IRS Nationwide TaxForum 2017

Foreign Tax Credit
Common Issues

Nationwide Tax Forums

2017

Objectives

After the completion of this course, you will be able to:

- Explain the creditability of foreign taxes with respect to treaty rates vs. statutory withholding rates.
- Differentiate between the annual election to claim the foreign tax credit or deduct foreign taxes.
- Define foreign tax redeterminations.

Foreign Tax Credit Concepts

- Foreign tax credit (FTC) mitigates the effect of double taxation.
- FTC reduces a U.S. taxpayer's tax liability by all or part of foreign taxes paid or accrued during a tax year.
- Determining the source of income as U.S. source or foreign source is important to correctly compute the FTC.

IRS Nationwide Tax Forum | 2017

Foreign Tax Credit Concepts

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

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

2016

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
	A	**B**	**C**	(Add cols. A, B, and 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**

Foreign Tax Credit Concepts

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

1. Be an income tax, or a tax imposed in lieu of an income tax,
2. Be the legal and actual foreign tax liability,
3. Be a tax imposed on the taxpayer and
4. Must have been tax paid or accrued by the taxpayer.

Treaty Rates vs Statutory Withholding Rates

- The U.S. has income tax treaties with over 60 countries.
- Tax treaties establish specific withholding rates for certain types of income.
  - Generally passive income when FTC applies.
- Treaty rates may be used by taxpayers to reduce the amount of foreign taxes they pay to the foreign country.

Treaty Rates vs Statutory Withholding Rates

- The statutory withholding rate is the rate of tax withheld on certain types of income based on the internal tax laws of particular countries.
- If a treaty is in place with a foreign country, taxpayers must use the lower treaty rate instead of the higher statutory withholding rate for FTC computation purposes.

Statutory Withholding Rates 1099

IRS Tax Forum | IRS Nationwide | 2017

9191 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	1a Total ordinary dividends $ 1b Qualified dividends $	OMB No. 1545-0110 2017 Form 1099-DIV	**Dividends and Distributions**
	2a Total capital gain distr. $	2b Unrecap. Sec. 1250 gain $	**Copy A For Internal Revenue Service Center**
PAYER'S federal identification number / RECIPIENT'S identification number	2c Section 1202 gain $	2d Collectibles (28%) gain $	**File with Form 1096.**
RECIPIENT'S name	3 Nondividend distributions $	4 Federal income tax withheld $	For Privacy Act and Paperwork Reduction Act Notice, see the **2017 General Instructions for Certain Information Returns.**
Street address (including apt. no.)		5 Investment expenses $	
	6 Foreign tax paid $	7 Foreign country or U.S. possession	
City or town, state or province, country, and ZIP or foreign postal code	8 Cash liquidation distributions $	9 Noncash liquidation distributions $	
FATCA filing requirement ☐	10 Exempt-interest dividends $	11 Specified private activity bond interest dividends $	
Account number (see instructions) / 2nd TIN not. ☐	12 State / 13 State identification no.	14 State tax withheld $ $	

IRS TaxForum IRS Nationwide | 2017

Form 1116 – Foreign Taxes Paid

Part II Foreign Taxes Paid or Accrued (see instructions)

Country	Credit is claimed for taxes (you must check one) (h) ☐ Paid (i) ☐ 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	XX/XX/XXXX	$XX,XXX				$X,XXX				$X,XXX
B										
C										

8 Add lines A through C, column (s). Enter the total here and on line 9, page 2 . . . . ▶ 8 $X,XXX

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11440U Form **1116** (2016)

Example 1: Treaty Rates vs. Statutory Withholding Rates

Taxpayer A earned $10,000 of interest income from Foreign Country B. Tax was withheld at a rate of 30% but the treaty rate is 15%.

• Statutory Withholding rate ($10,000 x 30%)	$3,000
• Reduced Withholding rate ($10,000 x 15%)	$1,500
• **Creditable Foreign Taxes**	**$1,500**

Example 2: Treaty Rates vs. Statutory Withholding Rates

Taxpayer B received a 1099-DIV reporting total dividends of $20,000 and foreign taxes withheld of $6,000. The foreign country is listed as "various".

In reality, the $20,000 in dividends consisted of:

- $10,000 in dividends from Country C (treaty rate of 15% for dividends) and
- $10,000 in dividends from Country D (treaty rate of 0% for dividends)

Example 2: Treaty Rates vs. Statutory Withholding Rates

Taxpayer B's Form 1116 listed $6,000 in foreign taxes paid on foreign dividends and listed the country as "various".

Taxpayer B incorrectly reported the amount of creditable foreign taxes. The correct reporting was:

- Each foreign country should have been identified on the Form 1116.
- The creditable foreign taxes should have been claimed based on the treaty rate, not the statutory withholding rate

Example 2: Treaty Rates vs. Statutory Withholding Rates

Taxpayer B's **correct** foreign taxes paid:

Country	Dividends Received	Foreign Taxes Paid (Treaty Rate)
C	$10,000	$1,500
D	$10,000	$ 0
	Foreign Taxes Paid	$1,500

Credit vs. Deduction

- Individuals are allowed to make an annual choice to either elect the foreign tax credit or to deduct foreign taxes.
- Individuals may claim the foreign tax credit one year and deduct foreign taxes in the following year and vice versa.
- Treas. Reg. § 1.901-1(c) and IRC§ 275(a)(4) disallow a deduction for foreign taxes if those taxes are used for FTC computation purposes.

Example 3: Credit vs. Deduction

Tax Year 2XX7: Individual A accrued and paid $50,000 in income taxes to Country XYZ. A chose to deduct the foreign taxes in 2XX7.

Tax Year 2XX8: Individual A accrued and paid $30,000 in income taxes to Country XYZ. For 2XX8, A elected to claim the FTC instead of deducting the foreign taxes as she did in 2XX7.

Example 4: Credit vs. Deduction

For tax year 2XX8, A, an individual, accrued and paid $30,000 in income taxes to Country XYZ. A was confused about his tax situation. He thought he was correctly preparing his return when he deducted the $30,000 in foreign taxes on Schedule A **and** used the same foreign taxes to compute FTC on Form 1116.

A "double-dipped" and claimed a deduction and FTC on the same taxes. This is not allowed.

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
    - The accrued taxes claimed remain unpaid after 2 years.

Example 5: Foreign Tax Redeterminations

Taxpayer B properly accrued $50,000 of Country X taxes in 2015 and claimed $50,000 of FTC on his U.S. tax return.

B computed his 2015 Country X tax liability. His actual foreign tax liability was $25,000. He paid the tax. (B already filed his 2015 U.S. tax return.)

B must file an amended return 2015 return to notify the IRS of the redetermination and compute the correct U.S. tax liability.

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.
- If a redetermination results in an additional tax due, but the tax due is eliminated by a carryback or carryover, a Form 1040X does not generally need to be filed.

Foreign Tax Redeterminations

- Refund claims (General rule): must be filed within the later of 3 years from the date the return was filed **or** 2 years from the date when the tax was paid.
- Refund claims due to foreign tax redeterminations:
  - Must be filed within 10 years from the original due date of the return, without regard to extensions.

If a taxpayer redetermined his foreign tax for the 2015 tax year in 2017, he has until April 15, 2026 to file an amended return and claim the refund.

Example 6: Foreign Tax Redeterminations

Taxpayer C is subject to income tax in Country Z on net business income. C claimed a foreign tax credit for Country Z taxes when he filed his U.S. tax return. C later filed a claim for refund with Country Z due to extra deductions that were not originally claimed.

A foreign tax redetermination has occurred. Taxpayer C should file an amended return with IRS in the time provided by law.

- If Taxpayer C does not file an amended return to inform the IRS of the foreign tax redetermination, the IRS has an unlimited statute of limitations for FTC-related adjustments.

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 and the Form 1116 Instructions
- https://www.youtube.com/watch?v=ph8A1eA1lq4

Questions