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Foreign Tax Credit for Individuals

IRS Nationwide Tax Forums 2016



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Objectives

- Explain why foreign taxes cannot be used to claim both a foreign tax credit and a deduction
- Describe what constitutes a creditable tax
- Explain the application of treaty provisions that result in reduced creditable foreign taxes
- Describe adjustments to foreign source income
- Define a foreign tax redetermination





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Form 1040 (TY 2015), Line 48 Foreign Tax Credit

Form 1040 (2015) Page **2**

38	Amount from line 37 (adjusted gross income)	38	
Tax and Credits	39a Check <input type="checkbox"/> You were born before January 2, 1951, <input type="checkbox"/> Blind. Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1951, <input type="checkbox"/> Blind. checked ▶ 39a	39a	
	b If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>	39b	
Standard Deduction for—	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	
	41 Subtract line 40 from line 38	41	
	42 Exemptions. If line 38 is \$154,950 or less, multiply \$4,000 by the number on line 6d. Otherwise, see instructions	42	
	43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	
	44 Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/>	44	
	45 Alternative minimum tax (see instructions). Attach Form 6251	45	
	46 Excess advance premium tax credit repayment. Attach Form 8962	46	
	47 Add lines 44, 45, and 46	47	
	48 Foreign tax credit. Attach Form 1116 if required	48	
	49 Credit for child and dependent care expenses. Attach Form 2441	49	
	50 Education credits from Form 8863, line 19	50	
	51 Retirement savings contributions credit. Attach Form 8880	51	
	52 Child tax credit. Attach Schedule 8812, if required.	52	
	53 Residential energy credits. Attach Form 5695	53	
	54 Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/>	54	
	55 Add lines 48 through 54. These are your total credits	55	
	56 Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56	

• People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions.

• All others:

Single or Married filing separately, \$6,300

Married filing jointly or Qualifying widow(er), \$12,600

Head of household, \$9,250





Credit vs. Deduction

- Individuals can make an annual choice to either elect the foreign tax credit or to deduct foreign taxes
- Treas. Reg. § 1.901-1(c) & IRC§ 275(a)(4) disallow a deduction for foreign taxes if those taxes are used for FTC computation purposes





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Foreign Tax Credit – Form 1116

- U.S. citizens and resident aliens are taxed by the U.S. on their worldwide income
- Foreign source income can also be taxed by other countries; this is referred to as double taxation
- What is the purpose of the foreign tax credit?
 - *To avoid the double taxation of foreign source income*





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U.S. Source Income vs. Foreign Source Income

- **U.S. source Income**: income determined to be earned from sources within the U.S.



- **Foreign-source income**: income determined to be earned from sources outside the U.S.





Form 1116

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Form **1116**

Foreign Tax Credit

OMB No. 1545-0121

Department of the Treasury
Internal Revenue Service (99)

(Individual, Estate, or Trust)

▶ Attach to Form 1040, 1040NR, 1041, or 990-T.

▶ Information about Form 1116 and its separate instructions is at www.irs.gov/form1116.

2015
Attachment
Sequence No. **19**

Name

Identifying number as shown on page 1 of your tax return

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

- a Passive category income
- b General category income
- c Section 901(j) income
- d Certain income re-sourced by treaty
- e Lump-sum distributions

f Resident of (name of country) ▶

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)

	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
g Enter the name of the foreign country or U.S. possession ▶				
1a Gross income from sources within country shown above and of the type checked above (see instructions):				
				1a





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What Foreign Taxes Qualify for the Foreign Tax Credit?

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

1. The tax must be an income tax, or a tax imposed in lieu of an income tax
2. The tax must be the legal and actual foreign tax liability
3. It must be a tax imposed on the taxpayer
4. Taxpayer must have paid or accrued the tax





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Only the Legal and Actual Foreign Tax Liability Qualifies for the Credit

- The amount of foreign tax that qualifies for the credit is not necessarily the amount of tax withheld by the foreign country
- Only the legal and actual foreign tax liability that the taxpayer paid or accrued during the year qualifies
- A FTC cannot be taken for income taxes paid to a foreign country if, it is reasonably certain the amounts would be refunded, credited, abated, rebated or forgiven if a claim for refund was made





Tax Treaties



- The U.S. has tax treaties with many countries
- Tax treaties establish specific withholding rates for certain types of income
- Treaty rates may be used by taxpayers to reduce the amount of foreign taxes they pay to the treaty country
- The creditable foreign taxes are limited to the lower treaty rate, even if taxes were withheld at a higher statutory rate





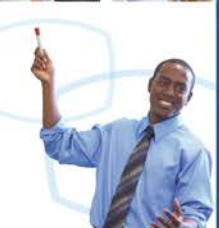
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Example 1: Statutory Withholding versus Treaty Rate

- A taxpayer earned \$1,000 of interest income from Foreign Country A; tax was withheld at a rate of 30%, but the treaty rate is 15%
- Statutory Withholding rate ($1,000 \times 30\%$) **\$300**
- Reduced Withholding rate ($1,000 \times 15\%$) **\$150**
- Creditable Foreign Taxes **\$150**





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Example 2: Statutory Withholding Versus Treaty Rate

- A U.S. citizen receives \$10,000 of interest income from investment activities in Foreign Country Y
- \$3,000 (30%) of foreign taxes were withheld
- Under the applicable treaty between the U.S. and Foreign Country Y, the treaty rate for interest income is 0%
- *What amount of foreign taxes should be entered on Part II of Form 1116?*





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Example 2: Statutory Withholding Versus Treaty Rate

Part II Foreign Taxes Paid or Accrued (see instructions)											
Country	Credit is claimed for taxes (you must check one) (h) <input checked="" type="checkbox"/> Paid (i) <input type="checkbox"/> Accrued	Foreign taxes paid or accrued									
		In foreign currency				In U.S. dollars					
		Taxes withheld at source on:				(n) Other foreign taxes paid or accrued	Taxes withheld at source on:			(r) Other foreign taxes paid or accrued	(s) Total foreign taxes paid or accrued (add cols. (o) through (r))
		(j) Date paid or accrued	(k) Dividends	(l) Rents and royalties	(m) Interest		(o) Dividends	(p) Rents and royalties	(q) Interest		
A	12/31/2015			0			0			0	
B											
C											
8 Add lines A through C, column (s). Enter the total here and on line 9, page 2 ▶										8	0

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11440U **Form 1116** (2015)





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General Category Part I – Line 1a Gross Income from Foreign Sources

- Gross foreign source income for the General Category is adjusted for the Foreign Earned Income Exclusion or Foreign Housing Exclusion if applicable (Line 1a)
- Form 2555 or Form 2555-EZ is used to report the Foreign Earned Income Exclusion claimed under IRC § 911; the exclusion includes items such as wages and self-employment income earned outside of the U.S.





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General Category

Example 3: Form 1116, Part I, Line 1a

Form 1116	Foreign Tax Credit (Individual, Estate, or Trust) ▶ Attach to Form 1040, 1040NR, 1041, or 990-T. ▶ Information about Form 1116 and its separate instructions is at www.irs.gov/form1116 .			OMB No. 1545-0121 2015 Attachment Sequence No. 19	
Department of the Treasury Internal Revenue Service (99)	Name _____ Identifying number as shown on page 1 of your tax return Taxpayer D XXX-XX-XXXX				
Use a separate Form 1116 for each category of income listed below. See Categories of Income in the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.					
<input type="checkbox"/> a Passive category income <input type="checkbox"/> c Section 901(j) income <input type="checkbox"/> e Lump-sum distributions <input checked="" type="checkbox"/> b General category income <input type="checkbox"/> d Certain income re-sourced by treaty					
f Resident of (name of country) ▶ _____					
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)					
		Foreign Country or U.S. Possession			Total
		A	B	C	(Add cols. A, B, and C.)
g	Enter the name of the foreign country or U.S. possession ▶	XYZ			
1a	Gross income from sources within country shown above and of the type checked above (see instructions): Wages - \$130,100 Form 2555 FEIE - (\$100,800)				
		29,300			1a 29,300





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Passive Category Part I – Line 1a Adjustments for Rate Differential

- **Foreign Source Qualified Dividends**
 - Qualified dividends are reported on Form 1040, line 9b, or Form 1040NR, line 10b
 - If a taxpayer has any foreign source qualified dividends, he or she may be required to make adjustments to the amount of those qualified dividends before taking them into account on Line 1a of Form 1116 – passive category





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Passive Category Part I – Line 1a Adjustments for Rate Differential

- **Foreign Source Capital Gains and Losses**
 - If a taxpayer has foreign source capital gains or capital losses (including any capital gain distributions), he or she may have to make certain adjustments to those gains or losses before taking them into account on Line 1a (gains) or Line 5 (losses) on Form 1116





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Foreign Tax Redeterminations

- Foreign tax redeterminations generally occur if there is a **change** to the amount of **creditable foreign taxes**
- A redetermination of U.S. tax liability is required under the following circumstances:
 - When a foreign tax claimed as a credit is refunded, or
 - When the taxpayer elects to accrue taxes, and
 - The amount of the creditable foreign taxes accrued differs from the amount actually paid, or
 - When accrued taxes claimed remain unpaid after 2 years





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Example 4: Foreign Tax Redeterminations

- Taxpayer A properly accrued \$100,000 of Country X taxes in 2014 and claimed \$100,000 of FTC on his U.S. Return
- When A paid his Country X tax for 2014, after he filed his U.S. return, his actual liability was \$75,000
- A foreign tax redetermination has occurred; A must notify the IRS on an amended return and A's U.S. tax liability must be re-determined





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Example 5: Foreign Tax Redeterminations

- Taxpayer B accrued \$5,000 of Country Z tax for FTC purposes on her 2012 U.S. tax return; As of December 31, 2014, these taxes were still unpaid
- A foreign tax redetermination has occurred; B must notify the IRS on an amended return for 2012 and B's U.S. tax liability must be re-determined
- If B subsequently pays the foreign tax, it will be a second foreign tax redetermination and B can claim a refund, for 2012, subject to the limitation in Section 6511; generally, it must be filed within 10 years of the unextended due date of the 2012 return





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Example 6: Foreign Tax Redeterminations

- In 2014, Taxpayer C paid \$20,000 of taxes to Country Q and claimed a FTC for this amount on his U.S. Return
- In 2016, Country Q refunded \$2,500 to C for a credit he forgot to claim on his 2014 Country Q tax return
- A foreign tax redetermination has occurred; C must notify the IRS on an amended return for 2014 and C's U.S. tax liability must be re-determined





Foreign Tax Redeterminations

- Taxpayers must file an amended return to notify the IRS of a foreign tax redetermination; An individual must file a Form 1040X with a revised Form 1116
- IRC § 6689 imposes a failure to notify penalty equal to 5% of the U.S. tax due on redetermination for each month the failure continues – with a 25% maximum
- If a redetermination results in an overpayment of U.S. tax, taxpayers must generally file a claim for refund with 10 years of the unextended due date of the return for the year to which the foreign tax relates





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IRS Publications and Additional Resources

- Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*
- Publication 514, *Foreign Tax Credit for Individuals*
- Publication 901, *U.S. Tax Treaties*
- Form 1116 & Instructions for Form 1116
- www.irs.gov





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Questions

