



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Process Unit

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| Unit Name | Foreign Earned Income Exclusion Adjustment | |
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| Library Level | Title |
|-----------------------|--|
| Knowledge Base | International |
| Shelf | Individual Outbound |
| Book | Foreign Tax Credits Individual |
| Chapter | Calculation of Amount of Allowable FTC |

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|--------------------------------------|-----------|
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Process Overview

Foreign Earned Income Exclusion Adjustment

The purpose of the foreign tax credit (FTC) is to relieve taxpayers of a double tax burden when their foreign source income is taxed by the foreign country and also by the United States. Taxpayers with foreign source earned income may be able to claim the foreign earned income exclusion (FEIE) on a portion of their foreign earnings. However, taxpayers are not allowed to claim a credit for taxes paid on earned income that is excluded under the FEIE. See IRC 911(d)(6).

Taxpayers that exclude all of their foreign earned income cannot take a credit for any taxes paid or accrued on that income. However, taxpayers that only exclude a portion of their foreign earned income, cannot take a credit for any part of the foreign taxes allocable to the excluded amount.

The focus of this unit is to determine the amount of foreign taxes allocable to excluded income, which will reduce the foreign taxes eligible for the FTC.

This process unit will apply when:

1. Taxpayers report foreign earned income, either wages or salaries on Form 1040 or Form 1040-SR, or as independent contractors on Schedule C or Schedule C-EZ, and
2. Taxpayers exclude a portion of their foreign earned income on Form 2555, and
3. Taxpayers claim a foreign tax credit on Form 1116 if the general category income box is checked.

Summary of Process Steps

Foreign Earned Income Exclusion Adjustment

Process Steps

An adjustment to foreign taxes paid on foreign earned income is required on Form 1116 when taxpayers exclude a portion of their earned income under the FEIE. If taxpayers exclude all of their income under the FEIE, then none of the foreign taxes paid on their foreign earned income can be included in determining the foreign tax credit. See IRC 911(d)(6).

| | |
|-------------------------------|--|
| <u>Step 1</u> | Determine the amount of foreign earned income excluded and verify that the excluded amount is not included on Form 1116 line 1a as foreign gross income. |
| <u>Step 2</u> | Compute the fraction needed to determine the amount of foreign taxes allocable to excluded income. |
| <u>Step 3</u> | Apply the fraction from Step 2 to compute the reduction in foreign taxes allocable to excluded foreign income. |

Step 1: Determine the Amount of Foreign Income Excluded

Foreign Earned Income Exclusion Adjustment

Step 1

Determine the amount of foreign earned income excluded and verify that the excluded amount is not included on Form 1116, line 1a as foreign gross income.


| Considerations | Resources |
|---|--|
| <p>Review Form 2555 or Form 2555-EZ to determine the amount of foreign earned income excluded. This amount should correspond to the amount of the exclusion in other income on line 21 of Form 1040 for tax years prior to 2018. For tax years 2018 going forward, other income is on Schedule 1. The line number is no longer consistent from year to year.</p> <p>Review Form 1116 for general category income to determine the amount of foreign earned income received (or accrued) and the amount of foreign taxes paid (or accrued). Verify that the excluded foreign income is not included on line 1a of Form 1116.</p> | <ul style="list-style-type: none">▪ Form 2555 - <i>Foreign Earned Income</i>▪ Form 2555-EZ - <i>Foreign Earned Income Exclusion</i>▪ Form 1040 - <i>U.S. Individual Income Tax Return</i>▪ Form 1116 - <i>Foreign Tax Credit</i>▪ Form 1116 Instructions |

Step 2: Determine the Amount of Foreign Taxes Allocable to Excluded Foreign Income

Foreign Earned Income Exclusion Adjustment

Step 2

Compute the fraction needed to determine the amount of foreign taxes allocable to excluded income.

| Considerations | Resources |
|--|--|
| <p>To determine the foreign taxes allocable to the excluded foreign income, first compute the numerator and the denominator of the allocation fraction.</p> <p>Numerator: Foreign earned income and housing amounts excluded for the tax year minus otherwise deductible expenses allocable to that income, not including the foreign housing deduction.</p> <p>Denominator: Total foreign earned income received or accrued for the tax year minus deductible expenses allocable to that income, including the foreign housing deduction.</p> <p> CAUTION: If the foreign jurisdiction taxes foreign earned income and some other income (i.e. 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 is the total amount of income subject to foreign tax minus deductible expenses allocable to that income.</p> | <ul style="list-style-type: none">▪ Pub. 514 – <i>Foreign Tax Credit for Individuals</i>▪ Form 1116 Instructions▪ Treas. Reg. 1.911-6(c) |

Step 2: Determine the Amount of Foreign Taxes Allocable to Excluded Foreign Income (cont'd)

Foreign Earned Income Exclusion Adjustment

Step 2

| Considerations | Resources |
|--|--|
| <p><u>Example</u></p> <p>A taxpayer who is a U.S. citizen works for Company B and lives in foreign country Z has records that show the following:</p> <ul style="list-style-type: none"> ▪ Foreign earned income received: \$175,000 ▪ Unreimbursed business expenses: \$25,000 ▪ Income tax paid to country Z: \$45,000 ▪ Exclusion of foreign earned income and housing deduction: \$102,100 <p>Determine the amount of business expenses, allocable to excluded wages, that are not deductible. Multiply the otherwise deductible expenses by a fraction. That fraction is the excluded wages over foreign earned income. For this example, the computation is as follows:</p> $\$25,000 \times \frac{\$102,100}{\$175,000} = \$14,586$ | <ul style="list-style-type: none"> ▪ Pub. 514 – <i>Foreign Tax Credit for Individuals</i> ▪ Form 1116 Instructions ▪ Treas. Reg. 1.911-6(c) |

Step 2: Determine the Amount of Foreign Taxes Allocable to Excluded Foreign Income (cont'd)

Foreign Earned Income Exclusion Adjustment

Step 2

| Considerations | Resources |
|---|--|
| <p><u>Example (cont'd)</u></p> <p>Next, find the numerator of the fraction by subtracting business expenses allocable to excluded wages and therefore not deductible.</p> $\$102,100 - \$14,586 = \$87,514$ <p>Then, find the denominator of the fraction by subtracting all deductible expenses from all foreign earned income.</p> $\$175,000 - \$25,000 = \$150,000$ | <ul style="list-style-type: none"> ▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i> ▪ Form 1116 Instructions ▪ Treas. Reg. 1.911-6(c) |

Step 3: Compute the Foreign Earned Income Exclusion Adjustment

Foreign Earned Income Exclusion Adjustment

Step 3

Apply the fraction from Step 2 to compute the reduction in foreign taxes allocable to excluded foreign income.

| Considerations | Resources |
|--|--|
| <p><u>Example (cont'd)</u></p> <p>Now that we have determined the numerator and denominator, we continue with our example from Step 2.</p> $\$87,514 \div \$150,000 \times \$45,000 = \$26,254$ <p>The amount of tax paid or accrued to foreign country Z that cannot be credited is \$26,254.</p> <p>This is the amount that should be reported on line 12, Reduction in Foreign Taxes, of Form 1116.</p> | <ul style="list-style-type: none"> ▪ Pub. 514 – <i>Foreign Tax Credit for Individuals</i> ▪ Form 1116 Instructions ▪ Treas. Reg. 1.911-6(c) |

Other Considerations / Impact to Audit

| Foreign Earned Income Exclusion Adjustment | |
|--|---|
| Considerations | Resources |
| The computation of the FEIE adjustment is not included in the body of Form 1116, but rather as a side calculation. Request details of the computation from the taxpayer. | <ul style="list-style-type: none">▪ Form 1116 Instructions▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i> |
| Additional examples with different fact patterns are available. See the examples in the regulation. | <ul style="list-style-type: none">▪ Treas. Reg. 1.911-6(d) |

Index of Referenced Resources

Foreign Earned Income Exclusion Adjustment

Form 1040 - *U.S. Individual Income Tax Return*

Form 1116 - *Foreign Tax Credit*

Form 2555 - *Foreign Earned Income*

Form 2555-EZ - *Foreign Earned Income Exclusion*

Form 1116 Instructions

Pub. 514 - *Foreign Tax Credit for Individuals*

IRC 911

Treas. Reg. 1.911-6

Training and Additional Resources

| Foreign Earned Income Exclusion Adjustment | |
|--|---|
| Type of Resource | Description(s) |
| Saba Meeting Sessions | <ul style="list-style-type: none">▪ <i>How to Audit FTC - Form 1116 Part IV 2015 CPE</i> – 2015 Saba Meeting |
| Issue Toolkits | <ul style="list-style-type: none">▪ Audit Tool - FTC Workbook |
| Databases / Research Tools | <ul style="list-style-type: none">▪ <i>BNA Tax Management Portfolio Foreign Income Series 6080-1st Sec. III</i>▪ <i>Kuntz & Peroni - U.S Int'l Tax Para B4.06</i> |

Glossary of Terms and Acronyms

| Term/Acronym | Definition |
|--------------|---------------------------------|
| FEIE | Foreign Earned Income Exclusion |
| FTC | Foreign Tax Credit |
| IRC | Internal Revenue Code |

Index of Related Practice Units

| Associated UIL | Related Practice Unit |
|----------------|--|
| 9432.01 | <i>FTC General Principles</i> |
| 9432.01 | <i>Creditable Foreign Taxes</i> |
| 9432.02 | <i>Sourcing of Salary and Compensation</i> |