

LB&I Process Unit

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Primary UIL Code	9432.02	Calculation of Amount of Allowable FTC

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Process Overview

FTC Limitation and Computation

United States (U.S.) citizens and resident aliens are subject to tax on worldwide taxable income (WWTI), which includes both U.S. source taxable income (USTI) and foreign source taxable income (FSTI). When a foreign jurisdiction also taxes FSTI, the U.S. provides a foreign tax credit (FTC) to relieve this double taxation. This credit is limited to the amount of U.S. income tax imposed on FSTI. This is called the FTC limitation. This Practice Unit explains in general terms the computation of an individual taxpayer's FTC limitation.

The purpose of the FTC limitation is to prevent foreign taxes from offsetting the U.S. tax on USTI. In other words, U.S. national tax policy is not to subsidize the levies of foreign countries but to provide relief where double taxation exists. The FTC should only reduce U.S. tax on FSTI.

The FTC limitation is also designed to prevent the blending of high foreign tax rates in excess of the U.S. tax rate with low foreign tax rates to get to an overall foreign tax rate below the U.S. tax rate. To this end, a separate FTC limitation is determined with respect to various specific categories of income. A separate Form 1116 - *Foreign Tax Credit (Individual, Estate, or Trust)*, must be completed to determine the FTC amount allowed for each separate category.

The amount of a taxpayer's FTC is the lesser of the creditable foreign income taxes actually paid or accrued, or the FTC limitation. In other words, if the creditable foreign taxes paid or accrued by a taxpayer in a given tax year exceeds the taxpayer's FTC limitation, the taxpayer cannot take a credit for the excess amount of foreign taxes. However, the taxpayer may carry back and/or carry over the unused foreign taxes to another tax year in which the taxpayer's FTC limitation exceeds the amount of creditable taxes paid or accrued (taxpayer is in an excess limitation position).

Note: FTC issues related to creditability, categorization, sourcing, alternative minimum tax FTC, carryback and/or carryover and residency are beyond the scope of this Practice Unit. The Index of Related Practice Units slide provides a listing that may address some of these issues.

Process Overview (cont'd)

FTC Limitation and Computation

As described on the previous slide, the FTC limitation is equal to the U.S. income tax imposed on FSTI. This amount is determined by multiplying the taxpayer's entire U.S. income tax liability (determined without regard to the credit) by a fraction, the numerator of which is FSTI and the denominator of which is WWTI.

$$\frac{\text{FSTI}}{\text{WWTI}} \times \text{U.S. Income Tax Before Credit} = \text{FTC Limitation}$$

Step 1: Determine Worldwide Taxable Income

FTC Limitation and Computation

Step 1

Determine worldwide taxable income.

Considerations	Resources
<p>Step 1 is to determine the denominator, WWTI. For years prior to 2018 that number is taxable income before the deduction for personal exemptions. For years after 2017, there are no longer deductions for personal exemptions. Therefore, the denominator, WWTI, for 2019 is taxable income reported on Form 1040 line 11b. WWTI is entered on line 18 of Form 1116.</p> <p>If any other amount is received by the taxpayer which is, for any one of a number of reasons, excluded from the taxpayer's U.S. taxable income, then that amount is not properly includable in WWTI. Ask direct questions to ensure the taxpayer is reporting all WWTI. Review the taxpayer's records to ensure that includible amounts are accurate and complete.</p>	<ul style="list-style-type: none"> ▪ IRC 61(a) ▪ IRC 904(a) ▪ Form 1040 - <i>U.S. Individual Income Tax Return</i> ▪ Form 1116 - <i>Foreign Tax Credit (Individual, Estate, or Trust)</i> ▪ Form 1116 Instructions ▪ Form 2555 - <i>Foreign Earned Income</i> ▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i> ▪ IRC 904(b)(1)

Step 2: Determine Foreign Source Taxable Income

FTC Limitation and Computation

Step 2

Determine foreign source taxable income.


Considerations	Resources
<p>Step 2 is to determine the numerator, FSTI. Foreign source taxable income plays a major part in the determination of how much FTC a taxpayer may be able to take in a particular year.</p> <p>The taxpayer is required to first identify the gross foreign source income (FSI) in accordance with sourcing rules under the Internal Revenue Code. Next the taxpayer identifies, allocates and apportions expenses and deductions to that gross FSI in accordance with specific rules under the Internal Revenue Code. Gross FSI less allocable expenses and deductions equals FSTI. FSTI is determined by preparing a separate Form 1116 for each separate category of income.</p> <p>It is recommended that a schedule be requested in which the taxpayer identifies the source of all items of gross income and the allocation and apportionment of all expenses and deductions to either gross FSI or gross U.S. source income.</p>	<ul style="list-style-type: none"> ▪ IRC 904 ▪ IRC 861-865 ▪ Treas. Reg. 1.861-8, -8T ▪ Form 1116 - <i>Foreign Tax Credit (Individual, Estate, or Trust)</i> ▪ Form 1116 Instructions ▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i>

Step 3: Determine U.S. Income Tax Liability Before Any Credits

FTC Limitation and Computation

Step 3

Determine U.S. income tax liability before any credits.

Considerations	Resources
<p>Step 3 is to determine the individual's U.S. income tax liability before FTCs.</p> <p>For tax years prior to 2018, this can be found on Form 1040, lines 44 and 46. For 2018, this can be found on Form 1040 line 11a and Schedule 2, line 46. For 2019, this can be found on Form 1040, line 12a and Schedule 2, line 2. For purposes of determining the FTC limitation, this is also entered on Form 1116, line 20.</p> <p> CAUTION: The U.S. income tax liability before FTCs does not include AMT Tax.</p> <p>This number is multiplied by the ratio of FSTI (Step 2) to WWTI (Step 1).</p>	<ul style="list-style-type: none">▪ IRC 904(a)▪ Form 1040 - <i>U.S. Individual Income Tax Return</i>▪ Form 1116 - <i>Foreign Tax Credit (Individual, Estate, or Trust)</i>▪ Form 1116 Instructions▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i>

Step 4: Compute FTC Limitation

FTC Limitation and Computation

Step 4

Compute FTC limitation.

Considerations	Resources
<p>Step 4 is to compute the FTC limitation. The product of the equation $(FSTI / WWTI) \times \text{U.S. income tax before credit}$ equals the maximum amount of allowable FTC for the year, the FTC limitation. This is reported on Form 1116, line 21. If the creditable foreign taxes (reported on Form 1116, line 14) are less than the FTC limitation, the taxpayer's FTC is limited to the creditable foreign taxes. The creditable foreign taxes are then reported on Form 1040 to reduce the U.S. income tax liability for the year (for 2017, Form 1040, line 48; for 2018, Form 1040, Schedule 3, line 48; for 2019, Form 1040, Schedule 3, line 1).</p> <p>Foreign taxes in excess of the FTC limitation may be credited in the prior tax year to the extent there is excess FTC limitation in that year. Any excess foreign taxes not credited in the prior tax year may be carried forward and credited to the extent of excess FTC limitation in each of the subsequent ten years.</p> <p>The FTC limitation is calculated and applied separately for each of the five separate categories of income which are discussed in detail in another related Practice Unit.</p>	<ul style="list-style-type: none"> ▪ IRC 904 ▪ Form 1040 - <i>U.S. Individual Income Tax Return</i> ▪ Form 1116 - <i>Foreign Tax Credit (Individual, Estate, or Trust)</i> ▪ Form 1116 Instructions ▪ Pub. 514 - <i>Foreign Tax Credit for Individuals</i> ▪ IRM 4.61.10.9 - <i>FTC Limitation</i>

Example of the Process

FTC Limitation and Computation

Description

Example:

FSTI = \$100,000 from country Y. USTI = \$900,000. Therefore, WWTI = \$1,000,000. The U.S. income tax before credit = \$310,000. Assume country Y's tax rate = 46%. Country Y only taxes Country Y source income. Foreign taxes paid = \$46,000. Taxpayer is a cash basis taxpayer.

The FTC limitation is calculated as follows:

$$\frac{\text{FSTI}}{\text{WWTI}} \times \text{U.S. Income Tax Before Credit} = \text{FTC Limitation}$$
$$\frac{\$100,000}{\$1,000,000} \times \$310,000 = \$31,000 \text{ Maximum FTC for the Year (IRC 904(a) Limitation)}$$

The allowed FTC is \$31,000 which is the lesser of the U.S. income tax on the FSTI (\$31,000) or the foreign tax paid (\$46,000). In the above example, the taxpayer has paid \$46,000 of creditable foreign taxes but the credit is limited to \$31,000. The taxpayer may be able to carry back the \$15,000 excess foreign taxes to the prior tax year and any amount in excess of the limitation in the carryback year may be carried forward for ten years.

Other Considerations / Impact to Audit

FTC Limitation and Computation	
Considerations	Resources
<ul style="list-style-type: none"> It is very important to check if the sourcing of the income has been done correctly. It is also important to check the assignment of income to a separate category. 	<ul style="list-style-type: none"> Practice Unit - <i>Sourcing of Income</i> Practice Unit - <i>Categorization of Income and Taxes into Proper Basket</i>
<ul style="list-style-type: none"> Certain adjustments to gross FSI for the passive category may apply if there are “Qualified Dividends” or “Capital Gains.” Refer to the Practice Unit on Qualified Dividends and Capital Gains Rate Differential Adjustment. 	<ul style="list-style-type: none"> IRC 904(b) Treas. Reg. 1.904(b)-1 Practice Unit - <i>Qualified Dividends and Capital Gains Rate Differential Adjustment</i>
<ul style="list-style-type: none"> Gross FSI for the general category does not include income excluded under the foreign earned income exclusion (FEIE) reported on Form 2555. Deductions and losses allocated and apportioned to reduce gross FSI do not include deductions and losses related to exempt or excluded income, such as foreign earned income excluded on Form 2555. Refer to the Practice Unit on Foreign Earned Income Exclusion Adjustment. 	<ul style="list-style-type: none"> IRC 911(d)(6) Treas. Reg. 1.911-6(a) Treas. Reg. 1.861-8T(d)(2)(iii)(D) Form 2555 - <i>Foreign Earned Income</i> Practice Unit - <i>Foreign Earned Income Exclusion Adjustment</i>
<ul style="list-style-type: none"> Foreign taxes paid or accrued with respect to the excluded income are disallowed. The disallowed FTC equals the fraction of total foreign income taxes imposed on the foreign earned income equal to excluded foreign earned income (less allocable expenses) / total foreign earned income (less allocable expenses). In addition, an individual entitled to an FTC under a U.S. income tax treaty cannot claim the credit if the credit is with respect to income excluded under the FEIE. 	<ul style="list-style-type: none"> Treas. Reg. 1.911-6(c) Treas. Reg. 1.911-6(d), Example 6 Rev. Rul. 79-199

Index of Referenced Resources

FTC Limitation and Computation
Form 1040
Form 1116
Form 2555
Form 1116 Instructions
IRC 61(a)
IRC 861 – 865
IRC 904
IRC 911(d)(6)
IRM 4.61.10.9 - <i>FTC Limitation</i>
Pub. 514 - <i>Foreign Tax Credit for Individuals</i>
Rev. Rul. 79-199
Treas. Reg. 1.861-8, -8T
Treas. Reg. 1.904(b)-1
Treas. Reg. 1.911-6

Training and Additional Resources

FTC Limitation and Computation	
Type of Resource	Description(s)
Saba Meeting Sessions	<ul style="list-style-type: none">▪ <i>How To Audit FTC - Form 1116, Part III Figuring the Credit, Lessons #4 - 2015 Saba</i>
Databases / Research Tools	<ul style="list-style-type: none">▪ <i>BNA Tax Management Int'l Portfolio 904-2nd Sec. II</i>▪ External Publications for Separate Computations of the Overall Section 904 Limitation Lexis International Taxation Corporate and Individual (CCH) P 6.18 - February 2016

Glossary of Terms and Acronyms

Term/Acronym	Definition
FEIE	Foreign Earned Income Exclusion
FSI	Foreign Source Income
FSTI	Foreign Source Taxable Income
FTC	Foreign Tax Credit
Gross FSI	Gross Foreign Source Income: Foreign source income before reduction for allocable expenses and deductions
USTI	U.S. Source Taxable Income
WWTI	Worldwide Taxable Income

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9432.01	<i>FTC General Principles</i>
9432.02	Sourcing of Fringe Benefits for FTC Limitation
9432.02	<i>Sourcing of Salary and Compensation</i>
9432.02-01	<i>Sourcing of Income</i>
9432.02-02	<i>Categorization of Income and Taxes Into Proper Basket</i>
9432.02-03	<i>Qualified Dividends and Capital Gains Rate Differential Adjustment</i>
9432.02-04	<i>Foreign Earned Income Exclusion Adjustment</i>