The Foreign Tax Credit Explained

By Roger B. Adams, EA

Introduction

Most of us working abroad have always had to worry about double taxation. US citizens and green card holders abroad are obliged to report their income to the IRS and also pay tax in our country of residence.

Paying the full rate of tax to two different countries, by the same person, on the same item of income is called "juridical" double taxation. This kind of double tax will kill any kind of meaningful commerce between states.

Congress, through the tax laws it legislates, has found ways to avoid double taxation, and still keep the part about Americans living anywhere being taxed on everything.

The ways we are interested in here are called the Foreign Earned Income Exclusion, the Foreign Tax Credit, and Deduction for Foreign Taxes. Each has its benefits and its drawbacks, which, if you are as astute as I know you are, you will use to your advantage.

As everyone knows by now a very big change was made to the Exclusion for tax year 2006 and all subsequent years. This little article is written to show you that many times it will be to your advantage to abandon the Exclusion in favor of the more efficient and money saving **Foreign Tax Credit.**

The Exclusion

The Exclusion was everyone's favorite mechanism for avoiding double taxation and with good reasons. Its rules are contained in §911 of the Code and it is computed using Form 2555 or 2555EZ. Form 2555EZ asks a few polite questions and takes about five minutes to complete. Form 2555 is more like a grilling at police headquarters and it takes longer. Still, it is easy to understand and complete.

Once upon a time, there was another excellent reason to choose the FEIE. When the FEIE and housing exclusion/deduction were employed it was a massive deduction from income **before** you took your other deductions and exemptions. Taxpayers with significant income from work, passive, and portfolio investments found this to their advantage because, in many cases, they were paying tax in a lower bracket. That advantage was eliminated several years ago as I am sure you have read elsewhere.

To be sure, the Exclusion **must** be used by Americans who live and work in countries who impose no income tax or a rate lower than that imposed in America. However, one size does not fit all when it comes to the exclusion.

For those of us who work in countries where the tax rate is the same or higher than the U.S. there are some serious disadvantages to employing the exclusion.

I do not mean to poke my finger in the eye of a very helpful tax statute but let me show you how the exclusion can work against you and takes some serious money out of your pocket.

But first there is a very important tax term you must know; **"MODIFIED ADJUSTED GROSS INCOME" (MAGI).** Most tax benefits and credits are based on the taxpayer's Adjusted Gross Income (AGI)" (the last line on page 1 of the 1040 return). Taxpayers who use the exclusion must **add the exclusion back onto their AGI** when computing these credits and benefits; that is why it's called "Modified"

<u>The Overseas Roth IRA</u>

The Roth IRA is a wonderful savings plan. You can contribute (with after tax dollars) from **taxable compensation**, up to $5,000 per taxpayer ($6,000 if 50 or over). Taxable compensation includes wages, salary, tips, professional fees, commissions, self employment income, non taxable combat pay, alimony, and separate maintenance payments. The money can be invested in virtually anything and any income or gain while in your Roth grows free of tax. When you withdraw the funds you pay no income tax on that sum; GREAT!!

But the Roth is targeted straight at the middle class. If you earn more than the amounts listed below you cannot contribute to a Roth. The phaseout is as follows for 2011:

- Married Filing Jointly - $179,000
- Single, Head of Household, Married Filing Separately (and not living together) - $122,000.
- Married Filing Separately (living together) - $10,000

So, if your MAGI with the exclusion added back in is over these amounts you are out of luck for contributing to a Roth IRA.

Far more important to this discussion is the fact that **if you have excluded all your income you have no "taxable compensation"** and thus are **ineligible** to contribute to a Roth.

Using the Foreign Tax Credit eliminates this problem.

<u>The Child Tax Credit</u>

This credit pays a benefit of $1,000 off your TAX for each kid under 17 years old if you make less than the phaseout amounts; GREAT!!

To see if you can claim the credit it is very important to carefully read Pub. 972; http://www.irs.gov/pub/irs-pdf/p972.pdf

Unfortunately, if you have excluded all your earned income you probably owe no tax after deductions and exemptions and there will be nothing to credit. You lose $1,000 per child.

But there is a remarkable thing about this credit; sometimes, even if you owe no tax you can still get the $1,000 a child **if you have taxable earned income**. This is accomplished by using **Form 8812**, the **Additional Child Tax Credit** http://www.irs.gov/pub/irs-pdf/f8812.pdf

Example: Jack and Dianne live on Pleasure Island. This is an island country with a flat tax of 15% on all worldwide income.
Jack is a US citizen; Dianne is a housewife and a native Islander. They have 3 little kids all under 17.
Jack works for Island T.V. as host of the evening news making $80,000 annually.
Dianne elects to be treated as a US resident for tax purposes under §6013(g).

If Jack excludes his earned income using Form 2555EZ his US tax is $0; not bad, but he has $0 in earned income.
The problem is **they just lost $3,000 in tax refunds**, and the ability to **contribute $10,000 to their IRA** in America whose gains Pleasure Island exempts from taxable income.
If he and many like him, have no earned income and no tax due to the US after deductions and exclusions, Jack and Dianne cannot take advantage of the Child Tax Credit or contribute to an IRA because there is no earned income to credit.

By using the Foreign Tax Credit that problem is eliminated as illustrated:

1. Jack and Dianne pay $12,000 to Pleasure Island in income tax.
2. They determine that they have $51,600 in US taxable income
3. US tax on that amount is $6,961 which they post on line 44 of 1040
4. Using the FTC that tax liability is reduced to $0

Now:

5. They do the Child Tax Credit Worksheet and discover to their dismay that the FTC eliminates their Child Tax Credit.
6. However, they are directed to the "Additional Child Tax Credit" Form 8812.
7. They fill that out and see to their delight that they may put $3,000 on line 65 of the 1040 as a "payment".
8. They get a $3,000 refund check six weeks later.
9. They put $10,000 in their ROTH IRA because they have sufficient earned income.
10. They hire a babysitter, go down to the beach for drinks, a grilled fish dinner, and stay up real late.

Using the Foreign Tax Credit assures that you have taxable earned income.

By the way, after reading this you discover that you have fallen victim to the Exclusion trap and have lost out on your Child Tax Credit refunds there is still hope. You can go back three years, refigure your tax using the FTC and Additional Child Tax Credit Form 8812 and then file a 1040X (amended return) to get the money you so richly deserve.

The Exclusion and Foreign Tax Credit in Combination

Depending on your income and the rate of tax in your resident country it sometimes makes sense to use both the exclusion and the credit in tandem, sometimes it does not.

Additionally, in some circumstances you will find that using the Exclusion first and then using the FTC for the remainder will actually result in higher tax than using only the FTC. The reason for this is complex but I assure you it is true. Try it both ways to see what is best for you.

Now let us turn our attention to the Foreign Tax Credit to see how this all works.

The Foreign Tax Credit (FTC)

The FTC has been developed by Congress as the **principal** method to avoid double taxation. It is available to any U.S. person. It does not require that you spend a certain minimum time abroad. Moreover, you are not interrogated; you merely need to know how to use a calculator.

Americans working abroad, or with payments or investments having a foreign component will generally pay tax to foreign States. **If the tax rate of the foreign country is the same or greater than the U.S. rate (and it frequently is) the FTC will eliminate all U.S. tax due on that foreign income.**

It is available to any U.S. person. It won't be available if you do business with someone the U.S. is mad at like Cuba, N. Korea, Sudan, Syria and Iran, but those few places aside, it applies to income earned in any country anywhere. (Taxes paid to those terrible blacklisted countries may, however, be deducted)

How This Works

The credit mechanism is simplicity itself. U.S. income tax due is reduced dollar for dollar (credited) by the amount that has been paid in income tax by a U.S. person to a foreign government. There are a few simple qualifications:

1. Only income tax is creditable.

Taxes like Value Added Tax, property taxes, taxes on capital or assets, and any other tax which the U.S. does not consider a tax on income are excluded from the foreign tax credit, although some of these taxes may be deductible from income on Schedule A. If you own your own business or rent out a property many of these other taxes may be **deducted** on Schedule C or E as an expense item.

2. You can credit only the amount of foreign tax that would have been due in U.S. income tax if the income had been earned in the U.S.;

This is called **the limitation**. For example, income tax in Germany can reach 60%. If the tax on the same income in the U.S. is 25%, you forfeit the difference although the excess unused credit may be carried forward to future years.

3. Foreign Taxes for Which You Cannot Take a Credit

- Taxes on excluded income, (the Foreign Earned Income Exclusion, income from Puerto Rico and Possessions)
- Taxes for which you can only take an itemized deduction,
- Taxes on foreign oil related income,
- Taxes on foreign mineral income,
- Taxes from international boycott operations,
- Taxes of U.S. persons controlling foreign corporations or partnerships, and
- Taxes on foreign oil and gas extraction income.

There is a simple formula to arrive at the foreign tax credit:

$$\frac{\textbf{Foreign Source Taxable Income}}{\textbf{Worldwide Taxable Income}} \times \textbf{U.S. Income Tax before Credit} = \textbf{FTC Limitation}$$

If the other country has a higher tax rate than the U.S. there will be unused credits. These may be carried back one year and forward ten years; they expire if unused. If the other country has a lower tax rate than the U.S., you will be required to pay the difference to the U.S.

The FTC is an election. The taxpayer gives up the right to deduct foreign income taxes.

The FTC is figured on Form 1116 http://www.irs.gov/pub/irs-pdf/f1116.pdf for individuals and 1118 for Corporations. The 1118 is outside the scope of this little article. We will examine the 1116 only.

Form 1116

The reason why so few people avail themselves of this method of double taxation relief is because at first glance, the Form looks very intimidating. That's why it's almost always referred to as "the dreaded" 1116. This is unfair; the 1116 is only hard the first time you use it. Actually, that is true of most things.

When you encounter the 1116 and accompanying instructions for the first time they demand such a thorough exercise in reading comprehension and arithmetic skill that many people have claimed to lose two pounds of body weight by the time they finished. Nevertheless, there is no algebra or calculus here; everything you need to know you learned by the seventh grade.

However, the IRS has provided a neat and relatively painless way of learning how to do this form right; it is called "link and learn". Go to this site; http://www.irs.gov/app/vita/international_module.jsp and look down the list of topics until you see "Foreign Tax Credit". When you click on that you get your lesson. As a matter of fact, the link and learn site covers just about everything you would wish to know about filing your tax return; it just takes some time to get through it.

There is no 1116EZ. However, there is a puny allowance of $300 for single filers or $600 for those married filing jointly that may be taken as a FTC without filing 1116.

The foreign tax must be stated on a 1099 DIV or INT or similar and be attributable to passive income only.

The complexity of the Form is not mere harassment by the IRS. Its point is to:

- Arrive at that all important ratio expressed in the first part of the formula.
- Allocate the income to a specific "basket".
- Adjust the foreign income and tax for deductions and exclusions.

Let me explain the term basket. The IRS wants to know the nature of your foreign income for foreign tax credit purposes. To that end they created categories, commonly called "baskets". The rules connected with baskets go on for pages. We will only concern ourselves with three. A couple years ago the baskets were simplified and some baskets were eliminated.

For example:

1. Income from work goes in the "general limitation" basket.

2. Interest, dividends, pensions, rents, royalties, annuities, and net gain from the sale of non-income-producing investment property or property that generates passive income go to the "passive" basket.

3. A pension paid to a US citizen who is resident abroad generally goes into the "income resourced by treaty" basket if you are taxable on your worldwide income in that country.

A separate 1116 MUST be made for each basket.

I know this seems somewhat complex and the best way to overcome fear is by confronting it. To that end, it might be profitable to examine the 1116. It really is not as bad as everyone says; fire up your calculators.

<u>Example:</u>

Steve and Marsha, U.S. citizens live in the mythical country of Exotica. They have two little kids ages 5 and 7.

Exotica has a tax system similar to that of the U.S. except that its highest rate of taxation (30%) starts at 75,000 Exotican Dollars (E$). In 2011 their income consists of Steve's E$65,000 wages from his company, E$34,000 in wages Marsha gets as a hair stylist, and $3,000 in bank interest from a U.S. bank. In 2011 they paid E$22,000 in tax; for purposes of this example **$1 USD = E$ .7308**

So, the family has E$99,000 in what is called "foreign earned income" and $3,000 from US sourced interest. As you know, foreign currency has to be converted to U.S. Dollars when you fill out your tax return. When you convert the couple's income to U.S. Dollars the E$99,000 swells to $135,468. Now add the $3,000 in US interest for a total of $138,468 in WORLDWIDE INCOME.

To make this a little easier to follow let's break up the Form 1116 into bite sized pieces and do it by sections.

The first section is purely informational and it looks like this:

Form **1116** — **Foreign Tax Credit**

Department of the Treasury
Internal Revenue Service (99)

(Individual, Estate, or Trust)
▶ **Attach to Form 1040, 1040NR, 1041, or 990-T.**
▶ **See separate instructions.**

OMB No. 1545-0121
2011
Attachment Sequence No. **19**

Name	Identifying number as shown on page 1 of your tax return
STEVEN & MARSHA VAN HELSING	100-20-3000

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** in the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

- a ☐ Passive category income
- b ☑ General category income
- c ☐ Section 901(j) income
- d ☐ Certain income re-sourced by treaty
- e ☐ Lump-sum distributions

f Resident of (name of country) ▶ EXOTICA

Note: *If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to* ***more than one*** *foreign country or U.S. possession, use a separate column and line for each country or possession.*

Steve and Marsha put in both their names and Steve puts in his Social Security number. Since they are seeking a credit for tax on their employment income they check the box that says "General Category Income". They are residents of Exotica so that goes on line f.

Now comes the exciting part:

Note: *If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to* ***more than one*** *foreign country or U.S. possession, use a separate column and line for each country or possession.*

Part I — Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)

		Foreign Country or U.S. Possession				Total (Add cols. A, B, and C.)
		A	B	C		
g	**Enter the name of the foreign country or U.S. possession** ▶	EXOTICA				
1a	Gross income from sources within country shown above and of the type checked above (see instructions): WAGES	135,468			1a	135,468
b	Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is $250,000 or more, and you used an alternative basis to determine its source (see instructions) ▶ ☐					
	Deductions and losses (*Caution:* *See instructions*):					
2	Expenses **definitely related** to the income on line 1a (attach statement)					
3	Pro rata share of other deductions **not definitely related:**					
a	Certain itemized deductions or standard deduction (see instructions)	11,600				
b	Other deductions (attach statement)	4,000	IRA CONTRIB.			
c	Add lines 3a and 3b	15,600				
d	Gross foreign source income (see instructions)	135,468				
e	Gross income from all sources (see instructions)	138,648				
f	Divide line 3d by line 3e (see instructions)	.9783				
g	Multiply line 3c by line 3f	15,261				
4	Pro rata share of interest expense (see instructions):					
a	Home mortgage interest (use worksheet on page 14 of the instructions)					
b	Other interest expense					
5	Losses from foreign sources					
6	Add lines 2, 3g, 4a, 4b, and 5	15,261			6	15,261
7	Subtract line 6 from line 1a. Enter the result here and on line 15, page 2 ▶				7	120,207

Line g asks you to whom you paid this foreign tax. Steve and Marsha write in Exotica. Then they convert their salaries to U.S. dollars and write in the total on line 1a.

The couple decided to take the standard deduction; they put that on line 3a. They contributed $4,000 to their IRA and deducted that on “adjustments to income” on their Form 1040; so now they put that figure on line 3b.

Now they need to find how much of their income from ALL sources is from FOREIGN sources so they whip out their calculator and follow the simple directions on lines 3d, e, and f to the FOURTH DECIMAL PLACE.

Line g is the amount that is subtracted from their gross foreign income to arrive at net foreign income after allowable deductions. This is the important number. They quickly put this number on line 15 as directed by the form instructions.

Now they convert the amount of Exotican tax they paid into US Dollars.

Part II **Foreign Taxes Paid or Accrued** (see instructions)

Country	Credit is claimed for taxes (you must check one) (h) ☑ Paid (i) ☐ Accrued	Foreign taxes paid or accrued								
		In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			(n) Other foreign taxes paid or accrued	Taxes withheld at source on:			(r) Other foreign taxes paid or accrued	(s) Total foreign taxes paid or accrued (add cols. (o) through (r))
	(j) Date paid or accrued	(k) Dividends	(l) Rents and royalties	(m) Interest		(o) Dividends	(p) Rents and royalties	(q) Interest		
A	12/31/2011				E$22,000				$30,104	$30,104
B										
C										
8	Add lines A through C, column (s). Enter the total here and on line 9, page 2 . . . . ▶ 8									$30,104

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11440U Form **1116** (2011)

Now they go to page 2 of the Form and just follow the directions filling in the required information and doing a little simple arithmetic to four decimal places.

But first we have to know what their U.S. tax is before we can complete the 1116. Let’s say it is $19,312 after deductions and exemptions.

Part III Figuring the Credit

9	Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I	9	30,104		
10	Carryback or carryover (attach detailed computation)	10			
11	Add lines 9 and 10	11	30,104		
12	Reduction in foreign taxes (see instructions)	12	( )		
13	Taxes reclassified under high tax kickout (see instructions)	13			
14	Combine lines 11, 12, and 13. This is the total amount of foreign taxes available for credit			14	30,104
15	Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I (see instructions)	15	120,207		
16	Adjustments to line 15 (see instructions)	16			
17	Combine the amounts on lines 15 and 16. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 18 through 22. However, if you are filing more than one Form 1116, you must complete line 20.)	17	120,207		
18	**Individuals:** Enter the amount from Form 1040, line 41, or Form 1040NR, line 39. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	18	123,048		
	Caution: *If you figured your tax using the lower rates on qualified dividends or capital gains, see instructions.*				
19	Divide line 17 by line 18. If line 17 is more than line 18, enter "1"			19	.9769
20	**Individuals:** Enter the amount from Form 1040, line 44. If you are a nonresident alien, enter the amount from Form 1040NR, line 42. **Estates and trusts:** Enter the amount from Form 1041, Schedule G, line 1a, or the total of Form 990-T, lines 36 and 37			20	19,312
	Caution: *If you are completing line 20 for separate category **e** (lump-sum distributions), see instructions.*				
21	Multiply line 20 by line 19 (maximum amount of credit)			21	18,866
22	Enter the **smaller** of line 14 or line 21. If this is the only Form 1116 you are filing, skip lines 23 through 27 and enter this amount on line 28. Otherwise, complete the appropriate line in Part IV (see instructions) ▶			22	18,866

On line 10 you could add unused credits from past years, and line 12 needs to be computed if you used the Exclusion. Please note the caution for line 18.

Now there is just one little part left. If you had more than one category of income, let's say one from the passive basket and one from the general basket you would total everything up in part IV In our example this did not happen.

Part IV Summary of Credits From Separate Parts III (see instructions)

23	Credit for taxes on passive category income	23			
24	Credit for taxes on general category income	24			
25	Credit for taxes on certain income re-sourced by treaty	25			
26	Credit for taxes on lump-sum distributions	26			
27	Add lines 23 through 26			27	
28	Enter the **smaller** of line 20 or line 27			28	18,866
29	Reduction of credit for international boycott operations. See instructions for line 12			29	
30	Subtract line 29 from line 28. This is your **foreign tax credit.** Enter here and on Form 1040, line 47; Form 1040NR, line 45; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶			30	18,866

Form **1116** (2011)

The result is posted to line 47 of the Form 1040; Foreign Tax Credit.

Notice that even though they paid $30,104 to the Exotican IRS they may only take a credit for $18,886 on their U.S. tax. This is because U.S. tax is less than Exotican tax and the limitation (remember that?) comes into effect.

Also note that the Van Helsings still owe $446 to Uncle Sam. This is the tax on that $3,000 of interest income they got from America. This is eliminated by taking the Additional Child Tax Credit and they get a refund of $116.

And remember, the FTC can also be taken as a credit for AMT.

The accurate navigation and completion of Form 1116 can be accomplished by consulting the instruction for the Form http://www.irs.gov/pub/irs-pdf/i1116.pdf and Pub. 514 http://www.irs.gov/pub/irs-pdf/p514.pdf .

Conclusion

Still with me after all that?

Reading anything about taxes is about as much fun as a trip to the Dentist, but I hope I have given you a better understanding of the concept and the mechanics of the FTC. Far more important is the knowledge that, in many circumstances, using the FTC will put money in your pocket.

If the whole process is still a little intimidating for you be sure to show this article to your tax professional when filing for next year.

Roger B. Adams is an enrolled agent specializing in expatriate and nonresident alien taxation and tax treaty issues. He is also a Certified Acceptance Agent for obtaining ITINs. In addition to his private practice, he lectures on both domestic and international tax issues for the Enrolled Agents Exam Preparation Course at http://irsexams.com/. He is the instructor and consultant on US taxation issues to the Autonomous Regional Government of the Azores as well as the Foreign Affairs Directorate of Portugal.. He lives in Cascais, Portugal. Adams.family@mail.telepac.pt