Introduction

This lesson will show you how to help taxpayers claim the foreign tax credit. This credit applies to those who have paid or accrued taxes to a foreign country on foreign-sourced income and who are subject to U.S. tax on the same income.

To help these taxpayers, you must determine which taxes and types of foreign income are eligible for the foreign tax credit and accurately compute the credit using Form 1116, Foreign Tax Credit.

If the foreign tax paid is reported on a Form 1099-INT, Form 1099-DIV, or Schedule K-1 completion of the entire Form 1116 may not be required.

If the foreign tax paid is a result of living and working outside the U.S., then all the questions on Form 1116 need to be addressed.

Although the foreign tax credit is not specifically listed on Form 13614-C, Intake/Interview & Quality Review Sheet, ask taxpayers if they paid any tax to a foreign country.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine which taxes and types of foreign income are eligible for the foreign tax credit
- Accurately compute the credit using Form 1116
- Calculate and report the foreign tax credit as a nonrefundable credit

What is the foreign tax credit?

U.S. citizens and residents compute their U.S. taxes based on their worldwide income. This sometimes results in U.S. citizens having to pay tax twice on the same income — first to the government of the foreign country where the income was earned and again to the U.S. government.

**TIP** Taxpayers can choose whether to take the amount of any qualified foreign income taxes paid during the year as a foreign tax credit or as an itemized deduction. Taxpayers may change their choice each year.

As a general rule, taxpayers must choose to take either a credit or a deduction for all qualified foreign taxes. For exceptions to this general rule, see Publication 514, Foreign Tax Credit for Individuals.

The foreign tax credit was created to help taxpayers avoid this double taxation. Taxpayers who paid income, war profits, or excess profits taxes to a foreign country or U.S. possession may be entitled to a credit on their U.S. taxes. Like other nonrefundable credits, the foreign tax credit allows taxpayers to take a dollar-for-dollar reduction in the amount of U.S. tax owed. However, in some cases, not all taxes paid to a foreign government on foreign-sourced income can be used in the computation of the credit.
Four tests must be met to qualify for the credit:

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

Some foreign taxes, such as foreign real property tax, are not income taxes.

What if the foreign tax credit is reported on Form 1099-INT, Form 1099-DIV, or Schedule K-1?

Taxpayers who receive Form 1099-INT, Form 1099-DIV, or Schedule K-1 may have amounts indicating that foreign taxes have been paid on their behalf by the issuer of the document.

Taxpayers can elect to report foreign tax on Form 1040, Schedule 3 without filing Form 1116 as long as the following conditions are met:

• All of the gross foreign source income was from interest and dividends and all of that income and the foreign tax paid on it were reported on Form 1099-INT, Form 1099-DIV, or Schedule K-1 (or substitute statement).
• If you had dividend income from shares of stock, you must have held those shares for at least 16 days.
• You are not filing Form 4563, Exclusion of Income for Bona Fide Residents of American Samoa, or excluding income from sources within Puerto Rico.
• The total of your foreign taxes was not more than $300 (not more than $600 if married filing jointly).
• All of your foreign taxes were:
  o Legally owed and not eligible for a refund, and
  o Paid to countries that are recognized by the United States and do not support terrorism.

Taxpayers who must complete Form 1116 because they cannot qualify to claim the foreign tax credit without filing Form 1116 must be referred to a volunteer with an International certification or a professional tax preparer.

A credit for foreign taxes can be claimed only for foreign tax imposed by a foreign country or U.S. possession.

Additional information can be found in the Form 1040 Instructions, Form 1116 Instructions and Publication 514.

Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits.

Example

Ryan, who is single, received Form 1099-DIV showing $29 of foreign taxes paid. According to Ryan, he received no other foreign source income and paid no other foreign taxes. The dividends were paid on shares of a mutual fund that he owned all year. He is eligible to claim the foreign tax credit on Form 1040, Schedule 3 and does not have to complete Form 1116.
EXERCISES

Answers are after the lesson summary.

**Question 1:** To claim the foreign tax credit without filing Form 1116, a taxpayer who is filing Single must have paid foreign taxes as shown on Form 1099-DIV, Form 1099-INT, or Schedule K-1 that are equal to or less than $300.  □ True  □ False

**Question 2:** Clyde comes to your site seeking help with his foreign tax credit. He is single and his Forms 1099-DIV show a total of $324 of foreign tax paid. Can Clyde claim the foreign tax credit without filing Form 1116?  □ Yes  □ No

**Question 3:** Judy and Mark are married and will file a joint return. Their Forms 1099-DIV show a foreign tax paid of $590. Can they claim the foreign tax credit without filing Form 1116?
□ Yes  □ No

The remaining sections of this lesson are directed to volunteers seeking an International certification. All others may proceed to the next lesson.

What are the rules for claiming the foreign tax credit on Form 1116?

If the foreign tax paid is more than $300 ($600 for Married Filing Jointly) or they do not meet the other conditions to make the election to claim the foreign tax credit without filing Form 1116, taxpayers must file Form 1116 to claim the foreign tax credit. See Publication 514 for details.

**TIP** The foreign earned income exclusion differs from the foreign tax credit; try both methods for taxpayers and choose the approach that results in the lowest tax.

• The exclusion allows a portion of the foreign earned income to be excluded from taxable income.
• The credit adds the foreign income to the taxable income and then reduces the U.S. tax due by some portion of taxes paid to the foreign government(s).

What qualifies taxpayers for the credit?

To qualify for the credit, the following requirements must be met. A taxpayer must:

• Have income from a foreign country

• Have paid taxes on that income to the same foreign country

• Not have claimed the foreign earned income exclusion on the same income (see the foreign earned income exclusion section of the Income – Other Income lesson)

In addition, the foreign tax must:

• Be paid to a foreign country on income derived from that country

• Be similar to the U.S. income tax

• Provide no economic benefit to the taxpayer paying the tax
Foreign taxes that qualify for the foreign tax credit generally include taxes on:

- Wages
- Dividends
- Interest
- Royalties
- Annuities

Foreign taxes for which an individual may not take a credit include taxes:

- On excluded income
- On foreign mineral income
- On combined foreign oil and gas income for which the taxpayer can take only an itemized deduction
- From international boycott operations
- Of U.S. persons controlling foreign corporations and partnerships
- Taxes paid to a foreign country that a taxpayer does not legally owe, including amounts eligible for refund by the foreign country

⚠️ Taxpayers cannot take the foreign tax credit for foreign income taxes paid on income excluded under the foreign earned income exclusion.

---

**example**

Robb and his wife, Nina, are U.S. citizens who reside in France. Their Form 1040, Schedule B, Interest and Ordinary Dividends, lists $2,000 interest from a U.S. bank and $600 interest from a French bank. They paid income taxes on both amounts to both countries. On their U.S. tax return, they can compute a foreign tax credit to offset the taxes they owe to the U.S. on the interest received from the French bank. They would need to check with the French taxing authorities to determine if they can claim a similar tax credit on their French tax return to offset the taxes paid to the U.S. on the interest income earned in the U.S.

---

**example**

Eva is a U.S. citizen who lives in Hong Kong. Eva owns her home in Hong Kong and paid $2,000 in real estate taxes and $1,000 in personal property taxes. She also paid $3,000 in income taxes to the government of Hong Kong. She cannot claim a foreign tax credit for either the real estate taxes or the personal property taxes because they are not income taxes. Eva can compute a foreign tax credit on the $3,000 in income taxes paid to Hong Kong.

---

**TIP**

For more detailed information, see Publication 514 and the Form 1116 Instructions.
Lawrence is a business owner who lives in China, which has a two-tier income tax system:
• Everyone is taxed according to their income
• Business owners pay additional tax on their profits

The second tier entitles business owners to certain reduced fees and other benefits, such as ability to rent space in a government building. Because of the specific economic benefits Lawrence receives, he cannot use the second-tier tax payments to compute a foreign tax credit on his U.S. tax return. However, the first-tier income taxes are similar to U.S. income taxes and can be used to figure his foreign tax credit.

What is “economic benefit”?
As mentioned earlier, the foreign tax paid cannot provide a specific economic benefit for the taxpayer and be included in the foreign tax credit computation. This means that the tax cannot be a payment that results in an individual receiving:
• Goods
• Services
• Fees or other payments
• The right to use, acquire, or extract resources, patents, or other property that the foreign country owns or controls
• Discharges of contractual obligations

**Tip** Taxpayers are considered to receive a specific economic benefit if they conduct a business transaction with a person who receives an economic benefit from a foreign country, and under the terms and conditions of the transaction, the taxpayer directly or indirectly receives some part of the benefit.

**Example**
Lawrence is a business owner who lives in China, which has a two-tier income tax system:
• Everyone is taxed according to their income
• Business owners pay additional tax on their profits

The second tier entitles business owners to certain reduced fees and other benefits, such as ability to rent space in a government building. Because of the specific economic benefits Lawrence receives, he cannot use the second-tier tax payments to compute a foreign tax credit on his U.S. tax return. However, the first-tier income taxes are similar to U.S. income taxes and can be used to figure his foreign tax credit.

**Exercises (continued)**

**Question 4:** Anne is a U.S. citizen living in Japan. She listed wages, interest income, and dividend income on her U.S. tax return. She paid taxes on each of these types of income to Japan. Anne can claim a foreign tax credit for taxes paid on which of the following sources of income?
A. Wages from her job in the U.S.
B. Interest income from a U.S. bank
C. Interest income from a Japanese bank
D. Dividend income from a U.S. corporation

**Question 5:** Jean, a U.S. citizen, received an inheritance upon the death of an uncle in Spain and paid an inheritance tax to the Spanish government. Can Jean claim a foreign tax credit to offset the inheritance tax she paid in Spain? □ Yes  □ No

What is “economic benefit”? 
As mentioned earlier, the foreign tax paid cannot provide a specific economic benefit for the taxpayer and be included in the foreign tax credit computation. This means that the tax cannot be a payment that results in an individual receiving:

- Goods
- Services
- Fees or other payments
- The right to use, acquire, or extract resources, patents, or other property that the foreign country owns or controls
- Discharges of contractual obligations

**Tip** Taxpayers are considered to receive a specific economic benefit if they conduct a business transaction with a person who receives an economic benefit from a foreign country, and under the terms and conditions of the transaction, the taxpayer directly or indirectly receives some part of the benefit.
What are Sanctioned Country Restrictions and Section 901(j) Income?

Taxes paid to or accrued by certain countries do not qualify for the foreign tax credit. These are countries:

- That have been designated by the Secretary of State as repeatedly providing support for acts of international terrorism,
- With which the U.S. has severed or does not conduct diplomatic relations, or
- Whose government the U.S. does not recognize, unless that government is eligible to purchase defense articles or services under the Arms Export Control Act

See Publication 514 or visit https://www.irs.gov for the current list of sanctioned countries.

Foreign income earned in sanctioned countries is subject to U.S. tax. A separate Form 1116 must be completed for foreign income from a sanctioned country, using the “Section 901(j) income” category. This is beyond the scope of the VITA/TCE programs; refer taxpayers to a professional tax preparer.

EXERCISES (continued)

Question 6: Adele lived and worked in a sanctioned country until August of this tax year, when she was transferred to Italy. She paid taxes to each country on the income earned in that country. Can Adele take a foreign tax credit on her U.S. tax return for the taxes paid on income she earned in the sanctioned country? □ Yes □ No

Question 7: Write “Q” next to each tax that qualifies for the foreign tax credit or “NQ” next to those that do not. Assume the taxpayer is a U.S. citizen or resident living in a nonsanctioned foreign country and that the tax is being paid to a foreign government on foreign-sourced income.

___ Dividend taxes
___ Foreign oil related income tax
___ Interest income tax
___ Real estate taxes
___ Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion
___ Taxes paid that are returned to the taxpayer in the form of a subsidy

What categories of income qualify for the credit?

At the top of Form 1116, Part I, taxpayers are asked to indicate the type of foreign income they received. Two of these income categories fall within the scope of the VITA/TCE programs:

- Passive category income
- General category income

TIP A separate Form 1116 must be completed for each type of income; each Form 1116 can include income earned in as many as three foreign countries.
Passive Category Income

This category includes passive income and specified passive category income. Passive income generally includes the following:

- Dividends
- Interest
- Royalties
- Rents
- Annuities
- Net gain from the sale of property that produces such income, or non-income-producing investment property

For example, a taxpayer who lives in a foreign country and pays taxes on interest income could claim the foreign tax credit and check the Passive category income box on Form 1116.

**Tip**

Wages and salaries are considered to be general category income, which is discussed later in this topic. Passive category income may qualify as general category income if the foreign government taxes it at a rate higher than the highest U.S. tax rate; see High-Taxed Income later in this lesson.

For additional information on passive income and specified passive category income, see Publication 514.

General Category Income

General category income consists of income earned in a foreign country that an individual does not exclude, or excludes only part of, under the foreign earned income exclusion. Additionally, foreign income that does not come under any of the other categories on Form 1116 can typically be included as general category income.

**Example**

Robert paid taxes to Spain for earned income and did not claim the foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid to Spain.

What is high-taxed income?

Some passive category income can be included in general category income if it is taxed by a foreign government at a rate higher than the highest U.S. income tax rate. Therefore, if taxpayers pay more than the highest U.S. income tax rate on the foreign-sourced passive income for which they claimed the credit, the credit is computed under general category income.

**Example**

Brenda is a U.S. citizen who lives in a foreign country and pays 45% income tax on her interest income in that country. She lists this as "General Category Income" on Form 1116, since the tax rate paid on this passive income is higher than the highest U.S. income tax rate.
EXERCISES (continued)

**Question 8:** Regina lives in a foreign country and is a U.S. citizen. She has both dividend income and interest income from foreign countries. Her foreign bank withholds 15% of her interest income for income taxes. She also pays foreign income taxes on her dividend income, at a rate of 45%. For the purposes of Form 1116, how should the following types of income be classified?

Interest Income: ___ Dividend Income: ___

A. Passive category income
B. General category income

**Question 9:** Bernard is a U.S. citizen who lives in Barbados. This year, he paid 17% income tax on interest income from his bank account in Barbados. For the purposes of Form 1116, Bernard's foreign interest income should be classified as:

A. Passive category income
B. General category income

**Tax Law Application**

There are several factors to consider when determining if taxes paid to a foreign government are eligible for the foreign tax credit. Ask the taxpayer:

- Was the income foreign-sourced?
- What type of tax was paid to the foreign government?
- Will the taxpayer receive some kind of specific economic benefit from the payment of this tax?

**How do I complete Form 1116?**

If the taxpayer does not qualify for the election to claim the foreign tax credit without filing Form 1116, the form must be completed. The amount of the foreign tax credit is the portion of U.S. income tax liability based on gross taxable foreign income. Certain expenses reduce foreign gross income. Some of these situations are complicated and beyond the scope of the VITA/TCE programs, such as:

- Expenses directly related to the foreign income
- Investment interest expense
- Foreign losses, such as those from selling foreign assets or a loss from a business or partnership

If the taxpayers have any of these types of deductions, refer them to a professional tax preparer.

For step-by-step instructions on completing Form 1116, go to the Volunteer Resource Guide, Tab G, Nonrefundable Credits.
Summary

Taxpayers who paid taxes to a foreign country or U.S. possession may be able to take a nonrefundable foreign tax credit. Generally, to claim the credit, taxpayers are required to file Form 1116.

Taxpayers do not have to file Form 1116 if they meet certain requirements and can elect to claim the foreign tax credit directly on Form 1040, Schedule 3. This election is in scope for the Advanced certification. VITA/TCE volunteers must have International certification to help taxpayers who are required to file Form 1116.

To qualify for the foreign tax credit, the taxpayer, income, and taxes must all meet specific requirements. The credit is computed and reported on Form 1116. A separate Form 1116 must be completed for each category of income.

The foreign tax credit is different from the foreign earned income exclusion. If the taxpayer uses the foreign earned income exclusion, foreign tax paid on the excluded income cannot be used to claim the foreign tax credit. Taxpayers can choose the approach that results in the lowest tax.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who must complete Form 1116 because they cannot elect to report foreign tax on Form 1040 Schedule 3, unless your site has a volunteer and a reviewer with an International certification
- Taxpayers who may deduct a foreign income tax that is not allowed as a credit in certain circumstances
- Certain expenses deducted to reduce foreign gross income
- Taxpayers who must report a carryback or carryover on Form 1116
- Taxpayers who must file a separate Form 1116 required for foreign income from a sanctioned country, using the “Section 901(j) income” category

TAX LAW APPLICATION

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the Practice Lab on L&LT.
**Answer 1:** True. Form 1116 is not required if the total foreign taxes paid are less than or equal to $300 ($600 if Married Filing Jointly).

**Answer 2:** No. Clyde needs to complete Form 1116 because his foreign taxes exceed $300. Clyde will need to be referred to a volunteer with an International certification or seek the assistance of a professional tax preparer.

**Answer 3:** Yes. Judy and Mark do not have to complete Form 1116 because they file jointly and their foreign taxes are less than $600.

**Answer 4:** C. On Anne’s tax return, she can claim a foreign tax credit to offset taxes she paid to Japan on interest received from the Japanese bank.

**Answer 5:** No. An inheritance does not qualify as income from a foreign country. Under U.S. tax law, inheritances are not taxable to the beneficiaries. Jean is not eligible to claim a foreign tax credit for the inheritance taxes she pays to the Spanish government.

**Answer 6:** No. Adele cannot take a foreign tax credit for the taxes paid on income she earned in the sanctioned country. However, this income is taxable in the U.S., since she is a U.S. citizen.

**Answer 7:**

Q – Dividend taxes

NQ – Foreign oil–related income tax

Q – Interest income tax

NQ – Real estate taxes

Q – Income tax on wages from a foreign country, assuming the taxpayer does not take the foreign earned income exclusion

NQ – Taxes paid that are returned to the taxpayer in the form of a subsidy.

**Answer 8:** Interest Income – A; Dividend Income – B (High-taxed income is considered general category income.)

**Answer 9:** A. Since 17% (the tax rate Bernard paid) is not more than the highest U.S. income tax rate, Bernard’s income falls under “Passive Category Income.”