

Foreign Taxes

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Jim asks:

Hello! I was wondering if you can help me understand the IRS policy on foreign tax credits? From what I understand there's a cap, but there's also a deduction available?

Thanks,
Jim

My response:

Hello Jim! The foreign tax credit can get very complicated very fast, which is why, if you paid foreign taxes (or they were withheld from your foreign income) you should have a qualified tax professional help you.

It's much more complicated than my answer here, but hopefully this will provide you with a general idea of the concepts.

In general, if you are married, and are filing jointly, the IRS allows you to deduct up to \$600 of foreign taxes you paid each year on page 2 of Form 1040. If you want to deduct more than \$600 you must file Form 1116.

Form 1116 generally limits the credit you can take on your foreign taxes withheld or paid to about the same percentage of net foreign income as your income tax bears to your total income, on a per-country basis. This roughly means that if the foreign tax, or withholding, rate is 25% and you are in the 15% tax bracket you're not going to get more than about 1/2 your withheld foreign taxes back on Form 1040 page 2 using Form 1116. The good news is that you can carry forward your unused credits if you use Form 1116. The bad news is that in a year that you have no foreign income, you cannot take any foreign taxes as a credit on Form 1116 nor can you use any previously denied credits and you can't switch to the flat \$600 to include any carryovers from previous years.

And then to make it more complicated there's the dreaded AMT. If you claim foreign tax credits on your regular tax, those credits are subtracted from pre-credit tentative AMT liability, yielding tentative AMT liability. And to make it even more complicated foreign tax credits can reduce pre-credit tentative AMT liability by no more than 90 percent.

It is well worth it to have a qualified tax professional prepare your return if you are dealing with the foreign tax credit.

Gina L. Gwozdz is a CPA who has chosen to specialize in taxes. Visit her website at <http://GLGcpa.com> to view more Tax Tip Articles.