Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit
Knowledge Base – International

Library Level	Number	Title
Shelf		Individual Outbound
Book	10	Foreign Tax Credit
Chapter	10.1	Creditability of Foreign Tax Credit Claimed
Section		
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Unit Name	FTC General Principles	
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General Overview

FTC General Principles

This Practice Unit discusses the following individual foreign tax credit (FTC) general principles:

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  - Foreign tax credit limitation

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- What foreign taxes qualify for the FTC?

- Foreign tax credit vs. foreign tax deduction
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FTC General Principles
Basic Concept of FTC

Analysis	Resources
The credit for foreign income taxes paid was first introduced into tax law by the Revenue Act of 1918. The existence of the credit is a testament to the recognition that some mechanism to prevent multiple instances of taxation on the same income is necessary to avoid double taxation that results when income earned in a foreign country is taxed by both the United States and the foreign country. Since the United States taxes its citizens, residents, and domestic corporations on their worldwide income, double taxation typically occurs whenever a U.S. person is taxed by a foreign country. Consider the following example: A U.S. individual taxpayer goes to Italy for a one-year assignment. This U.S. individual has to pay income taxes to Italy since he is working there, but also as a U.S. individual he has to pay taxes on his worldwide income to the U.S., including income earned in Italy. The taxpayer does not claim the foreign earned income exclusion. As such, the Italian income is taxed both by the U.S. and Italy. This is double taxation. In order to alleviate the effects of double taxation, subject to certain limitations, the U.S. provides a FTC to the U.S. taxpayer above. The FTC reduces a U.S. taxpayer's U.S. tax liability by all or part of the foreign taxes paid or accrued during the year. The FTC is generally limited to the lesser of the foreign tax paid or the U.S. tax on the foreign income. If in the above example the U.S. taxpayer paid $15,000 of income tax to Italy, but the U.S. tax on the same income earned in Italy is $14,500, then the FTC is limited to $14,500.	

Detailed Explanation of the Concept (cont'd)

FTC General Principles
Basic Concept of FTC

Analysis	Resources
As discussed earlier, the FTC is designed to alleviate double taxation when the foreign source income is taxed by both the United States and a foreign country. It is not generally the purpose of the FTC, however, to reduce U.S. income tax on other income that is unrelated to the foreign taxes paid. Consider the following example: Assume country Y's tax rate is 46% and the U.S. tax rate is 35%. Taxpayer B pays $46 of foreign tax on $100 of income earned in country Y. Taxpayer B earned no other foreign source income, but earns $50 of U.S. source income. If the foreign tax were fully creditable, the after-credit U.S. tax on the $100 country Y income would be a negative $11 ($35 of pre-credit U.S. tax less $46 of credit). The credit would not only reduce U.S. tax on the country Y income, but also reduce U.S. tax on U.S. source income by $11. The latter effect is not necessary to alleviate double taxation. Under IRC 904(a), the credit for foreign income taxes is limited to an amount equal to the pre-credit U.S. tax on the taxpayer's foreign source income. In the above example, IRC 904(a) will limit the FTC to $35, the lesser of the foreign tax paid or the U.S. tax on the foreign source income. The taxpayer is allowed to carry back the excess foreign taxes of $11 to the preceding tax year and any unused portion forward 10 tax years, as explained later.	▪ IRC 904(a) ▪ IRC 904(c)

Detailed Explanation of the Concept (cont'd)

FTC General Principles
Basic Concept of FTC

Analysis	Resources
For individuals, there are five separate categories of income for which a separate FTC limitation must be calculated: general, passive, IRC 901(j) income, certain income re-sourced by treaty and lump-sum distributions. It is not the purpose of this Practice Unit to discuss in depth the complex limitation rules under IRC 904.	

FTC General Principles

Identify Taxpayers Eligible to Claim FTC

Analysis	Resources
IRC 901(b) allows the following categories of taxpayers to claim the FTC:	▪ IRC 901(b)
I. U.S. citizens.	▪ Treas. Reg. 1.901-1(a)
II. U.S. residents (green card holders or those who meet the substantial presence test).	▪ Pub. 514 – *Foreign Tax Credit for Individuals*
III. Bona fide residents of Puerto Rico.	▪ Pub. 519 - *U.S. Tax Guide for Aliens*
IV. Domestic corporations.	
V. Any person described in I through IV who is a member of a partnership or a beneficiary of an estate or trust may claim as a credit a proportionate share of the qualifying foreign taxes paid or accrued by the entity.	▪ IRC 901(b)(4)
Nonresident aliens (NRAs) and foreign corporations generally cannot claim the FTC because they are not taxed by the U.S. on their foreign source income. However, when an NRA or a foreign corporation is engaged in a trade or business in the U.S., they are taxed on their effectively connected income (ECI) and may claim a FTC for foreign income taxes paid with respect to the ECI, provided the tax is not imposed solely because of residency or citizenship, or with respect to a foreign corporation’s place of incorporation or domicile. Note: ECI is an inbound topic. If you encounter this issue with an NRA or a foreign corporation, consider consulting with the U.S. Business Activities Practice Network.	▪ IRC 906

Detailed Explanation of the Concept (cont'd)

FTC General Principles
What Foreign Taxes Qualify for the FTC?

Analysis	Resources
While it is not the purpose of this Practice Unit to discuss in detail what foreign taxes qualify for the FTC (creditability), in order for a foreign tax to qualify for the FTC, the following four tests must be met: I. The tax must be the legal and actual foreign tax liability. II. The tax must be an income tax (or a tax in lieu of an income tax). III. The tax must be imposed on the taxpayer. IV. The taxpayer must have paid or accrued the tax.	▪ Treas. Reg. 1.901-2 ▪ Pub. 514 - *Foreign Tax Credit for Individuals*

Detailed Explanation of the Concept (cont'd)

FTC General Principles
Foreign Tax Credit vs. Foreign Tax Deduction

Analysis	Resources
Taxpayers can make an annual election to claim the FTC, or choose to deduct the foreign taxes. Taxpayers may claim a credit in one year and a deduction in the following year, or vice versa. If a taxpayer chooses to claim a deduction, he or she must file Schedule A and itemize deductions. Generally, a taxpayer has to complete a Form 1116 to claim the credit. There is an exception to filing Form 1116, which we will discuss later in this Unit.	▪ IRC 901(a) ▪ IRC 164(a)(1) ▪ Form 1116
Once an election is made to either claim a credit or a deduction, all foreign taxes must be treated the same way for that particular year. In other words, if the taxpayer chooses to take a credit for qualified foreign taxes, he or she must take the credit for all of the foreign taxes paid or accrued; the taxpayer cannot take a credit for some foreign taxes and a deduction for others. Exceptions to this rule permit deductions for certain taxes for which credit is disallowed even though a credit is claimed for all other foreign taxes. Conversely, if the taxpayer chooses to deduct the foreign taxes, all of the foreign taxes must be deducted. If a deduction is taken in lieu of the credit in a particular tax year, the taxpayer loses the opportunity to use any FTC carryback or carryover to that year. In this case, the taxpayer nonetheless has to treat any FTC carryback or carryover as if it was used in that year.	▪ IRC 275(a)(4) ▪ Treas. Reg. 1.901-1(c) ▪ IRC 901(j)(3) ▪ IRC 901(k)(7) ▪ IRC 901(l)(4) ▪ IRC 901(m)(6) ▪ IRC 908(b) ▪ IRC 904(c) ▪ Treas. Reg. 1.904-2(d)

Detailed Explanation of the Concept (cont'd)

FTC General Principles
Applicable Limitations Periods

Analysis	Resources
Period to Make Credit/Deduction Election: A taxpayer can make or change his or her choice to claim a credit or deduction for creditable foreign taxes at any time during the period within 10 years from the unextended due date of the return for the tax year for which he or she paid or accrued the tax. The taxpayer makes or changes his or her choice on the original tax return, or on an amended return, for the year for which the choice is made. A timely election to claim a deduction under IRC 164 or a credit under IRC 901 is a separate and distinguishable requirement from making a timely refund claim, if a change in election affects the taxpayer's U.S. tax liability for the election year or another affected year.	▪ Treas. Reg. 1.901-1(d) ▪ Treas. Reg. 1.905-2(a)
Period to Claim Refund: The general rule is that a taxpayer's claim for refund can be made within three years from the time the U.S. return was filed or two years from the time the U.S. tax was paid, whichever is later. A special 10-year period applies if the refund is attributable to a foreign tax credit.	▪ IRC 6511(a) ▪ IRC 6511(d)(3)(A) ▪ Treas. Reg. 301.6511(d)-3(a)

Detailed Explanation of the Concept (cont'd)

FTC General Principles
Applicable Limitations Periods

Analysis	Resources
Period to Assess Tax: Generally, the IRS can assess additional tax due within three years after the date the return was filed. However, there is an unlimited statute of limitations for assessment of U.S. tax that becomes due as the result of a redetermination of foreign tax claimed as a credit. Taxpayers are obligated to notify the IRS if any foreign tax claimed as a credit is refunded, or remains unpaid two years after the close of the year for which the foreign tax was accrued.	▪ IRC 6501(a) ▪ IRC 905(c) ▪ IRC 6501(c)(5)

Detailed Explanation of the Concept (cont'd)

FTC General Principles
Exception to Filing Form 1116

Analysis	Resources
The elimination of double taxation does not always require a taxpayer to file Form 1116. Taxpayers may elect to claim the credit directly on Form 1040 line 48 (TY 2015) if all of the following conditions are met: I. All foreign source income is passive. II. The foreign tax is withheld at the source. III. All foreign passive income was reported on qualified payee statements. IV. The foreign tax withheld is not more than $600 for married filing jointly or $300 for all other filing statuses. Example: Taxpayer A, a single filer, received a dividend from a country X corporation and $280 foreign income tax was withheld from the dividend. Taxpayer A received a statement from the taxing authority in country X reporting the passive income and showing how much tax was withheld in country X currency and U.S. dollars. Because the foreign tax withheld is not more than $300, taxpayer A can elect to claim the credit directly on Form 1040 without having to file a Form 1116.	▪ IRC 904(j) ▪ Form 1040

FTC General Principles

Carryback and Carryover of Unused Credit

Analysis	Resources
If, because of the limit on the credit, a taxpayer cannot use the full amount of qualified foreign taxes paid or accrued in the tax year, he or she is allowed a 1-year carryback and then a 10-year carryover of the unused foreign taxes. The unused foreign tax in each separate category of foreign source income is the amount by which the qualified taxes paid or accrued are more than the limit for that category. On the other hand, the excess limit in each separate category is the amount by which the limit is more than the qualified taxes paid or accrued for that category. Taxpayers should figure their carrybacks or carryovers separately for each separate category of income. Example: Assume all foreign income is general category income for 2014 and 2015. The limit on the credit and the qualified foreign taxes paid on the income are as follows:	▪ IRC 904(c)

Tax Year	Limit on FTC	Tax Paid	Unused Foreign Tax (+) or Excess Limit (-)
2014	$200	$100	($100.00)
2015	$300	$500	$200.00

In 2015, the taxpayer has unused foreign tax of $200 to carry to other years. The taxpayer is considered to have paid this unused foreign tax first in 2014 (the first preceding tax year) up to the excess limit in that year of $100. The taxpayer can then carryover the remaining $100 of unused tax.

Index of Referenced Resources

FTC General Principles
Form 1040
Form 1116
IRC 164(a)(1)
IRC 275(a)(4)
IRC 901(a)
IRC 901(b)
IRC 901(b)(4)
IRC 901(k)(7)
IRC 901(l)(4)
IRC 901(m)(6)
IRC 904(a)
IRC 904(c)
IRC 904(j)
IRC 905(c)
IRC 906
IRC 908(b)
IRC 6501(a)

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FTC General Principles
IRC 6501(c)(5)
IRC 6511(a)
IRC 6511(d)(3)(A)
Treas. Reg. 1.901-1(a)
Treas. Reg. 1.901-1(c)
Treas. Reg. 1.901-1(d)
Treas. Reg. 1.901-2
Treas. Reg. 1.904-2(d)
Treas. Reg. 1.905-2(a)
Treas. Reg. 301.6511(d)-3(a)
Pub. 514 - *Foreign Tax Credit for Individuals*
Pub. 519 - *U. S. Tax Guide for Aliens*

FTC General Principles	
Type of Resource	**Descriptions**
SABA Sessions	▪ *How to Audit FTC-FTC Concepts-IIC FY15 CPE* - 2015 CPE Centra. This course focuses on the high level concepts in understanding foreign tax credit and Form 1116.
Issue Toolkits	▪ *FTC Workbook.* Used to assist agents in computing FTC limitation for Form 1116, the FTC Workbook is available on the WIIC FTC Practice Network SharePoint site under "Best Practices."
Databases / Research Tools	▪ *BNA Tax Management Int'l Portfolio* 900-2nd Sec. III − Foreign Income Series, Provisions Applicable to U.S. and Foreign Persons, Foundations of U.S. International Taxation, the Foreign Tax Credit in Overview. ▪ *CCH International Taxation* − Corporate and Individual, The Foreign Tax Credit in Overview available through LexisNexis Tax Center – February 2016

Glossary of Terms and Acronyms

Term/Acronym	Definition
ECI	Effectively Connected Income
FTC	Foreign Tax Credit
IRC	Internal Revenue Code
NRA	Nonresident Alien

Index of Related Practice Units

Associated UILs	Related Practice Unit	DCN
9431.01-01	Substantial Presence Test	JTO/P/09_01_01-01 (formerly JTO/9431.01_03(2013))
9431.01-02	Determining Tax Residency Status of Lawful Permanent Residents	JTO/P/09_01_02-01 (formerly JTO/9431.01_02(2013))
9432.02	Sourcing of Salary and Compensation	FTC/P/10_02-02 (formerly FTC/9432.02_01(2014))