For this purpose, the amount of your U.S. source income is your taxable income from U.S. sources 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 category income, $1,000 of income re-sourced by treaty, and $5,000 of general category income. Because $1,200 of the general category loss was used to reduce your passive category income in the previous year, $1,200 of the current year’s general category income of $5,000 must be recharacterized as passive category income. This makes the current year’s total passive category income $5,200 ($4,000 + $1,200). Similarly, because $800 of the general category loss was used to reduce your income re-sourced by treaty, $800 of the general category income must be recharacterized as income re-sourced by treaty. This makes the current year’s total income re-sourced by treaty $1,800 ($1,000 + $800). The total general category income is $3,000 ($5,000 – $1,200 – $800).

U.S. Losses

You should allocate any net loss from sources in the United States among the different categories of foreign income after allocating all foreign losses as described earlier, and before recapturing any prior year overall foreign loss as described below, and recharacterizing subsequent income in a loss category 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.

Alternatively, the adjustments can be made using any reasonable method, including one based on the ordering rules of Notice 89-3, 1989-1CB 623. The ordering rules of Notice 89-3 are covered in the line 15 instructions of the 2006 Instructions for Form 1116.

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 income from foreign sources for a tax year is less than the sum of your expenses, losses, or other deductions that you allocated and apportioned to foreign income under the rules explained earlier under Determining Taxable Income From Sources Outside the United States. But see Losses not considered, later, for exceptions.

Example. You are single and have gross dividend income of $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 general category income. You are a bona fide resident of a foreign country and you would elect to exclude your foreign earned income. You exclude the maximum $85,700. You also have itemized deductions of $6,100 that are not definitely related to any item of income.

In figuring your overall foreign loss for general category income 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:

\[
\text{Ratable part of itemized} = \left( \frac{\$6,100}{\text{Foreign gross income}} \right) \times 100
\]

Therefore, your overall foreign loss for the year is $7,690, figured as follows:

\[
\begin{align*}
\text{Foreign gross income} & \quad \text{\$100,000} \\
\text{Less:} & \\
\text{Foreign earned income} & \quad \text{\$85,700} \\
\text{Exclusion} & \quad \text{\$5,495} \\
\text{Allowable definitely related} & \quad \text{107,690} \\
\text{expenses ($14,300)} & \quad \text{16,445} \\
\text{($100,000 + \$115,000)} & \quad \text{Ratable part of itemized} \\
\text{16,445} & \quad \text{deductions} \\
& \quad \text{\$5,495} \\
\text{5,545} & \quad 170,690 \\
\text{Overall foreign loss} & \quad 107,690
\end{align*}
\]

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 reimburse ment.
• 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 ear-
lier).

Example. During 2006 and 2007, you were single and a 20% general partner in a partner-
ship that derived its income from Country X. You also received dividend income from U.S.

sources during those years. For 2006, the partnership had a loss and your share was $20,000, consisting of $110,000 gross income less $130,000 expenses. Your net loss from the partnership was $8,600, after deduct-
ing the foreign earned income exclusion and definitely related allowable expenses. This loss is related to general category income. Your U.S. dividend income was $20,000. Your item-
ized deductions totaled $6,000, and were not definitely related to any item of income. In figur-
ing your taxable income for 2006, you deducted your share of the partnership loss from Country X from your U.S. source income.

During 2007, the partnership had net income from Country X. Your share of the net income was $40,000, consisting of $100,000 gross in-
come less $60,000 expenses. Your net income from the partnership was $11,600, after deduct-
ing the foreign earned income exclusion and the definitely related allowable expenses. This is general category income. You also received div-
idend 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 2007, you must find the foreign source taxable income that you must treat as U.S. source in-
come because of the foreign loss recapture pro-
visions.

You figure the foreign taxable income that you must recapture as follows:

A. Determination of 2006 Overall Foreign Loss

1) Partnership loss from Country X ........ $8,600
2) Add: Part of itemized deductions allocable to gross income from Country X $110,000 × $6,000 = $5,077
3) Overall foreign loss for 2006 ........ $13,677

B. Amount of Recapture for 2007

1) Balance for general category income foreign loss account ........ $13,677
2) Foreign source net income ........ $11,600
Less: itemized deductions allocable to foreign source net income ($110,000 × $6,000) = $5,077
3) 50% of foreign source taxable income subject to recapture ........ $6,523
4) Taxable general category income after allocation of foreign losses—General category income ........ $11,600
Less: itemized deductions allocable to that income ($110,000 × $6,000) = $5,077
General category taxable income less allocated foreign losses ($6,523 - 0) $6,523
5) Recapture for 2007 (smallest of (1), (3), or (4))........ $6,523

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 amount 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 for-
eign taxable income that you are treating as U.S. source income, and
• The percentage and amount of the bal-
ance (both before and after the recapture) in the overall foreign loss account that you are recapturing.

Deduction for foreign taxes. You must re-
capture part (or all, if applicable) of an overall foreign loss in tax years in which you deduct, for purposes of your foreign taxes. You recap-

ture the lesser of:

• The balance in the applicable overall for-
eign loss account, or
• The foreign source taxable income of the same separate limit category that resulted in the overall foreign loss minus the for-
eign taxes imposed on that income.

Dispositions. If you dispose of appreciated trade or business property used predominantly outside the United States, and that property generates foreign source taxable income of the same separate limit category that resulted in an overall foreign loss, the disposition is subject to the recapture rules. Generally, you are consid-
ered to recognize foreign source taxable income in the same separate limit category as the over-
all 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 fore-

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 cat-

If you actually 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 sepa-
rate limit category for gain that is considered foreign source taxable income in the overall for-

Disposition defined. A disposition includes the following transactions:

• A sale, exchange, distribution, or gift of property.
• A transfer upon the foreclosure of a secur-
ity 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 is definitely related to the disposition rules is the same as if you had sold or exchanged the prop-

However, a disposition does not include either of the following:

• A disposition of property that is not a ma-
terial factor in producing income. (This ex-
ception does not apply to the disposition of stock in a controlled foreign corporation (CFC) to which Internal Revenue Code sec-

• A transaction in which gross income is not rea-

Basis adjustment. If gain is recognized on a disposition solely because of an overall foreign loss account balance at the time of the disposi-

The recipient of the property must increase its basis by the amount of gain deemed recog-
nized. 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 computed in addition to, 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, Bangladesh, 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 category income to the 2006 separate category for general limitation 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 920
Bensalem, PA 19020-8518.

You can also contact the United States Tax Attaché at the U.S. Embassies in London or Paris, or the U.S. consulate in Frankfurt, 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.

Example 1. All of your foreign income is in the general limitation income category for 2006. All your foreign income is general category income for 2007. 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 (+) or excess limit (-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$200</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>2007</td>
<td>$300</td>
<td>$500</td>
<td>$200</td>
</tr>
</tbody>
</table>

In 2007, you had unused foreign tax of $200 to carry to other years. You are considered to have paid this unused foreign tax first in 2006 (the first preceding tax year) up to the excess limit in that year of $100. You can then carry forward the remaining $100 of unused tax.

Example 2. All your foreign income is general category income for 2007 and 2008. Before 2007, all of your foreign income was in the general limitation income category. In 2003, you had an unused foreign tax of $200. Because you had no foreign income in 2001 and 2002, 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 2003–2006 (general category income for 2007 and 2008) are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax limit</th>
<th>Tax paid</th>
<th>Unused foreign tax (+) or excess limit (-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$600</td>
<td>$800</td>
<td>+200</td>
</tr>
<tr>
<td>2004</td>
<td>$600</td>
<td>$700</td>
<td>+100</td>
</tr>
<tr>
<td>2005</td>
<td>$500</td>
<td>$700</td>
<td>+200</td>
</tr>
<tr>
<td>2006</td>
<td>$550</td>
<td>$400</td>
<td>−150</td>
</tr>
<tr>
<td>2007</td>
<td>$800</td>
<td>$700</td>
<td>−100</td>
</tr>
<tr>
<td>2008</td>
<td>$500</td>
<td>$550</td>
<td>+ 50</td>
</tr>
</tbody>
</table>

You cannot carry the $200 of unused foreign tax from 2003 to 2004 or 2005 because you have no excess limit in either of those years. Therefore, you can carry the tax forward to 2006, 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 2003 can be carried to 2007. At this point, you have fully absorbed the unused foreign tax from 2003 and can carry it no further. You can also carry forward the unused foreign tax from 2004 and 2005.

Special rules for carryforwards and carrybacks of pre-2007 and post-2006 unused foreign taxes. The foreign taxes carried forward generally are allocated to your post-2006 separate category for general limitation income, and the unused foreign taxes would have been allocated if the taxes were paid or accrued in a tax year beginning after 2006. Alternatively, you can allocate unused foreign taxes in the pre-2007 separate category for passive category income, and you can allocate all other unused foreign taxes in the eliminated categories to the post-2006 separate category for general category income.

Foreign taxes paid or accrued on income in a separate category in 2007 that are carried back to 2006 generally are allocated to the same separate categories to which the taxes would have been allocated if they had been paid or accrued in 2006. Alternatively, you can allocate all unused taxes in the 2007 separate category for passive category income to the 2006 category for passive income and allocate all unused taxes in the 2007 separate category for general category income to the 2006 separate category for general limitation income.

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 and carrybacks of pre-2007 and post-2006 unused foreign taxes. The foreign taxes carried forward generally are allocated to your post-2006 separate category for general limitation income, and the unused foreign taxes would have been allocated if the taxes were paid or accrued in a tax year beginning after 2006. Alternatively, you can allocate unused foreign taxes in the pre-2007 separate category for passive category income to the 2006 category for passive income and allocate all unused taxes in the 2007 separate category for general category income to the 2006 separate category for general limitation income.

Time Limit on Tax Assessment

When you carry back an unused foreign tax, the IRS is given additional time to assess any tax resulting from the carryback. An assessment can be made up to the end of 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.
Figure A. Allocation Between Husband and Wife

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Scenario</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>Joint return—Unused foreign tax year</td>
<td>You and your spouse file separate returns for the current tax year (2006), to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return.</td>
</tr>
<tr>
<td>2007</td>
<td>Separate return—Excess limit year</td>
<td>You and your spouse file separate returns for the current tax year (2007), to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return.</td>
</tr>
<tr>
<td>2005</td>
<td>Separate returns—Unused foreign tax year</td>
<td>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.</td>
</tr>
<tr>
<td>2006</td>
<td>Joint return—Excess limit year</td>
<td>You and your spouse file a joint return for the current tax year (2006), 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.</td>
</tr>
<tr>
<td>2007</td>
<td>Separate returns—Excess limit year</td>
<td>You and your spouse file separate returns for the current tax year (2007), to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return.</td>
</tr>
</tbody>
</table>

J—Joint return filed
S—Separate return filed

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 any year to which you carry them unless you also claim a credit for foreign taxes actually paid or accrued in that year.

You cannot carry back or carry over any unused foreign taxes to or from a year for which you elect not to be subject to the foreign tax credit limit. See Exemption from foreign tax credit limit under How To Figure the Credit, earlier.

Unused taxes carried to deduction year.

If you carry unused foreign taxes to a year in which you chose to deduct qualified foreign taxes, you must compute a foreign tax credit limit for the deduction year as if you had chosen to credit foreign taxes for that year. If the credit computation results in an excess limit (as defined earlier) for the deduction year, you must treat the unused foreign taxes carried to the deduction year as absorbed in that year. You cannot actually deduct or claim a credit for the unused foreign taxes carried to the deduction year. But, this treatment reduces the amount of unused foreign taxes that you can carry to another year.

Because you cannot deduct or claim a credit for unused foreign taxes treated as absorbed in a deduction year, you will get no tax benefit for them unless you file an amended return to 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 2007, you paid foreign taxes of $600 on general category income. You have a foreign tax credit carryover of $200 from the same category for 2006. For 2007, your foreign tax credit limit is $700.

If you choose to claim a credit for your foreign taxes in 2007, you would be allowed a credit of $700, consisting of $600 paid in 2007 and $100 of the $200 carried over from 2006. You will have a credit carryover to 2008 of $100, which is your unused 2006 foreign tax credit carryover.

If you choose to deduct your foreign taxes in 2007, your deduction will be limited to $600, which is the amount of taxes paid in 2007. You are not allowed a deduction for any part of the carryover from 2006. However, you must treat $100 of the credit carryover as used in 2007, because you have an unused credit limit of $100 ($700 limit minus $600 of foreign taxes paid in 2007). This reduces your carryover to later years.

If you claimed the deduction for 2007 and later decided you wanted to receive a benefit for that $100 part of the 2006 carryover, you could reverse the choice of a deduction for 2007. You would have to claim a credit for those taxes by filing an amended return for 2007 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.

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 separate returns, but through a tax year for which you and your spouse filed a joint return.
3. You and your spouse file a joint return for the current tax year, to which you carry an unused foreign tax from a tax year for which you and your spouse filed a joint return.
These three situations are illustrated in Figure A. In each of the situations, 2007 is the current year.

Method of allocation. For a tax year in which you must allocate the unused foreign tax or the excess limit for your separate income categories between you and your spouse, you must take the following steps.

1. Figure a percentage for each separate income category by dividing the taxable income of each spouse from sources outside the United States in that category by the joint taxable income from sources outside the United States in that category. Then, apply each percentage to its category’s joint foreign tax credit limit to find the part of the limit allocated to each spouse.

2. Figure the part of the unused foreign tax, or of the excess limit, for each separate income category allocable to each spouse. You do this by comparing the allocated limit (figured in (1)), with the foreign taxes paid or accrued by each spouse on income in that category. If the foreign taxes you paid or accrued for that category are more than your part of its limit, you have an unused foreign tax. If, however, your part of that limit is more than the foreign taxes you paid or accrued, you have an excess limit for that category.

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

Example. A Husband (H) and Wife (W) filed joint returns for 2003, 2005, and 2006, and separate returns for 2004 and 2007. Neither H nor W had any unused foreign tax or excess limit for any year before 2003. For the tax years involved, the income, unused foreign tax, excess limits, and carrybacks and carryovers are shown in Table 5.

W’s allocated part of the unused foreign tax from 2003 ($30) is partly absorbed by her separate excess limit of $20 for 2004, and then fully absorbed by her allocated part of the joint excess limit ($65) for 2005. H’s allocated part of the unused foreign tax from 2003 ($50) is fully absorbed by his allocated part of the joint excess limit ($65) for 2005. H’s separate unused foreign tax from 2004 ($25) is partly absorbed (up to $15) by his remaining part of the joint excess limit for 2005 ($10). Each spouse’s excess limit on the 2005 joint return is reduced by:

1. Each spouse’s carryover from earlier years (W’s carryover of $10 from 2003 and H’s carryovers of $50 from 2003 and $15 from 2004).
2. The other spouse’s carryover. (H’s carryover of $10 from 2004 is absorbed by W’s remaining excess limit.)

W’s allocated part of the unused foreign tax of $29 from 2006 is partly absorbed by her excess limit in 2007 ($10), and the remaining

Form 1116
You must file Form 1116 with your U.S. income tax return, Form 1040 or Form 1040NR. You must file a separate Form 1116 for each of the following categories of income for which you claim a foreign tax credit.

• Passive category income.
• General category income.
• Section 901(j) income.
• Income re-sourced by treaty.

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 form. Do not include income you excluded on Form 2555 or Form 2555-EZ. From these, subtract the deductions that are definitely related to the separate limit income, and a ratable share of the deductions not definitely related to that income. If, in a separate limit category, you received income from more than one foreign country or U.S. possession, complete a separate column for each. You do not need to report income passed through from a regulated investment company (RIC) on a country by country basis. Aggregate all income passed through from a RIC in a single column in Part I. Enter RIC on line g of Part I.

2. Part II—Foreign Taxes Paid or Accrued. This part shows the foreign taxes you paid or accrued on the income in the separate limit category in foreign currency and U.S. dollars. If you paid (or accrued) foreign tax to more than one foreign country or U.S. possession, complete a separate line for each. If you receive income passed through from a RIC, aggregate all income on a single line in Part II.
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. You use this part on one Form 1116 (the one with the largest amount entered on line 21) to summarize the foreign tax credits figured on separate Forms 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, Form 1040, or Form 1040NR. You do not have to attach these records to your Form 1040 or Form 1040NR.

- 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. Requiring Rule 67-308 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, a U.S. business incorporated in Country Z and figures his foreign tax from sources within Country X and the United States.

Comprehensive Example — Filled-In Form 1116

Robert Smith, a U.S. citizen, is a salesman who earned $27,400 working as an auditor in Pittsburgh. He is a cash basis taxpayer who uses the calendar year as his tax year. During the year, Robert received wages from sources within Country X and the United States.

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).

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000 wages</td>
<td>$27,400</td>
</tr>
<tr>
<td>$27,400</td>
<td>(54,800 pesos)</td>
</tr>
<tr>
<td>$4,000 dividend income</td>
<td>$450</td>
</tr>
<tr>
<td>(8,000 pesos)</td>
<td>(900 pesos)</td>
</tr>
<tr>
<td>$1,000 interest income</td>
<td>$50</td>
</tr>
<tr>
<td>(2,000 pesos)</td>
<td>(100 pesos)</td>
</tr>
</tbody>
</table>

Foreign earned income. Robert is a bona fide resident of Country Y and figures his allowable exclusion of foreign earned income on Form 2555, Foreign Earned Income (not illustrated). He excludes $85,700 of the wages earned in Country X.

Employee business expenses. Robert must prorate the business expenses related to the wages earned in Country X between the wages he includes on his U.S. tax return and the amount he excludes as foreign earned income. He cannot deduct the part of the expenses related to the income that he excludes. He figures his allowable expenses (related to the wages earned in Country X) as follows:

\[ \frac{14,300}{100,000} \times 2,400 = 3,434 \]

His employer business expense deduction is $849. This is the difference between his business expenses of $1,343 ($340 + $1,000 from U.S. business trip) and the 2%-of-adjusted-gross-income limit ($494).
tax credit on his interest income of $1,000 and dividend income of $4,000.

Under the later discussions for each part on the 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 $16,151 figured as follows:

1. Enter gross foreign source income of the type shown on Form 1116.
2. Enter deductible home mortgage interest, $2,900, to general category income as follows: $14,300
3. Divide line 1 by line 2 and enter the result as a decimal .5789
4. Enter deductible home mortgage interest (from Schedule A (Form 1040)) .5789
5. Multiply line 4 by line 3. Enter the result here and on Form 1116, line 4a $851
6. Enter deductible home mortgage interest (from Schedule A (Form 1040)) .5789
7. Multiply line 4 by line 3. Enter the result here and on Form 1116, line 4a $851

The result of $851 is the total allowable unreimbursed business expenses ($1,000 + $343). The amount of deductible expenses definitely related to $14,300 of taxable foreign income is $217 ($343 – $126). He enters $217 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. Robert must prorate this itemized deduction by using the ratio of gross income from Country X in general category income (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 $85,700 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.

\[
\begin{align*}
\text{Gross Income} & = \frac{14,300 \times 940}{85,700} = 126 \\
\text{Line 3g} & = \frac{14,300}{85,700} \times 940 = 126
\end{align*}
\]

Robert figures the amount of foreign tax credit in

1. Enter gross foreign source income of the type shown on Form 1116. Do not enter income excluded on Form 2555 $5,000
2. Enter gross income from all sources. Do not enter income excluded on Form 2555 $24,700
3. Divide line 1 by line 2 and enter the result as a decimal $940
4. Enter deductible home mortgage interest (from Schedule A (Form 1040)) $940
5. Multiply line 4 by line 3. Enter the result here and on Form 1116, line 4a $851

He enters this amount, $587, on line 4a.

**Line 6.** Robert adds the amounts on lines 3g and 4a and enters that total ($630) on line 6.

**Line 7.** He subtracts the amount on line 6 from the amount on line 1a to arrive at foreign source taxable income of $4,370 in this category. Robert enters this amount on line 7.

**Part II—Foreign Taxes Paid or Accrued**

Robert uses Part II, Form 1116, to report the foreign tax paid or accrued on income from foreign sources.

**Form 1116—General category income.** On this Form 1116, Robert enters the amount of foreign taxes paid (withheld at source), in foreign currency and in U.S. dollars, on the wages from Country X.

**Form 1116—Passive category income.** On this Form 1116, Robert enters the amount of foreign taxes paid, in foreign currency and in U.S. dollars, on 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 category 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 2006 and enters that amount on line 10. He attaches a schedule showing how he figured his $200 carryover to 2007 after carrying back the unused $350 tax paid in 2006 to the first preceding tax year. (This schedule is shown in Table 6.) The unused foreign tax in 2006 and the excess limit in 2005 are general category income. The unused foreign tax of $200 is carried over to general category income in 2007.

**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 foreign wages by a fraction. The numerator of the fraction is his foreign earned income exclusion ($85,700) minus a proportionate part of his definitely related business expenses ($2,400 – $343 = $2,057).
The denominator of the fraction is his total foreign wages ($100,000) minus his total definitely related business expenses ($2,400).

$27,400 \times \frac{85,700 - 2,057}{100,000 - 2,400} = \frac{23,482}{977,600 - 23,482} = \frac{23,482}{954,118}$

He enters the result, $23,482, on line 12.

**Line 13.** His total foreign taxes available for credit are $4,118 ($200 carryover from 2006 + $3,918 paid in 2007 ($27,400 – $2,400)).

**Line 20.** By completing the rest of Part III, Robert finds that his limit is $2,668.

**Line 21.** The foreign tax credit on the general category income is the lesser of the foreign tax available for credit, $4,118, or the limit, $2,668.

**Form 1116—Passive category income.**

Robert now figures the foreign tax credit allowable for the foreign taxes he paid on his interest and dividend income from Country X.

By completing Part III of Form 1116, he finds that the limit on his credit is $1,009.

The foreign tax credit is the lesser of the foreign tax paid, $500, or the limit, $1,009.

**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 the Form 1116 with the largest amount on line 21. He uses the Part IV of Form 1116—General category income.

Robert leaves line 28 blank because he did not participate in or cooperate with an international boycott during the tax year. The allowable foreign tax credit is $3,168 ($500 + $2,668), shown on line 29. He also enters this amount on Form 1040, line 51.

**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.

**Table 6. Robert’s Schedule Showing Computation of His Carryover**

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum credit allowable under limit</td>
<td>$750</td>
<td>$1,200</td>
</tr>
<tr>
<td>Foreign tax paid in tax year</td>
<td>$600</td>
<td>$1,550</td>
</tr>
<tr>
<td>Unused foreign tax (+) to be carried over or excess of limit (-) over tax</td>
<td>$-150</td>
<td>$350 +</td>
</tr>
<tr>
<td>Tax credit carried back from 2006</td>
<td>$150</td>
<td>0</td>
</tr>
<tr>
<td>Net excess tax to be carried over to 2007</td>
<td>0</td>
<td>$350 +</td>
</tr>
<tr>
<td>Amount carried over to 2007</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Less carrybacks to 2005</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amount carried over to 2007</td>
<td>$200</td>
<td></td>
</tr>
</tbody>
</table>
Use a separate Form 1116 for each category of income listed below. See Categories of Income beginning 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.

- Passive category income
- Section 901(j) income
- Certain income re-sourced by treaty

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>Foreign Country or U.S. Possession</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
</tr>
<tr>
<td>1a Gross income from sources within country shown above and of the type checked above (see page 14 of the instructions): Dividends</td>
<td>5,350</td>
</tr>
<tr>
<td></td>
<td>620</td>
</tr>
<tr>
<td>1b Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is $250,000 or more, and you used an alternative basis to determine its source (see instructions):</td>
<td></td>
</tr>
</tbody>
</table>

**Deductions and losses (Caution: See pages 14 and 15 of the instructions):**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Expenses definitely related to the income on line 1a (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 (see instructions)</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 14 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, 3g, 4a, 4b, and 5</td>
</tr>
</tbody>
</table>

**Part II Foreign Taxes Paid or Accrued (see page 16 of the instructions):**

<table>
<thead>
<tr>
<th>Country</th>
<th>Foreign taxes paid or accrued in foreign currency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>In U.S. dollars</td>
</tr>
<tr>
<td></td>
<td>Taxes withheld at source on:</td>
</tr>
<tr>
<td></td>
<td>(a) Dividends</td>
</tr>
<tr>
<td></td>
<td>(b) Rents and royalties</td>
</tr>
<tr>
<td></td>
<td>(c) Interest</td>
</tr>
<tr>
<td></td>
<td>(d) Other foreign taxes paid or accrued</td>
</tr>
<tr>
<td></td>
<td>(e) Dividends</td>
</tr>
<tr>
<td></td>
<td>(f) Rents and royalties</td>
</tr>
<tr>
<td></td>
<td>(g) Interest</td>
</tr>
<tr>
<td></td>
<td>(h) Other foreign taxes paid or accrued (add cols. (a) through (h))</td>
</tr>
</tbody>
</table>

| A | 1099 Taxes | 93 | 93 |
| B |             |    |    |
| C |             | 93 |

**For Paperwork Reduction Act Notice, see page 20 of the instructions.**

Cat. No. 11440U

Form 1116 (2007)
**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.  
10. Carryback or carryover (attach detailed computation). 
11. Add lines 9 and 10.  
12. Reduction in foreign taxes (see pages 16 and 17 of the instructions).

13. Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit (see instructions).

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 17 of the instructions).

15. Adjustments to line 14 (see pages 17 and 18 of the instructions).

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 18.)

17. **Individuals:** Enter the amount from Form 1040, line 41. If you are a nonresident alien, enter the amount from Form 1040NR, line 38. **Estate and trusts:** Enter your taxable income without the deduction for your exemption.  
Caution: If you figured your tax using the lower rates on qualified dividends or capital gains, see page 18 of the instructions.

18. Divide line 16 by line 17. If line 16 is more than line 17, enter "1".

19. **Individuals:** Enter the amount from Form 1040, line 44. If you are a nonresident alien, enter the amount from Form 1040NR, line 41. **Estate and trusts:** Enter the amount from Form 1041, Schedule G, line 1a, or the total of Form 990-T, lines 36 and 37.  
Caution: If you are completing line 19 for separate category (lump-sum distributions), see page 20 of the instructions.

20. Multiply line 19 by line 18 (maximum amount of credit).  
21. Enter the smaller of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 26 and enter this amount on line 27. Otherwise, complete the appropriate line in Part IV (see page 20 of the instructions).

**Part IV  Summary of Credits From Separate Parts III** (see page 20 of the instructions)

22. Credit for taxes on passive category income.  
23. Credit for taxes on general category income.  
24. Credit for taxes on certain income re-sourced by treaty.  
25. Credit for taxes on lump-sum distributions.  
26. Add lines 22 through 25.  
27. Enter the smaller of line 19 or line 26.  
28. Reduction of credit for international boycott operations. See instructions for line 12 beginning on page 16.  
29. Subtract line 28 from line 27. This is your foreign tax credit. Enter here and on Form 1040, line 51; Form 1040NR, line 46; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a.
# Foreign Tax Credit

**Form 1116**

**Foreign Tax Credit**

**Individual, Estate, or Trust**

Attach to Form 1040, 1040NR, 1041, or 990-T.  
See separate instructions.

---

**Information for State and Local Governments**

**For Paperwork Reduction Act Notice, see page 20 of the instructions.**

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

<table>
<thead>
<tr>
<th>Country or U.S. Possession</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Total (Add cols. A, B, and C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>14,300</td>
<td></td>
<td></td>
<td>14,300</td>
</tr>
</tbody>
</table>

**Deductions and losses (Caution: See pages 14 and 15 of the instructions):**

1. **Expenses definitely related to the income on line 1a (attach statement):**
   - 217

2. **Pro rata share of other deductions not definitely related:**
   - a. Certain itemized deductions or standard deduction (see instructions):
     - 940
   - b. Other deductions (attach statement):
     - 940
   - c. Add lines 3a and 3b:
     - 100,000
   - d. Gross foreign source income (see instructions):
     - 110,400
   - e. Gross income from all sources (see instructions):
     - 9,059
   - f. Divide line 3d by line 3e (see instructions):
     - 851

3. **Pro rata share of interest expense (see instructions):**
   - a. Home mortgage interest (use worksheet on page 14 of the instructions):
     - 1,679
   - b. Other interest expense:
     - 2,747

4. **Losses from foreign sources:**

5. **Add lines 2, 3g, 4a, 4b, and 5:**

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

7. **Foreign Taxes Paid or Accrued (see page 16 of the instructions):**
   - a. Section 901(j) income
   - b. Lump-sum distributions
   - c. Certain income re-sourced by treaty

---

**For Paperwork Reduction Act Notice:**

**Cat. No. 11440U**

**Form 1116 (2007)**
Form 1116 (2007)

### Part III  Figuring the Credit

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>9</strong></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>
</tr>
<tr>
<td><strong>10</strong></td>
<td>Carryback or carryover (attach detailed computation)</td>
</tr>
<tr>
<td><strong>11</strong></td>
<td>Add lines 9 and 10</td>
</tr>
<tr>
<td><strong>12</strong></td>
<td>Reduction in foreign taxes (see pages 16 and 17 of the instructions)</td>
</tr>
<tr>
<td><strong>13</strong></td>
<td>Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit (see instructions)</td>
</tr>
<tr>
<td><strong>14</strong></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 17 of the instructions)</td>
</tr>
<tr>
<td><strong>15</strong></td>
<td>Adjustments to line 14 (see pages 17 and 18 of the instructions)</td>
</tr>
<tr>
<td><strong>16</strong></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>
</tr>
<tr>
<td><strong>17</strong></td>
<td><strong>Individually:</strong> Enter the amount from Form 1040, line 41. If you are a nonresident alien, enter the amount from Form 1040NR, line 38. <strong>Estates and trusts:</strong> Enter your taxable income without the deduction for your exemption.</td>
</tr>
<tr>
<td><strong>18</strong></td>
<td>Divide line 16 by line 17. If line 16 is more than line 17, enter “1”</td>
</tr>
<tr>
<td><strong>19</strong></td>
<td><strong>Individually:</strong> Enter the amount from Form 1040, line 44. If you are a nonresident alien, enter the amount from Form 1040NR, line 41. <strong>Estates and trusts:</strong> Enter the amount from Form 1041, Schedule G, line 1a, or the total of Form 990-T, lines 36 and 37.</td>
</tr>
<tr>
<td><strong>20</strong></td>
<td>Multiply line 19 by line 18 (maximum amount of credit)</td>
</tr>
<tr>
<td><strong>21</strong></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 26 and enter this amount on line 27. Otherwise, complete the appropriate line in Part IV (see page 19 of the instructions)</td>
</tr>
</tbody>
</table>

### Part IV  Summary of Credits From Separate Parts III (see page 20 of the instructions)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>22</strong></td>
<td>Credit for taxes on passive category income</td>
</tr>
<tr>
<td><strong>23</strong></td>
<td>Credit for taxes on general category income</td>
</tr>
<tr>
<td><strong>24</strong></td>
<td>Credit for taxes on certain income re-sourced by treaty</td>
</tr>
<tr>
<td><strong>25</strong></td>
<td>Credit for taxes on lump-sum distributions</td>
</tr>
<tr>
<td><strong>26</strong></td>
<td>Add lines 22 through 25</td>
</tr>
<tr>
<td><strong>27</strong></td>
<td>Enter the smaller of line 19 or line 26</td>
</tr>
<tr>
<td><strong>28</strong></td>
<td>Reduction of credit for international boycott operations. See instructions for line 12 beginning on page 16.</td>
</tr>
<tr>
<td><strong>29</strong></td>
<td>Subtract line 28 from line 27. This is your foreign tax credit. Enter here and on Form 1040, line 51; Form 1040NR, line 46; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a</td>
</tr>
</tbody>
</table>

Form 1116 (2007)
Use a separate Form 1116 for each category of income listed below. See Categories of Income beginning 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.

### 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>Country X</td>
<td>5,000</td>
<td>1a</td>
<td>5,000</td>
<td></td>
</tr>
</tbody>
</table>

**Deductions and losses:**

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

3 Pro rata share of other deductions not definitely related:
   a. Certain itemized deductions or standard deduction (see instructions).
   b. Other deductions (attach statement).
   c. Add lines 3a and 3b.
   d. Gross foreign source income (see instructions).
   e. Divide line 3d by line 3e (see instructions).
   f. Multiply line 3c by line 3f.

4 Pro rata share of interest expense (see instructions):
   a. Home mortgage interest (use worksheet on page 14 of the instructions).
   b. Other interest expense.

5 Losses from foreign sources.

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

7 Subtract line 6 from line 1a. Enter the result here.

### Part II: Foreign Taxes Paid or Accrued (see page 16 of the instructions)

<table>
<thead>
<tr>
<th>Country</th>
<th>Credit is claimed</th>
<th>In foreign currency</th>
<th>In U.S. dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(h) Paid</td>
<td>(i) Accrued</td>
<td>(j) Date paid or accrued</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

A 12-31-07 900 100 450 50 500

B

C

8 Add lines A through C, column (s). Enter the total here.

For Paperwork Reduction Act Notice, see page 20 of the instructions.
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.  

10 Carryback or carryover (attach detailed computation).  

11 Add lines 9 and 10.  

12 Reduction in foreign taxes (see pages 16 and 17 of the instructions)  

13 Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit (see instructions).  

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 17 of the instructions).  

15 Adjustments to line 14 (see pages 17 and 18 of the instructions).  

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.)  

17 Individuals: Enter the amount from Form 1040, line 41. If you are a nonresident alien, enter the amount from Form 1040NR, line 38.  

18 Divide line 16 by line 17. If line 16 is more than line 17, enter "1".  

19 Estates and trusts: Enter your taxable income without the deduction for your exemption.  

Caution: If you figured your tax using the lower rates on qualified dividends or capital gains, see page 18 of the instructions.  

20 Multiply line 19 by line 18 (maximum amount of credit).  

21 Enter the smaller of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 26 and enter this amount on line 27. Otherwise, complete the appropriate line in Part IV (see page 20 of the instructions).  

22 Credit for taxes on passive category income  

23 Credit for taxes on general category income  

24 Credit for taxes on certain income re-sourced by treaty  

25 Credit for taxes on lump-sum distributions  

26 Add lines 22 through 25  

27 Enter the smaller of line 19 or line 26  

28 Reduction of credit for international boycott operations. See instructions for line 12 beginning on page 16.  

29 Subtract line 28 from line 27. This is your foreign tax credit. Enter here and on Form 1040, line 51; Form 1040NR, line 46; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a.
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. The Taxpayer Advocate Service (TAS) is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving a tax problem that has not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

You can contact the TAS by calling the TAS toll-free case intake line at 1-877-777-4778 or TTY/TDD 1-800-829-4059 to see if you are eligible for assistance. You can also call or write to your local taxpayer advocate, whose phone number and address are listed in your local telephone directory and in Publication 1546, Taxpayer Advocate Service – Your Voice at the IRS. You can file Form 911, Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order), or ask an IRS employee to complete it on your behalf. For more information, go to www.irs.gov/advocate.

Taxpayer Advocacy Panel (TAP). The TAP listens to taxpayers, identifies taxpayer issues, and makes suggestions for improving IRS services and customer satisfaction. If you have suggestions for improvements, contact the TAP, toll free at 1-888-912-1227 or go to www.improveirs.org.

Low Income Taxpayer Clinics (LITCs). LITCs are independent organizations that provide low income taxpayers with representation in federal tax controversies with the IRS for free or for a nominal charge. The clinics also provide tax education and outreach for taxpayers with limited English proficiency or who speak English as a second language. Publication 4314, Low Income Taxpayer Clinic List, provides information on clinics in your area. It is available at www.irs.gov or at your local IRS office.

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 describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Accessible versions of IRS published products are available on request in a variety of alternative formats for people with disabilities.

Internet. You can access the IRS website at www.irs.gov 24 hours a day, 7 days a week:

- E-file your return. Find out about commercial tax preparation and e-file services available free to eligible taxpayers.
- Check the status of your 2007 refund. Click on Where’s My Refund? Wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2007 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 the withholding calculator online at www.irs.gov/withholding.
- Determine if Form 6251 must be filed using our Alternative Minimum Tax (AMT) Assistant.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

Phone. Many services are available by phone.

- 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/TTD equipment. If you have access to TTY/TTD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- TeleTax topics. Call 1-800-829-4477 to listen to pre-recorded messages covering various tax topics.
- Refund information. To check the status of your 2007 refund, call 1-800-829-4477 and press 1 for automated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2007 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.

Evaluating the quality of our telephone services. To ensure 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 listen in on or record random telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- 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 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 your 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. You should receive a response within 10 days after your request is received.

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

CD/DVD for tax products. You can order Publication 1796, IRS Tax Products CD/DVD, and other IRS products online.

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Bonus: Historical Tax Products DVD - Ships with the final release.
- Tax Map: an electronic research tool and finding aid.
- Tax law frequently asked questions.
The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

- 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.
- The CD which is released twice during the year.
  - The first release will ship the beginning of January 2008.
  - The final release will ship the beginning of March 2008.

Purchase the CD/DVD from National Technical Information Service (NTIS) at www.irs.gov/cdorders for $35 (no handling fee) or call 1-877-CDFORMS (1-877-233-6767) toll free to buy the CD/DVD for $35 (plus a $5 handling fee). Price is subject to change.

**CD for small businesses.** Publication 3267, The Small Business Resource Guide CD for 2007, is a must for every small business owner or any taxpayer about to start a business. 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 Map: an electronic research tool and finding aid.
- Web links to various government agencies, business associations, and IRS organizations.
- “Rate the Product” survey—your opportunity to suggest changes for future editions.
- A site map of the CD to help you navigate the pages of the CD with ease.
- An interactive “Teens in Biz” module that gives practical tips for teens about starting their own business, creating a business plan, and filing taxes.

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*

<table>
<thead>
<tr>
<th>I. U.S. tax on U.S. source income</th>
<th>COL. A</th>
<th>COL. B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<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>
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<td>4. Capital gain</td>
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<td>5. a. Gross earned income</td>
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<tr>
<td>b. Allocable employee business expenses</td>
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<tr>
<td>c. Net compensation. Subtract line 5b from line 5a</td>
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<tr>
<td>6. a. Gross rent, real property</td>
<td></td>
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<tr>
<td>b. Direct expenses</td>
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<td></td>
</tr>
<tr>
<td>c. Net rent. Subtract line 6b from line 6a</td>
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<td></td>
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<tr>
<td>7. Other</td>
<td></td>
<td></td>
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<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>
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<tr>
<td>9. Enter tax from Form 1040 (see instructions)</td>
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</tr>
<tr>
<td>10. Enter adjusted gross income (AGI) from line 37, Form 1040</td>
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<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>
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<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>
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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 line 14b) ____________________________

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 29 of Part IV Form 1116. ____________________________

* See the discussion on Tax Treaties for information on when you should use this worksheet.

Publication 514 (2007)
Worksheet Instructions.  **Additional Foreign Tax Credit on U.S. Income**

| STEP I | Figure the estimated tax on U.S. source income using U.S. source rules.  
| Lines 1–7 | Enter the gross amount for each type of income in Column A, and the net amount in Column B.  
| Line 9 | Enter the amount from Form 1040, line 44. |

| 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 I) 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 29, 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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