

# 1996



Department of the Treasury  
Internal Revenue Service

## Instructions for Form 1116

### Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual)

Section references are to the Internal Revenue Code unless otherwise noted.

#### Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping .....	2 hr., 44 min.
Learning about the law or the form .....	46 min.
Preparing the form .....	1 hr., 53 min.
Copying, assembling, and sending the form to the IRS .....	55 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the IRS at the address listed in the instructions of the tax return with which this form is filed.

#### General Instructions

##### Purpose of Form

Use Form 1116 to figure the foreign tax credit for certain taxes paid or accrued to a foreign country or U.S. possession. See **Foreign Taxes for**

**Which You May Take a Credit** on page 2 to determine if the taxes you paid or accrued qualify for the credit.

**Do not use** Form 1116 to figure a credit for taxes paid to the Virgin Islands. Instead, use **Form 8689**, Allocation of Individual Income Tax to the Virgin Islands.

If you claim a foreign tax credit, you may be liable for the alternative minimum tax. Get **Form 6251**, Alternative Minimum Tax—Individuals, for details.

For more information about how to figure the foreign tax credit, get **Pub. 514**, Foreign Tax Credit for Individuals, from an IRS Distribution Center. If you are in the United States, you may contact your local IRS office for assistance, or call 1-800-829-1040.

Overseas residents may contact Internal Revenue Service offices at U.S. embassies in Ottawa, Paris, Rome, London, Bonn, Sydney, Singapore, Tokyo, Mexico City, or Santiago, or the International office in Washington, D.C. for assistance in figuring the credit.

##### Who Should File

Use Form 1116 to figure a foreign tax credit if you are an individual, estate, or trust, and you paid or accrued foreign taxes on income from sources outside the United States for tax year 1996. If you are a nonresident alien, see **Nonresident Aliens** below.

##### Credit or Deduction

Instead of figuring the credit on Form 1116, you may choose to deduct foreign income taxes on **Schedule A (Form 1040)**, Itemized Deductions. Generally, if you take the credit for any allowable foreign taxes, you may not take any part of that year's foreign tax as a deduction. This is true for the year you take the credit and for any later year. However, you may take a deduction for foreign taxes not allowed as a credit because of boycott provisions, even if you take the credit for other allowable foreign

taxes for the year. You may also deduct taxes paid to certain foreign countries for which a credit has been denied under section 901(j)(2), even if you take the credit for other allowable foreign taxes.

If you want to change your election to take a deduction instead of a credit, or a credit instead of a deduction, you must do so within a special 10-year limitation period. See Pub. 514 for more information.

##### Nonresident Aliens

If you are a nonresident alien, you generally cannot take the credit. However, you may be able to take the credit if:

1. You are a resident of Puerto Rico during your entire tax year, or
2. You are a nonresident alien who pays or accrues tax to a foreign country or U.S. possession on income from foreign sources that is effectively connected with a trade or business in the United States. But if you must pay tax to a foreign country or U.S. possession on income from U.S. sources only because you are a citizen or a resident of that country or U.S. possession, do not use that tax in figuring the amount of your credit.

See **Pub. 519**, U.S. Tax Guide for Aliens, for more information.

##### How To Complete Form 1116

Use a separate Form 1116 to figure the credit for foreign taxes paid or accrued for each category of income specified above Part I of the form. See **Categories of Income** on page 3 to find out what kind of income is included in each category. If you have income from, or have paid taxes to, more than one foreign country or U.S. possession, use a separate column in Part I and a separate line in Part II for each country or possession. But see the **Exception** on page 2. If you paid taxes to more than three countries or possessions and do not meet the exception, attach additional sheets following the format of Parts I and II.

### Exception to country-by-country reporting requirements.—

Generally, if you received income from, or paid taxes to, more than one foreign country or U.S. possession, you must report information on a country-by-country basis on Form 1116, Parts I and II. However, this requirement does not apply if:

1. You had income only in the “passive income” category on Form 1116;
2. The income, and any foreign taxes paid on it, was reported to you on Form 1099-DIV, 1099-INT, or similar statements; **and**
3. The total of all your foreign taxes on Forms 1099-DIV (Box 3), Form 1099-INT (Box 5), or similar statements, does not exceed \$200 (\$400 if married filing jointly).

If **all** of the above apply, complete Form 1116, Parts I and II, as follows:

1. Check the box for passive income above Part I.
2. In Part I, do not use separate columns to report the income from each country. Instead, report all your foreign income in column A. On line j of column A, write “Various.” Complete the rest of Part I.
3. In Part II, complete only line A, columns (m) and (v). In column (m), write “12/31/96—Form 1099.” In column (v), enter the **total** foreign taxes from all Forms 1099-DIV, 1099-INT, or similar statements.
4. Complete Parts III and IV of the form.

### Foreign Taxes for Which You May Take a Credit

You may take a credit for income, war profits, and excess profits taxes paid or accrued during the tax year to any foreign country or U.S. possession, or any political subdivision (e.g., city, state, or province), agency, or instrumentality of the country or possession. This includes taxes paid or accrued **in lieu of** an income, war profits, or excess profits tax that is otherwise generally imposed. For purposes of the credit, U.S. possessions include Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa.

U.S. citizens who live in certain countries may be able to take an additional foreign tax credit against their U.S. tax liability for foreign tax

imposed on certain items of income from the United States. These countries are Australia, Barbados, Canada, the Czech Republic, Finland, France, Germany, India, Israel, Italy, Mexico, the Netherlands, New Zealand, Portugal, Slovakia, Spain, Sweden, and Tunisia. Use the worksheet in Pub. 514 to help you figure this special credit.

### Foreign Taxes for Which You May Not Take a Credit

You may not take a credit for the following foreign taxes:

1. If you are a bona fide resident of American Samoa, taxes attributable to excluded income from sources in American Samoa, Guam, or the Commonwealth of the Northern Mariana Islands. For more information, get **Pub. 570**, Tax Guide for Individuals With Income From U.S. Possessions.
2. Taxes imposed and paid on income earned from activities conducted in certain foreign countries. These countries include those designated by the Secretary of State as countries that repeatedly provide support for acts of international terrorism, countries with which the United States does not have diplomatic relations, or countries whose governments are not recognized by the United States. Pub. 514 contains a list of these countries.
3. Taxes paid to a foreign country that would be refunded to you if you made a refund claim.
4. Taxes paid or accrued to a foreign country in connection with the purchase or sale of oil or gas extracted in that country if **(a)** you do not have an economic interest in the oil or gas, and **(b)** the purchase price paid or sales price received is different from the fair market value of the oil or gas at the time of the purchase or sale.
5. Foreign taxes paid or accrued on foreign oil-related income to the extent the tax imposed by the foreign country on the oil-related income is materially greater than the tax generally imposed by that country on other kinds of income. However, the amount of tax not allowed as a credit under this rule is allowed as a business expense deduction.
6. Payments of foreign tax that are returned to you in the form of a subsidy.

You **may not** take a credit for any interest or penalties you must pay.

### Foreign Currency Conversion

Report all amounts on the form in U.S. dollars except where specified otherwise in Part II of the form. If you have to convert from foreign currency, attach a detailed explanation of how you figured the conversion rate.

If you take a credit for taxes paid, the conversion rate is the rate of exchange in effect on the day you paid the foreign taxes. If you receive a refund of foreign taxes paid, the conversion rate is the rate in effect when you paid the taxes, **not** when you receive the refund.

If you choose to take the credit for accrued taxes, use the rate of exchange in effect on the last day of your tax year. However, if a different rate of exchange is in effect when the tax is actually paid, see **Foreign Tax Redeterminations** below.

If you have a qualified business unit, see Pub. 514 for special rules for converting foreign income and taxes into U.S. dollars. You may have a qualified business unit if you own and operate a business or are self-employed in a foreign country.

For more information on conversion of foreign currency into U.S. dollars, get **Pub. 54**, Tax Guide for U.S. Citizens and Resident Aliens Abroad.

### Foreign Tax Redeterminations

A foreign tax redetermination is any change in your foreign tax liability that affects your U.S. foreign tax credit claimed. A redetermination occurs if:

1. You must pay additional foreign taxes or you receive a foreign tax refund, or
2. There is a change in the dollar amount of your foreign tax credit because of differences in the exchange rate at the time the foreign taxes were accrued and the time they were paid.

If, after you file your return, your foreign tax is redetermined, you must file **Form 1040X**, Amended U.S. Individual Income Tax Return, or an amended return to notify the IRS so that your U.S. tax for the year or years affected can be redetermined. Complete and attach to Form 1040X or the amended return a revised Form 1116 for the tax year affected by the redetermination. The revised Form 1116 must reflect the changes made

by the foreign tax redetermination. See Regulations section 1.905-4T(b) for more information.

**Exception.** If the change in your foreign tax liability occurred solely because of changes in the exchange rate (as in 2. above), you do not need to file Form 1040X or an amended return if the difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax you actually paid was less than the smaller of:

- \$10,000 or
- 2% of the foreign tax initially accrued.

If you meet this exception, you should adjust your U.S. tax for the year of the foreign tax redetermination instead of filing Form 1040X or an amended return.

**Note:** *If you do not notify the IRS of a foreign tax refund or change in the dollar amount of foreign taxes paid or accrued, you may have to pay a penalty.*

See Pub. 514 for more information.

## Income From Sources Outside the United States

This income generally includes, but is not limited to, the following:

- Compensation for services performed outside the United States,
- Interest income from a payer located outside the United States,
- Dividends from a corporation incorporated outside the United States, and
- Gain on the sale of nondepreciable personal property you sold while maintaining a tax home outside the United States, if you paid a tax of at least 10% of the gain to a foreign country.

Special rules apply in determining the source of income from the sale of inventory; sale of depreciable property used in a trade or business; sale of intangible property such as a patent, copyright, or trademark; ocean activities; and transportation services that begin or end in the United States or a U.S. possession. See Pub. 514 for more information.

## Categories of Income

Use a separate Form 1116 to figure the credit for each category of income listed above Part I of Form 1116. The

following instructions tell you what kind of income to include in each category. For more information see Pub. 514, section 904, and Regulations sections 1.904-4 and 1.904-5.

### Passive Income

Passive income generally includes dividends, interest (except high withholding tax interest), royalties, rents, and annuities. It also includes gain from the sale of non-income-producing investment property and gains from commodities transactions (except hedging transactions and active business gains or losses of producers, processors, merchants, or handlers of commodities).

Passive income does **not** include gain from the sale of inventory or property held primarily for sale to customers in the ordinary course of your trade or business. Passive income also does not include export-financing interest, active business rents and royalties from unrelated persons, or high-taxed income (see **High-Taxed Income** on page 5).

### High Withholding Tax Interest

In general, high withholding tax interest is foreign interest that is subject to a foreign withholding or other gross-basis tax of 5% or more.

### Financial Services Income

Financial services income generally includes income derived by a financial services entity predominantly engaged in the active conduct of a banking, financing, insurance, or similar business. Financial services income includes passive income and certain incidental income. If you qualify as a financial services entity because you treat certain items of income as active financing income under Regulations section 1.904-4(e)(2)(i)(Y), you must show the type and amount of each item on an attachment to Form 1116.

### Shipping Income

Shipping income generally includes income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in

foreign commerce, or income derived from space and ocean activities. Treat income that is both shipping income and financial services income as financial services income.

### Dividends From a DISC or Former DISC

This category includes dividends from a DISC or former DISC (see section 992(a) for definitions) to the extent these dividends are treated as foreign sourced.

### Certain Distributions From a FSC or Former FSC

This category includes distributions from a FSC or former FSC out of earnings and profits attributable to "foreign trade income" (see section 923(b) for definition).

### Lump-Sum Distributions

You may take a foreign tax credit for taxes you paid or accrued on a foreign source lump-sum distribution from a pension plan. Special formulas may be used to figure a separate tax on a qualified lump-sum distribution for the year in which the distribution is received. See **Pub. 575**, Pension and Annuity Income (Including Simplified General Rule), for more information.

If you are able to elect, and do elect, to figure your U.S. tax on a distribution using **Form 4972**, Tax on Lump-Sum Distributions, a separate foreign tax credit limitation applies. Use a separate Form 1116 and the **Worksheet for Lump-Sum Distributions** on page 4 to figure your credit.

Before you begin the worksheet, check box **g** above Part I on your separate Form 1116. Skip Part I. Complete Part II of Form 1116 showing only foreign taxes that are attributable to the lump-sum distribution. Then, complete the worksheet on page 4 to figure the amounts to enter in Part III.

Special rules apply in figuring the foreign tax credit for any part of a lump-sum distribution for which you made the 20% capital gain election in Part II of Form 4972. See section 904(b)(2).

## Worksheet for Lump-Sum Distributions

(Keep for your records.)

1. Enter the amount from Form 1116, line 8 .....
2. Enter the amount from Form 4972, line 12, that is from **foreign** sources. Also enter this amount on Form 1116, line 16 .....
3. Enter the total amount from Form 4972, line 12. Also enter this amount on Form 1116, line 17 .....
4. Divide line 2 by line 3. Enter the result as a decimal here and on Form 1116, line 18. If line 2 is equal to or more than line 3, enter the figure "1" .....
5. Enter the amount from Form 4972, line 37. Also, include this amount on Form 1116, line 19. **Caution: Do not include this amount in the tax you enter on line 19 of any other Form 1116 you are filing.** .....
6. Multiply line 5 by line 4. Enter the result here and on Form 1116, line 20 .....
7. Enter the **smaller** of line 1 or line 6 here and on Form 1116, line 21. To the left of line 21 write "LSD." .....

### General Limitation Income

Income from sources outside the United States that does not fall into one of the above categories is general limitation income. Common examples include wages, salary, and overseas allowances of an individual as an employee. Other examples include income earned in the active conduct of a trade or business that does not fall into one of the other separate categories, and gains from the sale of inventory or depreciable property used in a trade or business that do not fall into one of the other separate categories.

### Special Rules

#### Look-Through Rules

Certain income received or accrued by you as a U.S. shareholder in a controlled foreign corporation (CFC) is treated as income in a separate limitation category. Generally, Subpart F inclusions, dividends, interest, rents, and royalties from a CFC are treated as separate limitation income to the extent they are attributable to separate limitation income of the CFC. See Regulations section 1.904-5 for more information.

#### Income From a Partnership

Certain income from partnerships will be characterized under the look-through rules. But if a partner

has a less than 10% interest (by value) in a partnership, income from the partnership is generally treated as passive. See Regulations section 1.904-5(h) for more information.

### Foreign Capital Gain

Capital gains not related to the active conduct of a trade or business are generally passive income. Include on Form 1116 any gain from the sale or exchange of capital assets (including gains treated as capital gains under section 1231) only to the extent of foreign source capital gain net income. (This is either capital gain net income from sources outside the United States or from all sources, whichever is less.) Capital gain net income is the excess of gains over losses from the sale or exchange of capital assets. For more information, see section 904(b).

### Filers Using Maximum Capital Gains Tax Rate

If you figured your tax using the Capital Gain Tax Worksheet in the Instructions for Form 1040, and any part of your capital gain was from foreign sources, complete **Worksheet A (Capital Gains)** below to figure the amount of capital gain to include on line 1 of Form 1116. An estate or trust with foreign source capital gains should also use this worksheet if it figured its tax using the maximum 28% tax rate on capital gains.

Before you begin Worksheet A, complete a separate **Schedule D (Form 1040)**, Capital Gains and Losses, using only gains and losses from sources outside the United States. On this separate Schedule D, complete lines 1 through 18 (lines 1 through 17 on Schedule D (Form 1041)). On Worksheet A, this separate Schedule D is called "your foreign Schedule D."

**Note:** If a loss appears on line 18 (line 17 on Schedule D (Form 1041)) of your foreign Schedule D, **do not** complete Worksheet A. Instead, see **Foreign Capital Loss**, below.

Enter the smaller of line 17 or line 18 from your **foreign** Schedule D on line 2 of a separate Capital Gain Tax Worksheet in the Instructions for Form 1040. (Estates and trusts should complete line 37a on Schedule D (Form 1041).) This separate Capital Gain Tax Worksheet is called "your foreign Capital Gain Tax worksheet."

Use your foreign Schedule D and your foreign Capital Gain Tax Worksheet **only** to figure the gain to include on Form 1116. Do not file them with your tax return.

If you are reporting **only** capital gain distributions on Form 1040, line 13, compare your capital gain distributions from foreign sources with the total amount of your capital gain distributions. Enter your foreign source capital gain distributions on line 1 of Worksheet A.

**Caution:** If your capital gains or losses fall into two or more separate categories (e.g., the passive category and the general limitation category), do not use the worksheet below. Instead, see Pub. 514 for information on how to report the amounts.

### Worksheet A (Capital Gains)

(Keep for your records.)

1. Compare line 18 of your foreign Schedule D with line 18 of the Schedule D you are filing with your tax return. (Estates and trusts should use line 17 from Schedule D (Form 1041).) Enter the **smaller** of the two amounts. This is your foreign source capital gain net income. **Note:** If the amount on line 17 (line 16 on Schedule D (Form 1041)) of your foreign Schedule D is zero or a loss, do not complete the rest of this worksheet. Enter the amount here and on Form 1116, line 1. ....
2. Compare line 2 of your foreign Capital Gain Tax Worksheet with line 2 of the Capital Gain Tax Worksheet you used to figure the tax for your return. (Estates and trusts should use line 37a from Schedule D (Form 1041).) Enter the **smaller** of the two amounts. This is your foreign source net capital gain\* .....
3. Multiply line 2 by .2929 .....
4. Subtract line 3 from line 1. Include this amount as capital gain on line 1, Form 1116 .....

\*Net capital gain does not include any amount that a taxpayer elects under section 163(d) to treat as investment income for purposes of the investment interest expense limitation.

### Foreign Capital Loss

Your gross income from foreign sources on Form 1116, line 1, is reduced by any net capital loss from foreign sources to the extent taken into account in figuring capital gain net income. When figuring net capital loss, include gains and losses that are not from the sale or exchange of capital assets but that are treated as capital gains and losses, such as net section 1231 gains. For more

information on foreign capital losses, see Pub. 514.

### Net Capital Loss From Foreign Sources

If you figured your tax using the Capital Gain Tax Worksheet in the Instructions for Form 1040 and you had a net capital loss from foreign sources, you must adjust the amount of this loss by completing **Worksheet B (Capital Losses)** below. An estate or trust with a net capital loss from foreign sources should also use this worksheet if it figured its tax using the maximum 28% tax rate on capital gains.

**Caution:** *If your capital gains or losses fall into two or more separate income categories (e.g., the passive category and the general limitation category), do not use the worksheet below. See Pub. 514 for information on how to report the amounts.*

#### Worksheet B (Capital Losses) (Keep for your records.)

**Note: Treat all numbers as positive amounts.**

1. Enter your net capital loss from foreign sources (to the extent taken into account in determining capital gain net income). This is line 18 of your foreign Schedule D ..... \_\_\_\_\_
2. Enter net capital gain\* from sources within the United States. (This is the excess of net long-term capital gains from U.S. sources over net short-term capital losses from U.S. sources.) ..... \_\_\_\_\_
3. Enter the amount (net capital gain\*) from line 2 of the Capital Gain Tax Worksheet you used to figure the tax for your return. (Estates and trusts should use line 37a of Schedule D (Form 1041).) ..... \_\_\_\_\_
4. Subtract line 3 from line 2 ..... \_\_\_\_\_
5. Multiply line 4 by .2929 ..... \_\_\_\_\_
6. Subtract line 5 from line 1. This is your net capital loss from foreign sources. Enter here and on line 5 of Form 1116 ..... \_\_\_\_\_

\*Net capital gain does not include any amount that a taxpayer elects under section 163(d) to treat as investment income for purposes of the investment interest expense limitation.

### High-Taxed Income

In some cases, passive income may be placed in the general limitation income category. Passive income may qualify as general limitation income if the foreign taxes you paid on the income (after allocation of expenses) exceeds the highest U.S. tax that can be imposed on the income.

## Specific Instructions

### Part I—Taxable Income or Loss From Sources Outside the United States

**Caution:** *Lines 1 through 7 of Part I must be completed by all filers unless specifically indicated otherwise in the instructions.*

#### Line 1—Foreign Gross Income

Include income in the category checked above Part I that is taxable by the United States and is from sources within the country entered on line j. You must include income even if it is not taxable by that country. Identify the type of income on the dotted line next to line 1. **Do not** include any earned income excluded on **Form 2555**, Foreign Earned Income.

**Example.** If you received dividends (passive income) and wages (general limitation income) from foreign sources, you must complete two Forms 1116. On one Form 1116, enter the dividends on line 1 and write "Dividends" on the dotted line. On the other Form 1116, enter wages **not** excluded on Form 2555 on line 1 and write "Wages" on the dotted line. Complete Parts I, II and III of each Form 1116. Then, complete the summary Part IV on one Form 1116.

**Note:** *If you are reporting income from a partnership or an S corporation, include on line 1 any amount from line 17c, Schedule K-1 (Form 1065) or from line 15c, Schedule K-1 (Form 1120S).*

#### Lines 2 Through 5—Allocating Deductions

##### Introduction

You must reduce your foreign gross income on line 1 by entering on lines 2 through 5:

- Any of your deductions that definitely relate to that foreign income **and**
- A ratable share of your other deductions that do not definitely relate to either that foreign income or to your U.S. source income.

**Do not include** deductions and losses related to exempt or excluded income, such as foreign earned income you have excluded on Form 2555. Also, do not include the deduction for personal exemptions.

Special rules apply to the allocation of research and experimental expenditures. See section 864(f).

If the law of a U.S. state to which you pay income taxes does not specifically exempt foreign source income from tax, you may be required to make a special allocation of state taxes you paid. See Pub. 514 for more information.

**Itemized deduction limit.**— If you must reduce the total amount of your itemized deductions on Schedule A (Form 1040), line 28, because your adjusted gross income was more than \$117,950 (\$58,975 if married filing separately), you must reduce each of the itemized deductions that are subject to the reduction by the reduction percentage before you complete lines 2, 3a, and 4 on Form 1116.

Use the **Itemized Deductions Worksheet** in the Instructions for Schedule A (Form 1040) to figure the reduction percentage. Divide the amount on line 9 of the worksheet (the overall reduction) by the amount on line 3 of the worksheet (total itemized deductions subject to the reduction). This is your reduction percentage. Apply this percentage to each itemized deduction subject to the reduction to determine the amount to enter on the appropriate line of Form 1116.

**Example.** You are single and have an adjusted gross income of \$164,700. Your itemized deductions subject to the overall reduction (line 3 of the worksheet) total \$20,000. This amount includes a deduction for gifts to charity of \$12,000. The other \$8,000 (\$20,000 – \$12,000) of itemized deductions are definitely related to the income on Form 1116, line 1.

The amount of the overall reduction on line 9 of the worksheet is \$1,500. To figure the amount of the charitable deduction to include in the total for line 3a of Form 1116, divide the amount on line 9 (\$1,500) by the amount on line 3 (\$20,000). This is your reduction percentage (7.5%). You must reduce your \$12,000 deduction by \$900 (7.5% × \$12,000). The reduced deduction, \$11,100 (\$12,000 – \$900) is the amount to enter on line 3a of Form 1116. Make a similar computation to figure the amount of definitely related itemized deductions to enter on line 2.

**Note:** *You do not need to make the computation described above if the total amount of your itemized*

deductions is entered on any **one** of the following lines: line 2, line 3a, or line 4a. Simply enter your reduced itemized deductions on that line.

## Line 2

**Caution:** Before you complete lines 2, 3a, and 3b, read **Itemized deduction limit** on page 5.

Enter all deductions that definitely relate to the gross income from foreign sources shown on line 1. For example, if you are an employee reporting foreign earned income on Form 1116, line 2 may include expenses such as those incurred to move to a new principal place of work outside the United States or supplies you bought for your job outside the United States.

Also include on line 2 any amount from line 17d, Schedule K-1 (Form 1065) or from line 15d, Schedule K-1 (Form 1120S).

Do not include any interest expense on line 2. See lines 4a and 4b for special rules for interest expense.

## Lines 3a and 3b

Some deductions do not definitely relate to either your foreign source income shown on line 1 or to your U.S. source income. Enter on lines 3a and 3b any deductions (other than interest expense) that:

- Are not shown on line 2 AND
- Are not definitely related to your U.S. income.

If you do not itemize deductions, enter your **standard deduction** on line 3a. Enter on line 3b any other deductions that do not definitely relate to any specific type of income.

Schedule A (Form 1040) **itemized** deductions to be entered on line 3a are: real estate taxes on a personal residence from line 6; medical expenses from line 4; and gifts to charity from line 18.

Enter on line 3b any deduction from gross income (Form 1040, lines 23a–30) that is not shown on line 2 **and** is not definitely related to your U.S. source income (e.g., the deduction for alimony from Form 1040, line 29).

## Lines 3d and 3e

For lines 3d and 3e, gross income means income without regard to deductions and losses.

**Line 3d.**— Enter your gross foreign source income from the category you checked above Part I of this Form 1116. If the category you checked is “general limitation income,” you must include any foreign earned income you have excluded on Form 2555. However, if the category you checked is “passive income,” or “high withholding tax income,” do **not** include foreign earned income you have excluded.

If you had income from more than one country, enter in each column income from only one country. However, see **Exception to country-by-country reporting requirements** on page 2 of these instructions.

**Line 3e.**— Enter on line 3e in each column your gross income from ALL sources and ALL categories, both U.S. and foreign. This figure includes, but is not limited to, foreign earned income you have excluded on Form 2555, tax-exempt interest from Form 1040, line 8b, and the nontaxable portion of U.S. social security benefits included on Form 1040, line 20a.

If you are a nonresident alien, include on both lines 3d and 3e your income that is not effectively connected with a trade or business in the United States.

**Note:** When figuring gross foreign source income for line 3d of Form 1116, include any amount from line 17c, Schedule K-1 (Form 1065) or from line 15c, Schedule K-1 (Form 1120S). On line 3e, include your share of the partnership or S corporation's gross income from all sources. This amount should be shown on line 17g, Schedule K-1 (Form 1065) or line 15g, Schedule K-1 (Form 1120S).

## Line 4a

Deductible home mortgage interest (including points) is apportioned using a gross income method. Use the worksheet below to figure the amount to enter on line 4a of Form 1116.

Before you complete the worksheet, read **Itemized deduction limit** on page 5.

**Note:** If your foreign income (including income excluded on Form 2555) does not exceed \$5,000, you may allocate all of your interest expense to U.S. source income.

## Worksheet for Home Mortgage Interest

(Keep for your records.)

1. Enter gross foreign source income\* of the type shown on Form 1116. **Do not** enter income excluded on Form 2555 .....
2. Enter gross income from all sources. **Do not** enter income excluded on Form 2555 .....
3. Divide line 1 by line 2 and enter the result as a decimal ...
4. Enter deductible home mortgage interest (from Schedule A (Form 1040))\*\* .....
5. Multiply line 4 by the decimal on line 3. Enter the result here and on Form 1116, line 4a .....

\*If you are required to report income from more than one country on Form 1116, complete a separate worksheet for each country. Use only the income from that country on line 1 of the worksheet.

\*\*If you were required to reduce the amount of your itemized deductions on Schedule A, enter the reduced amount of home mortgage interest on line 4 of the worksheet.

## Line 4b

Other interest expense includes investment interest, interest incurred in a trade or business, and passive activity interest. Each of these types of interest is apportioned separately using an “asset method.”

**Example.** You have investment interest expense of \$2,000. Your assets of \$100,000 consist of stock generating U.S. source income (adjusted basis, \$40,000) and stock generating foreign source income (adjusted basis, \$60,000). You apportion 40% (\$40,000/\$100,000) of \$2,000 or \$800 of your investment interest to U.S. source income and 60% (\$60,000/\$100,000) of \$2,000 or \$1,200 to foreign source income. In this example, you will enter the \$1,200 apportioned to foreign source income on line 4b.

See Pub. 514 for more information.

## Part II—Foreign Taxes Paid or Accrued

You may take a foreign tax credit in the tax year you paid or accrued the foreign taxes, depending on your method of accounting. If you report on the cash basis, you may choose to take the credit for accrued taxes by checking the “accrued” box in Part II. But once you choose to do this, you must credit foreign taxes in the year they accrue on all future returns.

Enter in Part II the amount of foreign taxes (in both the foreign currency denomination and as

converted into U.S. dollars) that relate to the category of income checked above Part I. Taxes are related to the income if the income is included in the foreign tax base on which the tax is imposed. If the foreign tax you paid or accrued relates to more than one category of income, you must apportion the tax among the categories. The apportionment is based on the ratio of net foreign taxable income in each category to the total net income subject to the foreign tax. See Pub. 514 for an example.

If foreign taxes were paid or accrued on your behalf by a partnership or an S corporation, also include in Part II the total foreign taxes from line 17e, Schedule K-1 (Form 1065) or from line 15e, Schedule K-1 (Form 1120S).

**Note:** *If you are taking a credit for additional taxes paid or accrued as the result of an audit by a foreign taxing authority, attach a statement to Form 1116 identifying these taxes.*

## Part III—Figuring the Credit

### Line 10

You may carry back 2 years and then forward 5 years any foreign tax you paid or accrued to any foreign country or U.S. possession (reduced as described below) on income in a separate category that is more than the limitation. First, apply the excess to the earliest year to which it may be carried. Then apply it to the next earliest year, and so on. The 7-year carryback-carryover period may not be extended even if you are unable to take a credit in one of the intervening years.

You cannot carry a credit to a tax year for which you originally claimed a deduction, rather than a credit, for foreign taxes paid or accrued. Also, you must reduce the amount of any carryback or carryover by the amount that you would have used had you chosen to claim a credit rather than a deduction in that year.

File Form 1040X or an amended return and a revised Form 1116 for each earlier tax year to which you are carrying back excess foreign taxes.

Special rules apply to the carryback and carryover of foreign taxes paid or accrued on foreign oil-related income. See section 907(f).

See Pub. 514 for more information on carryback and carryover provisions, including examples.

### Line 12

You may have to reduce the foreign taxes you paid or accrued by the following items:

**1. Taxes on income excluded on Form 2555.**— You must reduce taxes paid or accrued by the taxes allocable to any foreign earned income excluded on Form 2555. If only part of your foreign earned income is excluded, you must find the amount of tax allocable to excluded income. Multiply the foreign taxes paid or accrued on foreign earned income received or accrued during the tax year by the following fraction.

*Numerator:* Foreign earned income you **excluded** for the tax year less otherwise deductible expenses allocable to that income.

*Denominator:* Your **total** foreign earned income received or accrued during the tax year less deductible expenses allocable to that income. However, if the foreign jurisdiction charges tax on foreign earned income and some other income (e.g., 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 less deductible expenses allocable to that income.

See Pub. 514 for a comprehensive example.

**2. Taxes on income from Puerto Rico exempt from U.S. tax.**— The reduction applies if you have income from Puerto Rican sources, such as U.S. Government wages, that is taxable on your U.S. tax return, and you also have income from Puerto Rican sources that is not taxable on your U.S. tax return. To figure the credit, reduce your foreign taxes paid or accrued by the taxes allocable to the exempt income. See Pub. 570 for more information.

**3. Taxes on foreign mineral income.**— Reduce taxes paid or accrued on mineral income from a foreign country or U.S. possession if you took a deduction for percentage depletion under section 613 for any part of the mineral income.

**4. Reduction for failure to file Form 5471.**— U.S. shareholders who control a foreign corporation must file **Form 5471**, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. If you do not file Form 5471 by the due date of your tax return, you must reduce by 10% all foreign taxes that you

otherwise may take into account for the foreign tax credit. You may have to make additional reductions if the failure continues. See section 6038(c).

**Note:** *The reduction in foreign taxes is reduced by any dollar penalty imposed under section 6038(b).*

**5. Reduction of taxes or credit due to international boycott operations.**— In general, if you

agree to participate in, or cooperate with, an international boycott, file **Form 5713**, International Boycott Report. Reduce either the total taxes available for credit or the credit otherwise allowable. If you can figure the taxes specifically attributable to boycott operations, enter the amount on line 12. If you cannot figure the amount of taxes specifically attributable to boycott operations, multiply the credit otherwise allowable by the international boycott factor and enter the result on line 31 of Part IV.

For more information, see Form 5713 and its instructions. If any of the above applies to you, attach a statement showing in detail how you figured the reduction.

**Note:** *Also include on line 12 any amount from line 17f, Schedule K-1 (Form 1065) or from line 15f, Schedule K-1 (Form 1120S).*

### Line 14

The amount on line 14 is your income from sources outside the United States before adjustments. If the amount on line 14 is zero or less, skip lines 15 through 21. You have no foreign tax credit for the category of income checked above Part I of this Form 1116. However, if you are required to recharacterize income from another category (see **Recharacterization of income** on page 8), you must complete line 15 and continue with the form even if line 14 is zero or less.

### Line 15

You are required to increase or decrease the amount on line 14 by the following adjustments. The adjustments must be made in the order listed. If you have more than one adjustment, enter the net adjustment on line 15, and attach a schedule showing your computation. See Pub. 514 for details. The adjustments are:

**1. Allocation of losses from other categories.**— This adjustment applies only if you are completing more than one Form 1116. If you

have a loss on line 14 of one Form 1116 and you have income on line 14 of one or more other Forms 1116, you must **reduce** the foreign income by a pro rata share of the loss before you use the loss to reduce U.S. source income.

**Example.** In 1995, you completed three Forms 1116. The first had a loss from general limitation income of \$2,000 on line 14, the second had income of \$4,000 from passive sources on line 14, and the third had income of \$1,000 from high withholding tax interest on line 14. The \$2,000 loss must be allocated between the passive income and the high withholding tax interest in the same proportion as each category's income bears to the total foreign income.

The amount of the loss that would reduce passive income would be 80% (\$4,000/\$5,000) of the \$2,000 loss or \$1,600. The \$1,600 would be entered on line 15 of the passive income Form 1116. Line 16 of that form would show \$2,400 (\$4,000 – \$1,600).

The amount of the loss that would reduce high withholding tax interest would be 20% (\$1,000/\$5,000) of the \$2,000 loss or \$400. The \$400 would be entered on line 15 of the high withholding tax interest Form 1116. Line 16 of that form would show \$600 (\$1,000 – \$400).

In this case, all of the \$2,000 loss was allocated between the foreign source passive income and the high withholding tax interest categories, and no reduction was made to U.S. source income. In situations where U.S. source income is reduced (i.e., the loss to be allocated exceeds foreign income in other categories), you must follow the rules described below under **Recapture of prior year overall foreign loss**.

**Note:** *If, for any tax year, you are required to allocate a foreign loss, you must make certain adjustments to income you receive in the loss category in later years. See **Recharacterization of income** below.*

**2. Recapture of prior year overall foreign loss.**— If you had an overall foreign loss in a prior year that offset U.S. source income, a part of your foreign income (in the same category as the loss) is treated as U.S. source income in each following tax year.

The part that is treated as U.S. source income is the **smallest** of: **(a)** the amount of overall foreign loss not recaptured in earlier years, **(b)** 50% or more of your taxable income from foreign sources from all categories, or **(c)** the amount from line 14, less any adjustment for allocation of losses from other categories, described on page 7.

**Reduce** the income on line 14 by entering (in parentheses) on line 15 the smallest of **(a)**, **(b)**, or **(c)** above. This is the amount of the recapture. Be sure to attach your computation. If you elect to recapture more of an overall foreign loss than is required, you must show in your computation the percentage of taxable income recaptured and the dollar amount of the recapture.

Regulations section 1.904(f)-1(b) requires that you attach a statement to Form 1116 showing the balance in each separate limitation overall foreign loss account.

**3. Recharacterization of income.**— If, in 1995, you reduced your foreign taxable income in the category shown above Part I on Form 1116 by a pro rata share of a loss from another category, you must recharacterize in 1996 all or part of any income you receive in 1996 in that loss category. **Increase** the amount on line 14 by entering on line 15 any recharacterized income.

Also include on line 15 any income required to be recharacterized in 1996 as income in the category shown above Part I on Form 1116 because of a foreign loss allocation in prior tax years.

**Example.** Using the facts in the example under **Allocation of Loss from Other Categories** above, in the next year (1997), you have \$5,000 of general limitation income, \$3,000 of passive income, and \$500 of high withholding tax interest. Because \$1,600 of the general limitation loss was used to reduce your passive income in 1996, \$1,600 of your 1997 general limitation income must be recharacterized as passive income. Similarly, \$400 of the general limitation income must be recharacterized as high withholding tax interest. On your 1997 Form 1116 for passive income, you would enter \$1,600 on line 15. On your 1997 Form 1116 for high withholding tax interest, you would enter \$400 on line 15.

**Note:** *Recharacterization of income from a separate category does not result in recharacterizing any tax.*

**4. Allocation of U.S. losses.**— If you have a net loss from U.S. sources in 1996, you must proportionately allocate that loss among the separate categories of your foreign income. **Reduce** the income on line 14 by entering (in parentheses) on line 15 the allocable portion of any U.S. loss. A U.S. loss includes a rental loss on property located in the United States.

## Line 17

If you figured your tax using the Capital Gains Tax Worksheet in the Instructions for Form 1040, use the worksheet below to figure the amount to enter on line 17. An estate or trust that used the maximum 28% tax rate on capital gains should also complete the worksheet.

### Worksheet for Line 17

1. Enter the amount (net capital gain\*) from line 2 of the Capital Gain Tax Worksheet used to figure the tax for your return.  
Estates and trusts: Enter the amount from line 37a of Schedule D (Form 1041) ..... \_\_\_\_\_
2. Individuals: Enter the amount from Form 1040, line 35.  
Estates and trusts: Enter taxable income without the deduction for your exemption .. \_\_\_\_\_
3. Multiply line 1 by .2929 ..... \_\_\_\_\_
4. Subtract line 3 from line 2.  
Enter the result here and on Form 1116, line 17 ..... \_\_\_\_\_

\*Net capital gain does not include any amount that a taxpayer elects under section 163(d) to treat as investment income for purposes of the investment interest expense limitation.

## Line 21.

If the amount in line 21 is **smaller** than the amount in line 13, see Pub. 514 for more information on carryback and carryover provisions, including examples.

## Part IV—Summary of Credits From Separate Parts III

Complete this part only if you are completing more than one Form 1116. Use only one Form 1116 to summarize the credits you figured on all your Forms 1116. Enter the credits from line 21 of the separate Forms 1116 on lines 22 through 29, as appropriate. File the other Forms 1116 as attachments.