STUDENT COURSEBOOK
For Use in Preparing Tax Year 2002 Returns

INTERNATIONAL ISSUES

VITA
Volunteer Income Tax Assistance
TCE
Tax Counseling for the Elderly
Providing Community Service to Millions

FOR USE IN IRS VOLUNTEER PROGRAMS

VITA Volunteer Income Tax Assistance

TCE Tax Counseling for the Elderly

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INTRODUCTION TO INTERNATIONAL ISSUES

LESSON 1

INTRODUCTION

Welcome to the world of international tax assistance! In this supplement, you will learn about the issues that affect Americans and U.S. resident aliens who live outside the United States. This publication is designed specifically for VECTA volunteers assisting U.S. taxpayers living abroad.

OBJECTIVES

At the end of this lesson the student will be able to:

1. Define worldwide income.
2. Compute the U.S. dollar value of a foreign currency if given an exchange rate table.
3. Determine if average annual exchange rate figures can be used.

WORLDWIDE INCOME

U.S. citizens and U.S. resident aliens are required to file a U.S. tax return based on their worldwide income. It has been a popular misconception that a person only has to file a U.S. tax return if he or she has income from the United States, especially if he or she pays taxes to another country. While U.S. citizens and U.S. resident aliens living abroad can claim tax benefits such as the foreign earned income exclusion and the foreign tax credit (later lessons), they have the same filing requirements as U.S. citizens living in the United States. This applies whether their income is from within or outside the U.S. Types of income, such as child support, which would not be taxed in the U.S., are generally not taxed if from outside the U.S. But, types of income which would be taxable if from within the U.S. are also taxable if from outside the U.S.

You may wish to refer to the lists of taxable and nontaxable income on the applicable pages of your Volunteer Assistor's student text (Publication 678 Lesson 3) for types of taxable and nontaxable income.

Example 1

In 2002, Joe Adams earned $40,000 while working in Austin, Texas, for XYZ Corporation. In September 2002, he transferred to their office in Stuttgart, Germany. While in Germany, he earned $30,000. His worldwide wages earned in 2002 would be $70,000. Line 7 of his Form 1040 would show $70,000.

Exercise 1

Marta Brener lives in Mussbach, Germany. Her 2002 income included $22,000 in wages earned in Germany. She earned $3,000 in interest from her U.S. bank and $2,000 unemployment compensation from the state of Iowa. What is Marta's worldwide gross income?

Exercise 2

Mary Carlton lives in Belgium. Her 2002 income included $10,000 in wages from her Belgian employer. She received $2,000 interest from her U.S. bank, $8,000 in alimony payments and $8,000 in child support payments from her ex-spouse. What is her worldwide gross income?

Exercise 3

Would Marta Brener (Exercise 1) have to file a U.S. tax return for 2002? Would Mary Carlton (Exercise 2) have to file a U.S. tax return?

Exchange Rates

Another question that you will frequently be asked is "What exchange rate do I use?" The exchange rates of foreign currencies to the U.S. tax dollar change on a daily basis. **All amounts on the U.S. tax return must be stated in U.S. dollars**. Since most taxpayers abroad receive some kind of income in foreign currency, you will find situations when you will need to convert foreign income into U.S. dollars in order to put these income amounts on the return. Most countries have a medium of currency compared to which the value of the dollar is larger. Very few countries have mediums compared to which the U.S. dollar is smaller. Exchange rates are stated in two ways: the foreign currency to the U.S. dollar, and the dollar's value in the foreign currency.

When making a conversion, you should make sure that the exchange rate is stated in foreign currency to one U.S. dollar. To convert a sum of money into U.S. dollars, you would divide the foreign currency by the exchange rate.

Example 2

If you received 3,000 Euros on a day that the exchange rate was 1.7115 Euros to $1 U.S., you would have $1,752.85 in equivalent U.S. dollar value (3,000/1.7115 = 1,752.85). To convert a sum of money into U.S. dollars when the currency unit is larger in value, you can use the same process.

Example 3

Caryn received 200 Euros on a day that the exchange rate was .5514 Euros to one U.S. dollar. In U.S. dollars, she would have $362.71 (200/.5514 = 362.71).

Exercise 4

Convert the following amounts to U.S. dollars.

a. 36,000 Euros (1.7115 exchange rate) ________

b. 800 Euros (.5514 exchange rate) ____________

When to Convert. Now that you have information on how to calculate exchange rates, we now need to discuss what exchange rates to use. Actually, what exchange rate to use is determined by the date of the transactions; that is the date on the check or the date money is credited to the taxpayer's account. If the taxpayer has income which was received evenly throughout the year, he or she can use the average annual exchange rate if the foreign exchange rate was relatively stable during the year. The average annual exchange rate is available from IRS offices throughout the world generally starting around January 15.

IRS also distributes information to its worldwide offices concerning the quarterly exchange rates for various currencies.

Example 4

Edward Pasco worked in Dallas for Megacorp Incorporated from January until September 2002. On September 29, he was transferred to their Mexico City office where he will be working for 3 years. While in the U.S., Edward earned his salary in U.S. dollars. When he moved to Mexico, he was paid in Mexican pesos. Since he did not receive his salary in foreign currency throughout the year, he should not use the annual average exchange rate. He should use the average rates for October, November, and December.

Where to Obtain Exchange Rates. To obtain exchange rates, you can call the IRS International office at 215-516-2000, or the overseas IRS offices. The phone numbers of these offices are listed in Publication 54. You may also contact banks who provide international currency exchange services. Since a taxpayer "should use the rate that most nearly reflects the value of the foreign currency" (Publication 54) at the time he or she receives the income, the taxpayer may use an exchange rate that is different from the rates posted in our worldwide offices if he finds it to be a truer representation.

Exercise 5

Deborah Vance lives and works in Manila, Philippines. In 2002, she had the following income: 16,000 Filipino pesos in wages, 1,200 Filipino pesos interest income and $500 in U.S. interest from her U.S. bank. On June 7, 2002, she sold her car and made a profit of 2,000 Philippine pesos (fully taxable capital gain). Since these items are fully taxable, what is the total income to be reported on her U.S. tax return (in U.S. dollars)?

For this exercise assume that the 2002 average annual exchange rate for the Philippine peso is 40.25 pesos to 1.00 U.S. dollar and the exchange rate for June 7, 2002 was 32.55 pesos to 1.00 U.S. dollar.

Wages ____________________________

Interest __________________________

Capital Gain ______________________

Total 2002 Income ___________________

Sometimes, you may get questions on exchanging money when there is "blocked income" or "soft currency". Questions on these issues should be referred to IRS. "Blocked income" refers to a situation where a taxpayer cannot convert foreign currency to U.S. dollars. This is generally due to local law or local government policy. There are special tax rules that exist when there is blocked income which allows a person to choose to put off reporting part of their income. "Soft currency" refers to a situation where a person can only convert back to U.S. dollars an amount that equals what he brought into that country in U.S. dollars.

►► SUMMING UP THIS LESSON ◄◄

- U.S. citizens (and resident aliens) are taxed on worldwide income and must file U.S. tax returns even if all the income is from foreign sources.
- You have learned how to exchange foreign currency to U.S. dollar equivalent values.
- Exchange rates used should reflect the closest accurate rate.

ANSWERS TO EXERCISES

1. $27,000

2. $20,000

3. Yes. Yes.

4. **a.** $21,034.18
b. $1,450.85

5. Wages 16,000.00 ÷ 40.25 = <u>$397.52</u>

Interest 1,200.00 ÷ 40.25 = <u>$29.81</u> from Philippines plus <u>$500</u> interest from U.S. = <u>$529.81</u>

Capital Gain 2,000.00 ÷ 32.55 = <u>$61.44</u>

Total 2002 Income – <u>$988.77</u>

FILING STATUS ISSUES

INTRODUCTION

Many areas of the tax return are directly tied to the filing status of the taxpayer. Therefore, it is extremely important to have the correct status and to complete the tax return consistent with the filing status chosen.

With these tax returns there are some interesting twists and turns that are possible. It is important to have your reference material handy when things get a little unusual to help you complete the return accurately. The discussion below should help. **Remember: the rules discussed only apply to a taxpayer that is a U.S. citizen or resident alien.**

OBJECTIVES

At the end of this lesson, you will be able to:

- Determine the correct filing status for resident aliens.
- Explain how to treat a nonresident spouse as a resident.

SINGLE

The normal rules apply. If the taxpayer is unmarried on December 31 and does not qualify for another filing status then the filing status is SINGLE.

MARRIED FILING SEPARATE

If married taxpayers do not choose to file joint or they are not eligible for another, more favorable, filing status, then they must file Married Filing Separately.

MARRIED FILING JOINT

In order to file Married Filing Jointly, the taxpayers must be married on the last day of the tax year and agree to file a joint return. However, "A joint return generally cannot be made if either spouse is a nonresident alien at any time during the tax year" (Pub 17).

Nonresident Spouse Treated as a Resident

If, at the end of the tax year, the taxpayer is married and one spouse is a U.S. citizen or a resident alien and the other spouse is a nonresident alien, the taxpayer can elect to treat the nonresident spouse as a U.S. resident. This includes situations in which one spouse is a nonresident alien at the beginning of the tax year, but a resident alien at the end of the year, and the other spouse is a nonresident alien at the end of the year.

If this choice is made, the taxpayer and spouse are treated for income tax purposes as residents for the entire tax year. For example, neither the taxpayer nor the spouse can claim tax treaty benefits as a resident of a foreign country for a tax year for which the choice is in effect. Taxpayers must file a joint income tax return for the year the choice is made, but the taxpayer and spouse can file joint or separate returns in later years.

Example 1

Debra Green, a U.S. citizen for all of tax year 2002, is married to Charles, a nonresident alien. Debra and Charles make the choice to treat Charles as a resident alien by attaching a statement to their joint return for 2002. Debra and Charles must report their worldwide income in 2002 and later years unless the choice is ended or suspended. Although they must file a joint return for 2002, they can file joint or separate returns for later years.

Example 2

Jim and Judy Adams are married and both are nonresident aliens. In June 2002, Jim became a resident alien and remained a resident for the rest of the year. Jim and Judy both choose to be treated as resident aliens by attaching a statement to the 2002 joint return. Jim and Judy must report their worldwide income in 2002 and later years unless the choice is ended or suspended. They must file a joint return for 2002, but they can file either joint or separate returns for later years.

How to Make the Choice

Attach a statement, signed by both spouses, to the joint return for the first tax year for which the choice applies. It should contain the following:

1. A declaration that one spouse was a nonresident alien and the other spouse a U.S. citizen or resident alien on the last day of the tax year, and that the taxpayer and spouse chose to be treated as U.S. residents for the entire tax year, and
2. The name, address, and social security number or ITIN of each spouse. (If one spouse died, include the name and address of the person making the choice for the deceased spouse.)

The choice can also be made by filing a joint amended return. Publication 54 contains specifics on this option.

Suspending the Choice

The choice to be treated as a resident alien does not apply to any later tax year if neither spouse is a U.S. citizen or resident alien at any time during the tax year.

Example 3
Dick Brown was a resident alien on December 31, 1999, and married to Judy, a nonresident alien. They chose to treat Judy as a resident alien and filed joint returns for tax years 1999 and 2000. On January 10, 2001, Dick became a nonresident alien. Judy had remained a nonresident alien throughout the period. Dick and Judy can file joint or separate returns for 2001. However, since neither Dick nor Judy is a resident alien at any time during 2002, their choice is suspended for that year. If either has U.S. source income or foreign source income effectively connected with a U.S. trade or business in 2002, they must file separate returns as nonresident aliens. If Dick becomes a resident alien again in 2003, their choice is no longer suspended.

Ending the Choice

Once made, the choice to be treated as a resident applies to all later years unless suspended or ended in one of the ways shown below. If the choice is ended for any of these reasons, neither spouse can make a choice in any later tax year.

Revocation	● Either spouse can revoke the choice for any tax year.
	● The revocation must be made by the due date for filing the tax return for that year.
	● The spouse who revokes must attach a signed statement declaring that the choice is being revoked. If the spouse revoking the choice does not have to file a return and does not file a claim for refund, send the statement to the Internal Revenue Service Center where the last joint return was filed.
	● The statement revoking the choice must include the following:
	  ● The name, address, and social security number (or taxpayer identification number) of each spouse.
	  ● The name and address of any person who is revoking the choice for a deceased spouse.
	  ● A list of any states, foreign countries, and possessions that have community property laws in which either spouse is domiciled or where real property is located from which either spouse receives income.

Death	● The death of either spouse ends the choice, beginning with the first tax year following the year the spouse died. ● If the surviving spouse is a U.S. citizen or resident and is entitled to the joint tax rates as a surviving spouse, the choice will not end until the close of the last year for which these joint rates may be used. ● If both spouses die in the same tax year, the choice ends on the first day after the close of the tax year in which the spouses died.
Divorce or Legal separation	● A divorce or legal separation ends the choice as of the beginning of the tax year in which the legal separation occurs.
Inadequate records	● The Internal Revenue Service can end the choice for any tax year that either spouse has failed to keep adequate books, records, and other information necessary to determine the correct income tax liability, or to provide adequate access to those records.

HEAD OF HOUSEHOLD

In general, in order to claim Head of Household status, the taxpayer must:

1. Be unmarried or considered unmarried on the last day of the year and

2. Have paid more than half the cost of keeping up a home for the year and

3. Have a qualifying person in the home for more than half the year.

The general rules are discussed in Publication 17 and should be consulted often to determine if a taxpayer qualifies for this filing status.

EXEMPTIONS FOR FOREIGN SPOUSE OR DEPENDENT

INTRODUCTION

In general, the rules that govern the claiming of exemptions are the same for these returns as they are for other returns. The special rules that can be applied will be discussed below. **Remember: in order to claim an exemption for someone, all the rules must be met, and this needs to be communicated to the taxpayer**.

PERSONAL EXEMPTIONS

Each taxpayer is allowed a personal exemption (unless the taxpayer is claimed by someone else). On a Married Filing Separate return a spouse's personal exemption may be claimed by the taxpayer if the spouse had no gross income and is not claimed by anyone else. **Remember: a spouse is never the dependent of the taxpayer.**

DEPENDENTS

The five dependency tests are essentially the same for taxpayers living overseas.

Citizenship Test. To meet this test a person must be a U.S. citizen or national, or a resident of the U.S., Canada or Mexico for some part of the tax year. If a U.S. citizen marries a nonresident alien, any child born to them may be entitled to U.S. citizenship. In most instances the U.S. parent will register the child with the U.S. Embassy or Consulate closest to where they live. If the child may claim U.S. citizenship, the child meets the citizenship test for dependency purposes, even though the family is living in a foreign country. Proof of citizenship is not required to be atttached to the return. But if the item is questioned by the IRS, the U.S. citizen parent will have to obtain the necessary documentation from the U.S. government.

Example 1

Betty Glinn, a U.S. citizen, is married to Giovanni Glinn, an Italian citizen. They are currently living in Rome. Their daughter, Patricia, meets the citizenship test for dependency since she is entitled to U.S. citizenship because of her U.S. parent.

Occasionally, you will encounter a situation where a U.S. citizen adopts a child who is not a U.S. citizen. In those circumstances, the adopted child can meet the citizenship test if he or she lives with the U.S. citizen parent for the entire tax year (except for temporary absences).

ALIEN STATUS

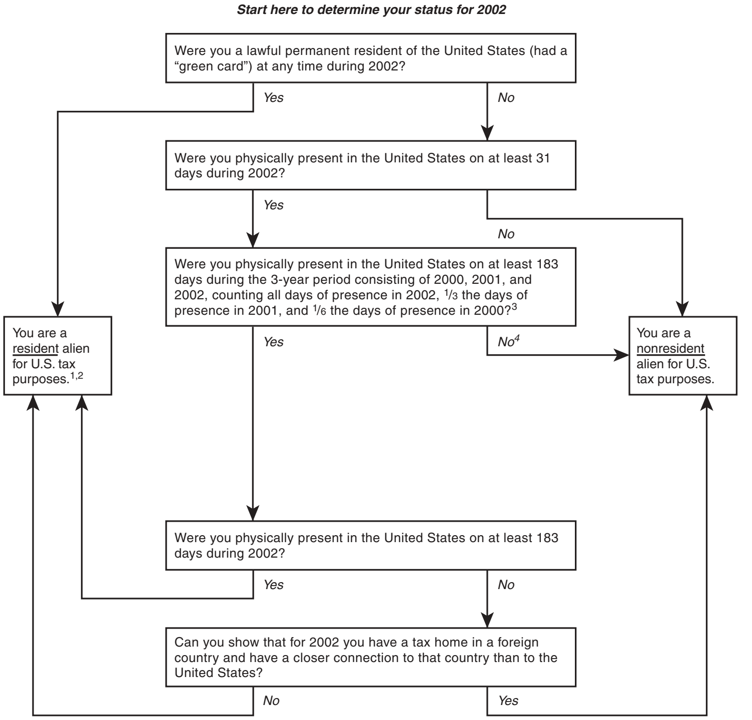
Throughout this course material, we refer to U.S. citizens or resident aliens. In order to apply the tax law correctly, you need to determine alien status.

The first issue that must be decided is whether the taxpayer is a nonresident alien. If he/she is a nonresident alien then the taxpayer must be referred to get specialized help. Your training covers only the tax law as it applies to a citizen or a resident alien so this determination is very important. Remember that we are discussing taxes here. A resident for tax purposes is not necessarily a resident for immigration purposes.

The following is an excerpt from Publication 519 (U.S. Tax Guide for Aliens). This section discusses the rules for determining alien status. These issues are complex. In this lesson, we will use examples to review the differences between resident and non-resident aliens.

Glance or read over the following material, especially the flow chart, and get a feel for what is involved.

Exhibit 1. Nonresident Alien or Resident Alien?



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[1] If this is your first or last year of residency, you may have a dual status for the year. See the discussion of *Dual Status Aliens*, in Publication 519.

[2] In some circumstances you may still be considered a nonresident alien under an income tax treaty between the U.S. and your country. Check the provisions of the treaty carefully.

[3] Do not count the days you were unable to leave the United States because of a medical condition that arose while you were in the United States.

[4] If you meet the substantial presence test for 2003, you may be able to choose treatment as a U.S. resident alien for part of 2002. For details see *Substantial Presence Test* under *Resident Aliens*, and *First-year choice* under *Dual-Status Aliens*, in Publication 519.

NONRESIDENT ALIENS

If the taxpayer is an alien (not a U.S. citizen), he or she is considered a nonresident alien unless he or she meets one of the two tests described next under Resident Aliens.

RESIDENT ALIENS

This section describes the two tests taxpayers must use to determine if they are resident aliens of the United States.

A taxpayer is a resident alien of the United States for tax purposes if he or she meets either the ***green card test*** or the ***substantial presence test*** for the calendar year (January 1-December 31).

Green Card Test

You are a resident for tax purposes if you are a lawful permanent resident of the United States **at any time** during the calendar year. (However, see ***Dual Status***, later.) This is known as the "green card" test. You are a lawful permanent resident of the United States at any time if you have been given the privilege, according to the immigration laws, of residing permanently in the United States as an immigrant. You generally have this status if the Immigration and Naturalization Service (INS) has issued you an alien registration card, also known as a "green card." You continue to have resident status under this test unless it is taken away from you or is administratively or judicially determined to have been abandoned.

Substantial Presence Test

You will be considered a U.S. resident for tax purposes if you meet the substantial presence test for the calendar year. To meet this test, you must be physically present in the United States on at least:

1. 31 days during the current year, ***and***
2. 183 days during the 3-year period that includes the current year and the two years immediately before that, counting:
    - **a.** All the days you were present in the current year (2002) and
    - **b.** 1/3 of the days you were present in the first year before the current year (2001) and
    - **c.** 1/6 of the days you were present in the second year before the current year (2000).

Example 2

You were physically present in the United States on 120 days in each of the years 2000, 2001, and 2002. To determine if you meet the substantial presence test for 2002, count the full 120 days of presence in 2002, 40 days in 2001 (1/3 of 120), and 20 days in 2000 (1/6 of 120). Since the total for the 3-year period is 180 days, you are not considered a resident under the substantial presence test for 2002.

The term United States includes the following:

1. All 50 states and the District of Columbia
2. The territorial waters of the United States, and
3. The seabed and subsoil of those submarine areas that are adjacent to the U.S. territorial waters and over which the United States has exclusive rights under international law to explore and exploit natural resources.

The term does not include U.S. possessions and territories or U.S. air space.

Days of Presence in the United States

You are treated as present in the United States on any day if you are physically present in the country at any time during the day. However, there are exceptions to this rule. Do not count the following as days of presence in the United States for the substantial presence test:

1. Days you regularly commute to work in the United States from a residence in Canada or Mexico.
2. Days you are in the United States for less than 24 hours when you are in transit between two places outside the United States.
3. Days you were unable to leave the United States because of a medical condition that developed while you were in the United States.
4. Days you were an exempt individual.

Regular commuters from Canada or Mexico. Do not count the days on which you regularly commute to work in the United States from your residence in Canada or Mexico. You are considered to commute regularly if you commute to work in the United States on ***more than*** 75 percent of the workdays during your working period.

For this purpose, commute means to travel to work and return to your residence within a 24-hour period. ***Workdays*** are the days on which you work in the United States or Canada or Mexico. ***Working period*** means the period beginning with the first day in 2002 which you are physically present in the United States to work. If your work requires you to be present in the United States only on a seasonal or cyclical basis, your working period begins on the first day of the season or cycle on which you are present in the United States to work and ends on the last day of the season or cycle on which you are in the United States to work. Thus, you may have more than one working period in 2002, and your working period may begin in one calendar year and end in the following calendar year.

Exempt individual. For the substantial presence test, do not count days for which you are an exempt individual. The term “exempt individual” does not refer to someone exempt from U.S. tax, but to anyone in the following categories.

1. An individual temporarily present in the United States as a foreign government-related individual.

2. A teacher or trainee, temporarily present in the United States under a “J” or “Q” visa, who substantially complies with the requirements of the visa.

3. A student, temporarily present in the United States under an “F,” “J,” “M,” or “Q” visa, who substantially complies with the requirements of the visa.
4. A professional athlete temporarily in the United States to compete in a charitable sports event.

After reviewing the rules above, if there are still questions, refer the taxpayer to Publication 519 or to the IRS Information line for alien status determination.

DUAL STATUS

In general, for the first and last year of resident alien status the taxpayer will be considered a “dual status” alien (both resident and nonresident) and special rules apply. Generally, dual status aliens should be referred to the IRS or paid tax professional.

►► SUMMING UP THIS LESSON ◄◄

Remembering that a **resident alien is treated the same as a citizen for tax purposes**, here are the main issues:

1. Does the taxpayer have a “green card”? If so, then the taxpayer will be considered a resident alien.
2. Has the taxpayer been here long enough to qualify for the substantial presence test? If so, then the taxpayer is considered a resident alien on a year by year basis (this applies even though the person may be considered “illegal”).
3. Remember that certain people are “exempt individuals” and do not count days toward the substantial presence test.

TAXPAYER IDENTIFICATION NUMBERS AND OTHER ENTITY ISSUES

INTRODUCTION

Every U.S. Federal tax return that is filed, must have each person identified by a number. Each person refers to the taxpayer, the taxpayer's spouse if the taxpayer is married, and any dependent claimed on the return. The identifying number will be a social security number for those persons who qualify to be issued one. All others must have an individual taxpayer identification number (ITIN).

INDIVIDUAL TAXPAYER IDENTIFICATION NUMBERS (ITIN's)

Beginning in July 1996, foreign taxpayers who were unable to get a social security number were able to apply for a tax return processing number called an ITIN. These taxpayers were unable to get an SSN because they were either not legally admitted into the United States or, some other social security regulation prevented the issuing of an SSN. This ITIN functions the same as a social security number *as it regards the filing and processing of a tax return.* It has no bearing on the alien's legal status or permission to work. An ITIN can be received by the *taxpayer, spouse, and dependents* because all have to be identified with a "number" on a tax return. **While the ITIN is valid for processing and exemptions, it is not valid for Earned Income Credit. Only taxpayers with valid SSN's can claim EIC.**

In general, to receive an ITIN the taxpayer files Form W-7 and supplies documentation that will establish: 1) Foreign or alien status, and 2) Personal/true identity (see Form W-7 and Instructions at the end of this lesson). The Form W-7 and original documentation, certified copies from the issuing agency or custodian of the original document, or approved notarized copies (see Form W-7 Instructions) must be presented and validated at an IRS walk-in office (for those in the U.S.) or mailed to the Philadelphia Service Center for validation. Once validated, the number will be issued in four to six weeks. **If a person cannot get an SSN and is required to file a return or files a return to claim a refund, he/she must obtain an ITIN to file.**

Note: An individual who is not close to an IRS office can contact the IRS Internet site to locate acceptance agents. An acceptance agent is an individual or entity, such as a university, bank, or accounting firm, who has entered into a formal agreement with the IRS that permits the agent to assist applicants in obtaining ITINs. The agent reviews the applicant's documentation and forwards the completed application (Form W-7) and required documentation to IRS for processing. These agents are located in both the U.S. and outside the U.S. The countries listed include Canada, Germany, Japan and Venezuela. Other individuals outside the U.S. may contact a U.S. Embassy to have their documents inspected. This process allows them to send for the ITIN without the possibility of losing their original documents. **The Internet site is: http://www.irs.gov**

SSN's, ITIN's AND FILING

The following is a discussion on the use and necessity of these numbers when filing these returns.

The Taxpayer

Each taxpayer is required to have his/her own SSN or ITIN and to file the tax forms with this number in the appropriate places. With citizens or legal resident aliens who are able to get an SSN, this should not be a problem. They will tell or show you their SSN. Use the information they give you and file the return.

Note: Canadians have a number like a Social Security Number, but it's for their old age pension. Do not use this number on a U.S. tax return. Canadians often have both a U.S. and Canadian Social Security Number.

If the taxpayer does not have either a valid SSN or ITIN direct them to either Form SS-5 for an SSN (if they are eligible), or a W-7 for an ITIN. Explain to him/her that they **must** have a number before you can file the return.

The Spouse

If the spouse is a citizen or legal resident alien able to get an SSN, use the SSN you're given and file the return.

If the taxpayer elects to file a **married filing joint** return with the nonresident alien spouse, then the spouse needs an ITIN.

Dependents

The tax forms require that an SSN or ITIN be listed for each dependent. For citizen or resident alien dependents, SSN's should be obtained from the Social Security Administration (SSA) and used. If the SSA will not issue an SSN for the dependent, have the taxpayer file for an ITIN for the dependent. If the dependent has not received the SSN or ITIN by filing time, file an extension until one is obtained.

STUDENT NOTES

FOREIGN EARNED INCOME EXCLUSION

LESSON 5

INTRODUCTION

Section 61 of the Internal Revenue Code states that all income is taxable unless some other section of the Code specifically exempts it. In this lesson, we will discuss the foreign earned income exclusion which is provided in Section 911 of the Code. It was enacted by Congress to give an incentive to Americans working overseas. By claiming this benefit, American taxpayers overseas may exclude up to $80,000 of earned income in 2002. Obviously, the taxpayers you assist are very interested in this provision of the law because it can reduce the taxpayer's taxable income substantially. As a volunteer, your responsibility will be to inform the taxpayer about the exclusion and help the taxpayer to claim the exclusion on the return.

OBJECTIVES

At the end of this lesson you will be able to:

1. Determine whether the taxpayer qualifies for the foreign earned income exclusion.
2. Calculate the foreign earned income exclusion on Form 2555 or Form 2555 EZ.

CHOOSING THE EXCLUSION

The foreign earned income exclusion is voluntary. The initial choice of the exclusion on Form 2555 or Form 2555 EZ must be filed with a timely filed return (including any extensions), a return amending a timely filed return, or a late filed return (determined without regard to any extensions) filed within one year from the original due date of the return. Regulations provide that the initial choice can be made after the above time limits if the tax return shows no income tax after taking into account the exclusion. The initial choice may also be made after the above time limits even if tax will be due provided that the tax return is filed prior to the Internal Revenue Service discovering the taxpayer failed to make the election. To take advantage of these new time limits the top of Form 1040 should be noted "Filed Pursuant to Section 1.911–7(a)(2)(i)(D)." The choice is made by attaching Form 2555 or Form 2555 EZ to the individual's tax return for the year.

Once the taxpayer chooses to exclude foreign earned income, the choice remains in effect for that year and all later years unless the taxpayer revokes it.

REVOCATION

The taxpayer may revoke the choice for any tax year. The revocation is accomplished by attaching a statement to the return or amended return for the first year the taxpayer no longer wishes to claim the exclusion. The statement must indicate that the exclusion is being revoked, and what years are being revoked. A 1990 revenue ruling holds that a person who has elected the exclusion but who in a subsequent year chooses to claim a foreign tax credit on qualifying earned income is considered to have revoked his election.

When an exclusion is revoked, the taxpayer may not claim the exclusion again for the next 5 tax years without the approval of the IRS.

REQUIREMENTS

It would be very easy to figure the exclusion if all income a person earned overseas were exempt from tax. But that is not the case. There are various requirements that must be met. When assisting taxpayers in foreign countries, you will find that many of them have a misconception that all their income is exempt, and as a result, they do not need to file. So, for those taxpayers, the most important requirement that you will explain to them is the requirement to file a tax return.

There are two requirements to qualify for the foreign earned income exclusion. First, the taxpayer must show that his or her tax home is in a foreign country. The second requirement is that the taxpayer meet either the bona fide residence test or the physical presence test.

The requirements are applied separately to each individual. If a husband and wife are each working overseas, each must meet both requirements. If they do so, each is entitled to an exclusion of up to $80,000.

Tax Home. To claim the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country. Generally, one's tax home is the general area of the taxpayer's main place of business, employment, or post of duty, regardless of where the taxpayer maintains his or her family home.

If the taxpayer does not have a regular or main place of business because of the nature of the work, then the tax home is the place where the taxpayer regularly lives.

When the taxpayer has a tax home in the U.S., and goes overseas temporarily, or on business, the tax home has not changed. On the other hand, when the taxpayer is assigned overseas on business for an indefinite period, the tax home is overseas and the taxpayer may be eligible for the foreign earned income exclusion. Often, the difference between temporary and indefinite is the duration of the stay.

Effective for 1993 and later years the law provides that the taxpayer will not be treated as temporarily away from home if the employment away from home exceeds one year. Therefore the person will generally be considered to have a tax home in a foreign country if the employment in the foreign country will be for more than one year. However for purposes of the foreign earned income exclusion a person will not be considered to have a tax home in a foreign country for any time during which his abode is in the United States.

Three questions are important in showing whether or not a U.S. home is the regular place of abode. The questions that you should ask the taxpayer are:

1. Did you use your home in the United States as a residence while you worked at your job in the United States just before going abroad to your new job, and did you continue to maintain work contacts, job seeking, leave of absence, ongoing business, etc.) in that area in the United States during the time you worked abroad?
2. Are your living expenses duplicated at the U.S. and foreign home because your work requires you to be away from your U.S. home?
3. Do you have a family member or members continuing to live at your U.S. home, or do you frequently use your U.S. home for lodging during the period you work abroad?

If the taxpayer **cannot** answer “yes” to at least two of these three questions, the taxpayer will be considered indefinitely assigned to the new location abroad. Thus, since the tax home is abroad, no expenses for travel, meals, or lodging while there are deductible. However, one may be able to exclude earnings from income under the foreign earned income exclusion rules.

If he/she realistically expects the job to last, and it does last, less than 1 year and that he/she will return to the U.S. home, and can answer “yes” to all three questions, the taxpayer is considered temporarily away from home. The taxpayer does not qualify for the foreign earned income exclusion, but may qualify to deduct away-from-home expenses.

If the taxpayer can answer “yes” to two of the questions, with the same expectation of job duration and return to the U.S. home, the location of the tax home depends on all the facts and circumstances.

Period of Stay. Another qualification for the exclusion is the length of time the taxpayer stays overseas. This requirement can be satisfied in one of two ways. The taxpayer must be:

1. A U.S. citizen or resident alien from a tax treaty country who is a **bona fide resident** of a foreign country or countries for an uninterrupted period that includes an entire tax year, or
2. A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

Bona Fide Residence Test. In order to qualify for this test, the taxpayer must be a U.S. citizen, or a resident alien from a treaty country. A revenue ruling permits U.S. resident aliens who are residents of countries that have tax treaties with the U.S. to qualify for the bona fide residence test. This is because those treaties contain nondiscrimination clauses. Resident aliens from nontreaty countries cannot claim the bona fide residence test.

To meet the test, the taxpayer must show that he or she has set up permanent quarters in the foreign country. If the tax return is selected to be examined by the IRS, the taxpayer should be prepared to verify the facts that establish whether the bona fide residence test has been satisfied. If the taxpayer has made a statement to the authorities of the foreign country that he or she is not a resident of that country and the officials hold that the taxpayer is not subject to their tax as a resident the taxpayer does not qualify as a bona fide resident.

Bona fide residence must be for an uninterrupted period that includes an entire tax year. An entire tax year is from January 1 through December 31 for taxpayers who file their income tax returns on a calendar year basis.

Taking a brief trip to the U.S. will not prevent the taxpayer from being a bona fide resident, as long as the intention is clear to return to the foreign country of residence, without unreasonable delay.

Bona Fide Residence For Part of the Year. Once the taxpayer has established bona fide residence in a foreign country for an uninterrupted period that includes a complete tax year, the taxpayer will qualify as a bona fide resident for the period starting with the date the taxpayer actually began the residence and ending with the date the taxpayer abandoned the foreign residence. Therefore, he/she could qualify as a bona fide resident for part of a tax year.

Example 1
Sarah Burns moved to Thailand on March 1, 2000. She lived there until September 14, 2002. On September 15, 2002 she moved back to the United States. Since she was a bona fide resident of a foreign country for the entire year of 2001, she qualified as a bona fide resident from March 1, 2000 through September 14, 2002. She may claim the exclusion in 2000 and 2002 as well as 2001.

Physical Presence Test. The other test that may be met instead of the bona fide residence test is the physical presence test. In this test, intention of stay is not a factor. To qualify, the taxpayer must be physically present in a foreign country 330 full days during a period of 12 consecutive months. The 12-month period may begin with any day of the calendar month. It ends the day before the same calendar day 12 months later.

In order for a day to count for the test, it must be a full day in a foreign country. When arriving from the U.S., or returning to the U.S., any day in which part of the time is spent in the U.S. or over international waters does not count as a qualifying day in a foreign country.

The taxpayer may move about from one place to another in a foreign country, or to another foreign country without losing full days. But if any part of the taxpayer's travel is not within a foreign country or countries and takes 24 hours or more, the taxpayer will lose full days.

Example 2
The taxpayer leaves Southhampton, England, by ship at 10:00 p.m. on July 6 and arrives in Lisbon at 6:00 a.m. on July 8. Since the trip takes more than 24 hours, the taxpayer loses as full days, July 6, 7, and 8. If the taxpayer remains in Lisbon, the first full day is July 9.

If the taxpayer is in transit between two points outside the United States and is physically present in the United States for less than 24 hours, the taxpayer is not treated as present in the United States during the transit, but is treated as traveling over areas not within any foreign country.

Example 3
Mark Wright leaves Kingston, Jamaica at 1:00 p.m. on February 12. He arrives in Miami at 3:00 pm to change planes. He leaves for Toronto at 7:00 pm and arrives at 10:00 pm. He has not lost a day because he was in transit between two points outside the U.S., and was present in the U.S. only four hours.

Figuring the 12 Month Period. Any 12-month period may be used if the 330 days in a foreign country fall within that period. If necessary, more than one period may be used, including periods that overlap. By using more than one period, it may be possible to meet the physical presence test for an entire stay, even though there may have been intervening visits to the U.S.

WAIVER OF TIME REQUIREMENTS

Both the bona fide residence test and the physical presence test contain minimum time requirements that one must meet before one qualifies under that test. The bona fide residence test requires residence in a foreign country or countries for an uninterrupted period that includes an entire tax year (January 1–December 31 for calendar year taxpayers). The physical presence test requires presence in a foreign country or countries for 330 days during a period of 12 consecutive months.

The minimum time requirements may be waived, however, if forced to leave a foreign country because of war, civil unrest, or similar adverse conditions in that country. The taxpayer also must be able to show that he/she reasonably could have expected to meet the minimum time requirements if it had not been for the adverse conditions. Before one can qualify for the waiver, the person must actually have their tax home in the foreign country and be a bona fide resident of, or be physically present in, the foreign country.

U.S. TRAVEL RESTRICTIONS

There are U.S. federal travel restrictions that generally prohibit U.S. citizens and residents from traveling in certain countries. Time spent in these countries in violation of U.S. law will not qualify for either the bona fide residence test or the physical presence test. Income earned from these sources does not count as foreign earned income. Currently, the countries to which travel restrictions apply are Cuba, Libya, and Iraq.

DEFINITIONS

Foreign Country. In order to qualify for the bona fide residence or physical presence test, a taxpayer must be a resident of or present in a foreign country. “Foreign country” does not include Puerto Rico, Guam, the Northern Mariana Islands, the Virgin Islands, or U.S. possessions such as American Samoa, Wake Island, the Midway Islands and Johnston Island.

Earned Income. To qualify for the exclusion, income must be earned income. Examples of earned income are salaries, wages, commissions, and professional fees. Income from a sole proprietorship or partnership may or may not be earned income, depending on whether the income was produced by personal services or capital investment. In these situations, the taxpayer may need to refer to the IRS or professional assistance.

Earned income is not dividends, interest, capital gains, alimony, social security benefits, pensions, or annuities. Payments made by the U.S. government to its employees do not qualify for the exclusion. Included as part of the government are such activities as post exchanges, commissaries, and officers clubs. However, amounts paid by the United States or its agencies to persons who are not their employees may qualify as foreign earned income for purposes of the exclusion.

Earned income includes all compensation for services rendered. Allowances for housing, cost-of-living, education, home leave, moving and similar items are included in earned income.

Source of earned income. The source of earned income is the place where the services are performed. To qualify for the exclusion, services must be performed in a foreign country. Where the payments come from or where they are deposited is not a factor in the source of the income. If a taxpayer works predominantly in a foreign country, but does some work in the U.S., an adjustment must be made to the total of foreign earned income.

Example 4
Charles Thompson works and lives in the Bahamas. After vacation, he worked 50 weeks in 2002. For one week, he attended a business meeting in Florida. 1/50 or 2% of his wages are not foreign earned income, because that week was spent working in Florida.

FOREIGN HOUSING EXCLUSION – DEDUCTION

In addition to the foreign earned income exclusion, the taxpayer may also separately claim an exclusion for housing expenses if they exceed a specified amount. As with the foreign earned income exclusion, to qualify for these items, the taxpayer must have a tax home overseas and qualify under the bona fide residence or physical presence test. One important advantage of the housing exclusion is that it may be claimed in addition to the earned income exclusion. While the earned income exclusion is limited to $80,000, taxpayers whose earned income is above $80,000, by claiming the housing exclusion, may reduce their taxable income even further. Taxpayers with questions on the housing exclusion may refer to the IRS. The foreign housing deduction is claimed by self-employed individuals who do not have employer-provided housing amounts.

FORM 2555 OR 2555 EZ

If the taxpayer wishes to claim the foreign earned income exclusion, it is necessary to complete Form 2555 or 2555 EZ. Form 2555 or 2555 EZ is attached to Form 1040. Anyone who files Form 2555 or 2555 EZ must file their tax return with the Internal Revenue Service Center, Philadelphia, PA 19255. Generally, taxpayers living overseas are given an additional two months to file their return. To take advantage of this additional time, the taxpayer must attach a statement to the return explaining that he or she is living overseas.

To be able to use Form 2555 EZ the taxpayer must be a U.S. citizen or resident alien who has wages and salaries, but not self-employment income. The total foreign earned income must be $80,000 or less, and the person cannot be claiming any business or moving expenses. The person also may not be claiming the foreign housing exclusion or deduction. Anyone not meeting the above restrictions must file Form 2555. Those individuals meeting the above restrictions should complete all four sections of Form 2555 EZ.

For those who must file Form 2555, part of the form is for general information, and must be completed by all taxpayers who claim the exclusion.

Taxpayers who claim the bona fide residence test must complete Part II. Taxpayers who qualify under the physical presence test must complete Part III. The IRS determines whether or not the taxpayer qualifies for the exclusion by the answers to the questions in Part II or Part III. If the information is incomplete, the IRS may disallow the exclusion.

Part IV, completed by all taxpayers, is where foreign earned income is listed. It must be completed in U.S. dollars. If the taxpayer has difficulty in converting income, IRS can provide exchange rates to be used. However, the taxpayer is not required to use only rates provided by the IRS or the federal government. Note that earned income includes not only wages and salaries but also noncash income and allowances and reimbursements received by the taxpayer.

Page 3 of the form is where the exclusion is computed. Taxpayers claiming only the basic exclusion fill out Parts V and VII. Most of the lines are self-explanatory. The concept of qualifying period is essential. For those qualifying under the bona fide residence test, this qualifying period is the period of actual residence. For the physical presence test, the qualifying period or periods is chosen by the taxpayer. Any period may be chosen as long as 330 days are spent in a foreign country during the period.

Exhibit 1-1

Form **2555-EZ**

Department of the Treasury
Internal Revenue Service (99)

Foreign Earned Income Exclusion

▶ **See separate instructions.** ▶ **Attach to Form 1040.**

OMB No. 1545-1326

2002

Attachment Sequence No. **34A**

Name shown on Form 1040

Your social security number

You May Use This Form If You:

- Are a U.S. citizen or a resident alien.
- Earned wages/salaries in a foreign country.
- Had total foreign earned income of $80,000 or less.
- Are filing a calendar year return that covers a 12-month period.

And You:

- Do not have self-employment income.
- Do not have business/moving expenses.
- Do not claim the foreign housing exclusion or deduction.

Part I Tests To See If You Can Take the Foreign Earned Income Exclusion

1 Bonda Fide Residence Test

a Were you a bona fide resident of a foreign country or countries for a period that includes an entire tax year (see page 2 of the instructions)? . . . . ☐ **Yes** ☐ **No**

- If you answered "Yes," you meet this test. Fill in line 1b and then go to line 3.
- If you answered "No," you **do not** meet this test. Go to line 2 to see if you meet the Physical Presence Test.

b Enter the date your bona fide residence began ▶ ______________, and ended (see instructions) ▶ ______________.

2 Physical Presence Test

a Were you physically present in a foreign country or countries for at least 330 full days during—
{ 2002 **or**
any other period of 12 months in a row starting or ending in 2002? } . . . . ☐ **Yes** ☐ **No**

- If you answered "Yes," you meet this test. Fill in line 2b and then go to line 3.
- If you answered "No," you **do not** meet this test. You **cannot** take the exclusion unless you meet the Bona Fide Residence Test above.

b The physical presence test is based on the 12-month period from ▶ ______________ through ▶ ______________.

3 Tax Home Test. Was your tax home in a foreign country or countries throughout your period of bona fide residence or physical presence, whichever applies? . . . . ☐ **Yes** ☐ **No**

- If you answered "Yes," you can take the exclusion. Complete Part II below and then go to page 2.
- If you answered "No," you **cannot** take the exclusion. **Do not** file this form.

Part II General Information

4 Your foreign address (including country)

5 Your occupation

6 Employer's name

7 Employer's U.S. address (including ZIP code)

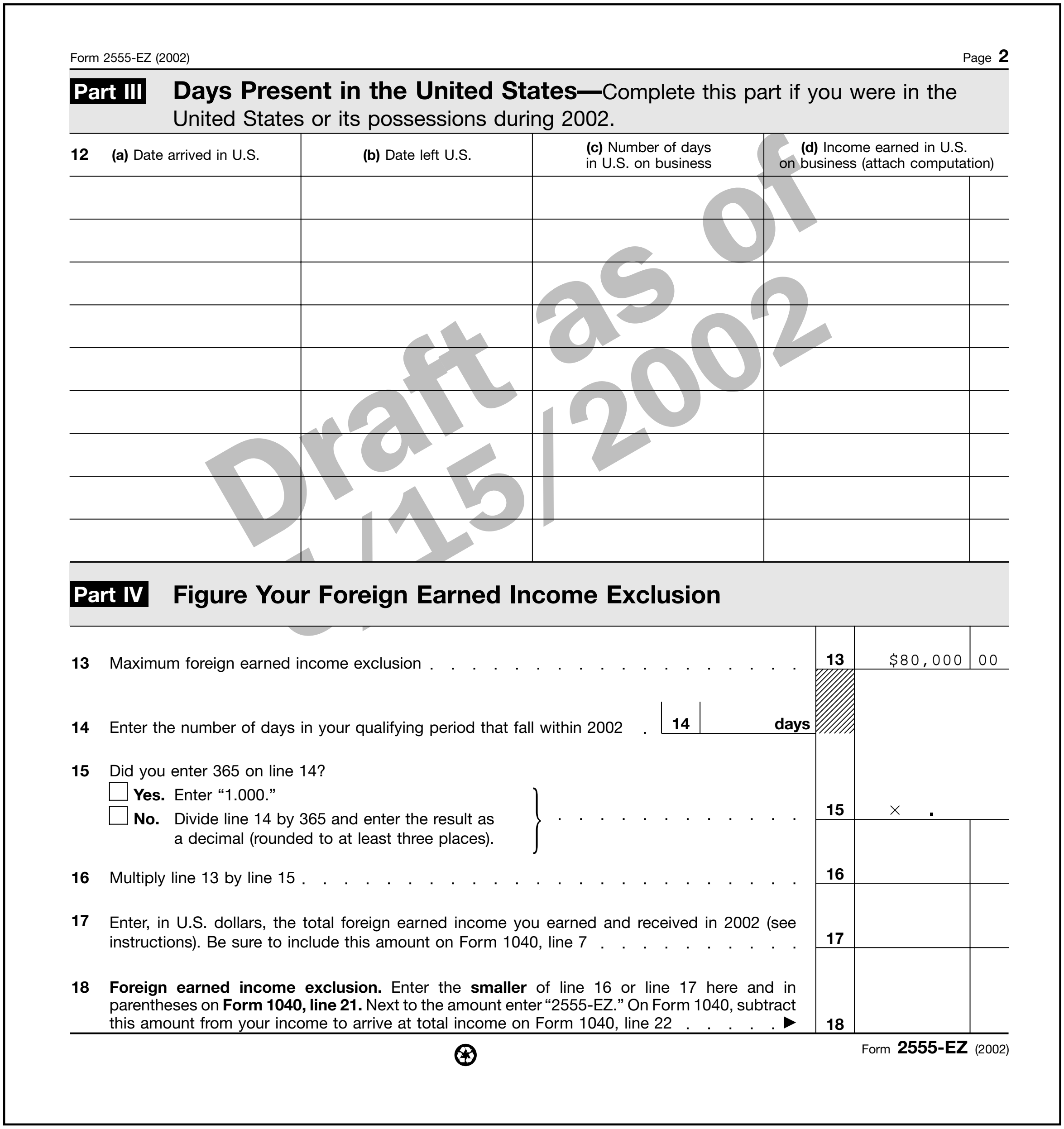
8 Employer's foreign address

9 Employer is (check any that apply):
a A U.S. business . . . . ☐
b A foreign business . . . . ☐
c Other (specify) ▶ ______________________________ ☐

10a If you filed Form 2555 or 2555-EZ after 1981, enter the last year you filed the form. ▶ ______________
b If you did not file Form 2555 or 2555-EZ after 1981, check here ▶ ☐ and go to line 11a now.
c Have you ever revoked the foreign earned income exclusion? . . . . ☐ **Yes** ☐ **No**
d If you answered "Yes," enter the tax year for which the revocation was effective. ▶ ______________
11a List your tax home(s) during 2002 and date(s) established. ▶ ______________
b Of what country are you a citizen/national? ▶

For Paperwork Reduction Act Notice, see page 3 of separate instructions. Cat. No. 13272W Form **2555-EZ** (2002)

Exhibit 1-2



Form 2555-EZ (2002) Page **2**

Part III Days Present in the United States—Complete this part if you were in the United States or its possessions during 2002.

12 **(a)** Date arrived in U.S.	**(b)** Date left U.S.	**(c)** Number of days in U.S. on business	**(d)** Income earned in U.S. on business (attach computation)	

Part IV Figure Your Foreign Earned Income Exclusion

13 Maximum foreign earned income exclusion **13** $80,000 00

14 Enter the number of days in your qualifying period that fall within 2002 . **14** **days**

15 Did you enter 365 on line 14?

☐ **Yes.** Enter “1.000.”

☐ **No.** Divide line 14 by 365 and enter the result as a decimal (rounded to at least three places). } . . . . **15** × .

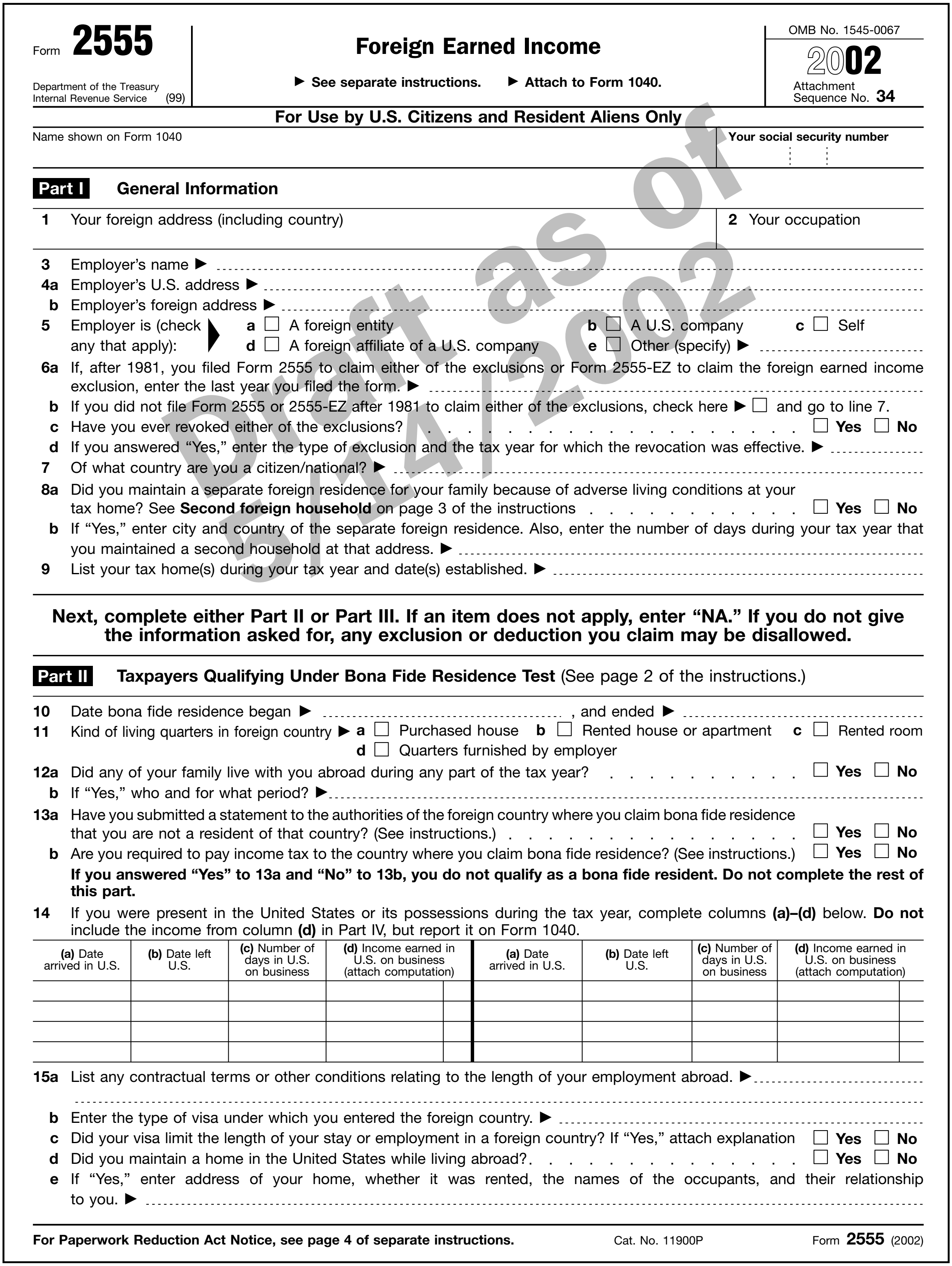
16 Multiply line 13 by line 15 . . . . **16**

17 Enter, in U.S. dollars, the total foreign earned income you earned and received in 2002 (see instructions). Be sure to include this amount on Form 1040, line 7 . . . . **17**

18 **Foreign earned income exclusion.** Enter the **smaller** of line 16 or line 17 here and in parentheses on **Form 1040, line 21.** Next to the amount enter “2555-EZ.” On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 . . . . . . ▶ **18**

Form **2555-EZ** (2002)

Exhibit 2-1



Form **2555**

Department of the Treasury
Internal Revenue Service (99)

Foreign Earned Income

▶ See separate instructions. ▶ Attach to Form 1040.

OMB No. 1545-0067

2002

Attachment Sequence No. **34**

For Use by U.S. Citizens and Resident Aliens Only

Name shown on Form 1040

Your social security number

Part I **General Information**

1 Your foreign address (including country)

2 Your occupation

3 Employer's name ▶

4a Employer's U.S. address ▶

b Employer's foreign address ▶

5 Employer is (check any that apply): ▶ **a** ☐ A foreign entity **b** ☐ A U.S. company **c** ☐ Self **d** ☐ A foreign affiliate of a U.S. company **e** ☐ Other (specify) ▶

6a If, after 1981, you filed Form 2555 to claim either of the exclusions or Form 2555-EZ to claim the foreign earned income exclusion, enter the last year you filed the form. ▶

b If you did not file Form 2555 or 2555-EZ after 1981 to claim either of the exclusions, check here ▶ ☐ and go to line 7.

c Have you ever revoked either of the exclusions? . . . . ☐ **Yes** ☐ **No**

d If you answered "Yes," enter the type of exclusion and the tax year for which the revocation was effective. ▶

7 Of what country are you a citizen/national? ▶

8a Did you maintain a separate foreign residence for your family because of adverse living conditions at your tax home? See **Second foreign household** on page 3 of the instructions . . . . ☐ **Yes** ☐ **No**

b If "Yes," enter city and country of the separate foreign residence. Also, enter the number of days during your tax year that you maintained a second household at that address. ▶

9 List your tax home(s) during your tax year and date(s) established. ▶

Next, complete either Part II or Part III. If an item does not apply, enter "NA." If you do not give the information asked for, any exclusion or deduction you claim may be disallowed.

Part II **Taxpayers Qualifying Under Bona Fide Residence Test** (See page 2 of the instructions.)

10 Date bona fide residence began ▶ , and ended ▶

11 Kind of living quarters in foreign country ▶ **a** ☐ Purchased house **b** ☐ Rented house or apartment **c** ☐ Rented room **d** ☐ Quarters furnished by employer

12a Did any of your family live with you abroad during any part of the tax year? . . . . ☐ **Yes** ☐ **No**

b If "Yes," who and for what period? ▶

13a Have you submitted a statement to the authorities of the foreign country where you claim bona fide residence that you are not a resident of that country? (See instructions.) . . . . ☐ **Yes** ☐ **No**

b Are you required to pay income tax to the country where you claim bona fide residence? (See instructions.) ☐ **Yes** ☐ **No**

If you answered "Yes" to 13a and "No" to 13b, you do not qualify as a bona fide resident. Do not complete the rest of this part.

14 If you were present in the United States or its possessions during the tax year, complete columns **(a)–(d)** below. **Do not** include the income from column **(d)** in Part IV, but report it on Form 1040.

(a) Date arrived in U.S.	**(b)** Date left U.S.	**(c)** Number of days in U.S. on business	**(d)** Income earned in U.S. on business (attach computation)	**(a)** Date arrived in U.S.	**(b)** Date left U.S.	**(c)** Number of days in U.S. on business	**(d)** Income earned in U.S. on business (attach computation)

15a List any contractual terms or other conditions relating to the length of your employment abroad. ▶

b Enter the type of visa under which you entered the foreign country. ▶

c Did your visa limit the length of your stay or employment in a foreign country? If "Yes," attach explanation ☐ **Yes** ☐ **No**

d Did you maintain a home in the United States while living abroad? . . . . ☐ **Yes** ☐ **No**

e If "Yes," enter address of your home, whether it was rented, the names of the occupants, and their relationship to you. ▶

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Cat. No. 11900P Form **2555** (2002)

Exhibit 2-2

Form 2555 (2002) Page **2**

Part III Taxpayers Qualifying Under Physical Presence Test (See page 2 of the instructions.)

16 The physical presence test is based on the 12-month period from ▶ .... through ▶ ....

17 Enter your principal country of employment during your tax year. ▶ ....

18 If you traveled abroad during the 12-month period entered on line 16, complete columns **(a)–(f)** below. Exclude travel between foreign countries that did not involve travel on or over international waters, or in or over the United States, for 24 hours or more. If you have no travel to report during the period, enter "Physically present in a foreign country or countries for the entire 12-month period." **Do not** include the income from column **(f)** below in Part IV, but report it on Form 1040.

(a) Name of country (including U.S.)	**(b)** Date arrived	**(c)** Date left	**(d)** Full days present in country	**(e)** Number of days in U.S. on business	**(f)** Income earned in U.S. on business (attach computation)

Part IV All Taxpayers

Note: *Enter on lines 19 through 23 all income, including noncash income, you earned and actually or constructively received during your 2002 tax year for services you performed in a foreign country. If any of the foreign earned income received this tax year was earned in a prior tax year, or will be earned in a later tax year (such as a bonus), see the instructions.* ***Do not*** *include income from line 14, column* ***(d),*** *or line 18, column* ***(f).*** *Report amounts in U.S. dollars, using the exchange rates in effect when you actually or constructively received the income.*

If you are a cash basis taxpayer, report on Form 1040 all income you received in 2002, no matter when you performed the service.

2002 Foreign Earned Income				**Amount (in U.S. dollars)**
19 Total wages, salaries, bonuses, commissions, etc.			**19**	
20 Allowable share of income for personal services performed (see instructions):				
a In a business (including farming) or profession			**20a**	
b In a partnership. List partnership's name and address and type of income. ▶			**20b**	
21 Noncash income (market value of property or facilities furnished by employer—attach statement showing how it was determined):			▨	
a Home (lodging)			**21a**	
b Meals			**21b**	
c Car			**21c**	
d Other property or facilities. List type and amount. ▶			**21d**	
22 Allowances, reimbursements, or expenses paid on your behalf for services you performed:			▨	
a Cost of living and overseas differential	**22a**		▨	
b Family	**22b**		▨	
c Education	**22c**		▨	
d Home leave	**22d**		▨	
e Quarters	**22e**		▨	
f For any other purpose. List type and amount. ▶	**22f**		▨	
g Add lines 22a through 22f			**22g**	
23 Other foreign earned income. List type and amount. ▶			**23**	
24 Add lines 19 through 21d, line 22g, and line 23			**24**	
25 Total amount of meals and lodging included on line 24 that is excludable (see instructions)			**25**	
26 Subtract line 25 from line 24. Enter the result here and on line 27 on page 3. This is your **2002 foreign earned income** ▶			**26**	

Form **2555** (2002)

Exhibit 2-3

Form 2555 (2002) Page **3**

Part V All Taxpayers

27	Enter the amount from line 26	27		

Are you claiming the housing exclusion or housing deduction?
☐ **Yes.** Complete Part VI.
☐ **No.** Go to Part VII.

Part VI Taxpayers Claiming the Housing Exclusion and/or Deduction

28	Qualified housing expenses for the tax year (see instructions)	28		
29	Number of days in your qualifying period that fall within your 2002 tax year (see instructions) — 29 days			
30	Multiply $29.70 by the number of days on line 29. If 365 is entered on line 29, enter $10,842.00 here	30		
31	Subtract line 30 from line 28. If the result is zero or less, do not complete the rest of this part or any of Part IX	31		
32	Enter employer-provided amounts (see instructions) — 32			
33	Divide line 32 by line 27. Enter the result as a decimal (rounded to at least three places), but do not enter more than "1.000"	33	× .	
34	**Housing exclusion.** Multiply line 31 by line 33. Enter the result but do not enter more than the amount on line 32. Also, complete Part VIII ▶	34		

Note: *The housing deduction is figured in Part IX. If you choose to claim the foreign earned income exclusion, complete Parts VII and VIII before Part IX.*

Part VII Taxpayers Claiming the Foreign Earned Income Exclusion

35	Maximum foreign earned income exclusion	35	$80,000	00
36	• If you completed Part VI, enter the number from line 29. • All others, enter the number of days in your qualifying period that fall within your 2002 tax year (see the instructions for line 29). — 36 days			
37	• If line 36 and the number of days in your 2002 tax year (usually 365) are the same, enter "1.000." • Otherwise, divide line 36 by the number of days in your 2002 tax year and enter the result as a decimal (rounded to at least three places).	37	× .	
38	Multiply line 35 by line 37	38		
39	Subtract line 34 from line 27	39		
40	**Foreign earned income exclusion.** Enter the **smaller** of line 38 or line 39. Also, complete Part VIII ▶	40		

Part VIII Taxpayers Claiming the Housing Exclusion, Foreign Earned Income Exclusion, or Both

41	Add lines 34 and 40	41		
42	Deductions allowed in figuring your adjusted gross income (Form 1040, line 35) that are allocable to the excluded income. See instructions and attach computation	42		
43	Subtract line 42 from line 41. Enter the result here and in parentheses on **Form 1040, line 21.** Next to the amount enter "Form 2555." On Form 1040, subtract this amount from your income to arrive at total income on Form 1040, line 22 ▶	43		

Part IX Taxpayers Claiming the Housing Deduction—Complete this part only if (a) line 31 is more than line 34 and (b) line 27 is more than line 41.

44	Subtract line 34 from line 31	44		
45	Subtract line 41 from line 27	45		
46	Enter the **smaller** of line 44 or line 45	46		

Note: *If line 45 is **more than** line 46 and you could not deduct all of your 2001 housing deduction because of the 2001 limit, use the worksheet on page 4 of the instructions to figure the amount to enter on line 47. Otherwise, go to line 48.*

47	Housing deduction carryover from 2001 (from worksheet on page 4 of the instructions)	47		
48	**Housing deduction.** Add lines 46 and 47. Enter the total here and on Form 1040 to the left of line 34. Next to the amount on Form 1040, enter "Form 2555." Add it to the total adjustments reported on that line ▶	48		

Form **2555** (2002)

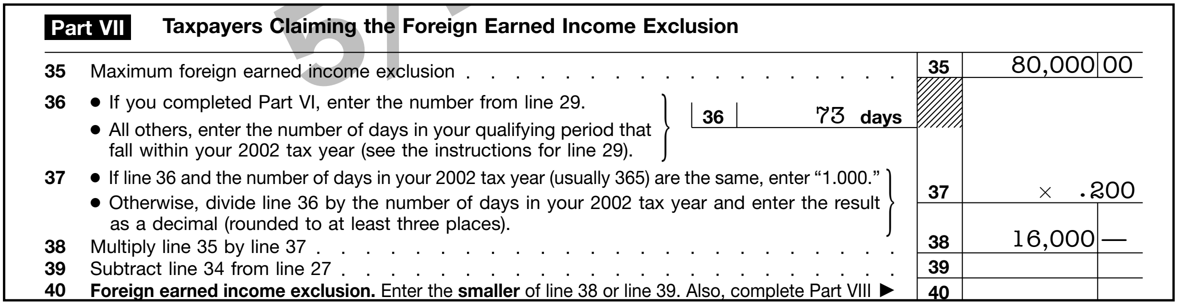
Although the exclusion may never be more than the foreign earned income, it may be less. The exclusion can be no more than $80,000. If the number of qualifying days in the tax year is less than 365, the $80,000 limit is lowered proportionally.

Example 5

Tina York is claiming the exclusion. Her qualifying period is March 15, 2001 to March 14, 2002. On line 36 of Form 2555, Tina enters 73 days because 73 days of her qualifying period fall in the 2002 tax year.

On line 37, she divides 73 by 365, and enters the result, ".200." On line 38, $80,000 is multiplied by .200, which results in "$16,000."

Exhibit 3 Form 2555



Part VII **Taxpayers Claiming the Foreign Earned Income Exclusion**

35	Maximum foreign earned income exclusion	35	80,000	00
36	● If you completed Part VI, enter the number from line 29. ● All others, enter the number of days in your qualifying period that fall within your 2002 tax year (see the instructions for line 29). 36 73 **days**			
37	● If line 36 and the number of days in your 2002 tax year (usually 365) are the same, enter "1.000." ● Otherwise, divide line 36 by the number of days in your 2002 tax year and enter the result as a decimal (rounded to at least three places).	37	× .200	
38	Multiply line 35 by line 37	38	16,000	—
39	Subtract line 34 from line 27	39		
40	**Foreign earned income exclusion.** Enter the **smaller** of line 38 or line 39. Also, complete Part VIII ▶	40		

Regardless of how much foreign earned income Tina had, her exclusion can be no more than $16,000.

DEDUCTIONS ALLOCABLE TO EXCLUDED INCOME

The only other item that presents some problems is line 42. “Deductions Allowed in Figuring Your Adjusted Gross Income.” The reasoning behind this line is that it is not consistent to claim a credit or deduction related to excluded income. To the extent a deduction is claimed that is allocable to the exclusion, the exclusion must be reduced by that deduction.

Self-Employment Tax. The taxpayer must take all earned income into account in figuring self-employment tax, even though the income is exempt from income tax because of the foreign earned income exclusion.

An individual is allowed a deduction for one-half of self-employment tax on the Form 1040. In essence this deduction is related to the operation of the business. Therefore, if foreign earned income is excluded, the deduction for S.E. tax must be allocated to the excluded income. The amount allocated to excluded income reduces the Foreign Earned Income exclusion allowed.

The following formula is used to determine the amount of the deduction allocable to excluded income:

$$\frac{\text{Excluded Earned Income}}{\text{Qualifying Earned Income}} \times \begin{array}{l}\text{Self-Employment Tax Deduction} \\ \text{(From Form 1040, Line 29)}\end{array}$$

When the qualifying earned income is fully excluded, none of the self-employment tax deduction is allowed; therefore the full amount of this deduction is put on line 42 of Form 2555. This will reduce your Foreign Earned Income exclusion by the amount of the deduction. However, the self-employment tax deduction is still entered on line 29 of Form 1040.

Itemized Deductions. The treatment for itemized deductions is somewhat different. In reporting itemized deductions on Schedule A (Form 1040) that are wholly or partly allocable to excluded income, the taxpayer must reduce the gross deduction by the disallowed amount in arriving at the net deduction shown on Schedule A. Then the taxpayer attaches a statement showing how the deductible amount was figured and writes “Form 2555” in the upper right corner of Schedule A. The most common itemized deductions that are allocable to excluded foreign earned income are unreimbursed employee business expenses. The same formula, as presented above, is used to determine the amounts allocable to the excluded foreign income.

Moving Expenses. The rules for deducting moving expenses allocable to excluded income are still more complex. ln the year of the move, if the taxpayer has at least 120 days of his qualifying period during the tax year, the moving expense is allocated solely to the year of the move. If the taxpayer has less than 120 full days in the tax year, the moving expense is allocated to income in the year of the move, and the year after. Taxpayers affected by this provision may want to seek assistance from the IRS or a tax preparer.

After adjusting the exclusion for any deductions allocable to excluded income the net exclusion needs to be carried to Form 1040. The amount from Form 2555 EZ line 18 or Form 2555 line 43 is entered in parenthesis on Form 1040 line 22. It is subtracted from other sources of income.

EXTENSIONS

For some taxpayers, the regular filing deadline may come before they have met either the bona fide residence test or the physical presence test. If they expect to meet one of these tests and qualify for the exclusion, they may wish to file Form 2350, “Application for Extension of Time to File U.S. Income Tax Return.” This form should be filed with the Internal Revenue Service Center, Philadelphia, PA 19255. The form may also be approved by IRS representatives at overseas offices. By filing the form, the taxpayer may be granted an extension to file 30 days after they qualify for one of these tests.

Example 6
Margaret took a job in Thailand. She left the U.S. in July of 2002: She expects to qualify as a bona fide resident. Since she will not qualify until the end of the year 2003, Margaret may file Form 2350 to request an extension to January 30, 2004 to file her 2002 return.

►► SUMMING UP THIS LESSON ◄◄

The foreign earned income exclusion is very important to taxpayers who work overseas. When you help taxpayers, you will need to ask them questions, so you can determine whether or not they qualify. If they qualify, it is necessary to complete Form 2555 or Form 2555 EZ.

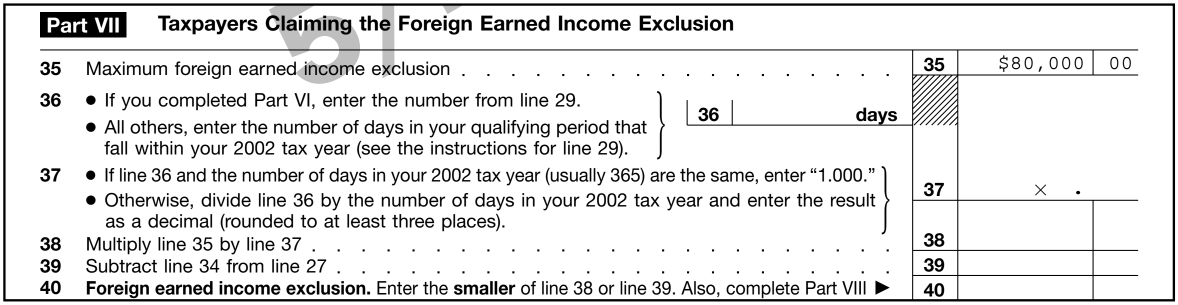
In this lesson, we have discussed the basic examples of the exclusion. When a taxpayer has a more complex situation, refer him or her to additional sources of help, such as the IRS or a private tax preparer.

LESSON 5

SUMMARY EXERCISES

1. What form is used to claim the foreign earned income exclusion?
2. When can the exclusion be elected?
3. How can the exclusion be revoked?
4. May the taxpayer claim the exclusion if gone from the U.S. temporarily on business?
5. How long a period is needed to qualify for the bona fide residence test?
6. Elizabeth Roberts moved to Taiwan on January 24, 2002. During 2002, she earned $43,000 working for an import-export business. She qualifies under the physical presence test. Complete Part VII of Form 2555.

Exhibit 4 Form 2555



Part VII **Taxpayers Claiming the Foreign Earned Income Exclusion**

35	Maximum foreign earned income exclusion	**35**	$80,000	00
36	● If you completed Part VI, enter the number from line 29. ● All others, enter the number of days in your qualifying period that fall within your 2002 tax year (see the instructions for line 29). **36** ______ **days**			
37	● If line 36 and the number of days in your 2002 tax year (usually 365) are the same, enter "1.000." ● Otherwise, divide line 36 by the number of days in your 2002 tax year and enter the result as a decimal (rounded to at least three places).	**37**	× .	
38	Multiply line 35 by line 37	**38**		
39	Subtract line 34 from line 27	**39**		
40	**Foreign earned income exclusion.** Enter the **smaller** of line 38 or line 39. Also, complete Part VIII ▶	**40**		

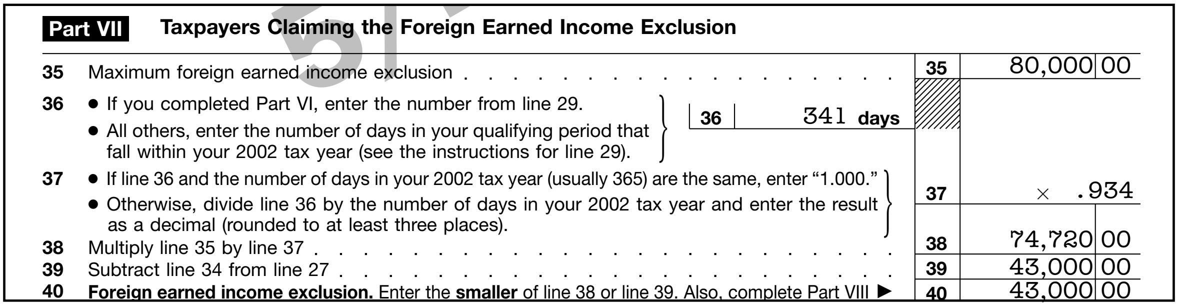
FOREIGN EARNED INCOME EXCLUSION

ANSWERS TO EXERCISES

1. Form 2555 or Form 2555 EZ
2. The exclusion must be filed with a timely filed return (including any extensions), a return amending a timely filed return, or a late filed return (determined without regard to any extensions) filed within one year from the original due date of the return. Taxpayers who would not have a tax after claiming the exclusion may elect the exclusion even after the above dates.
3. The exclusion is revoked by attaching a statement to the return or amended return for the first year the taxpayer no longer wishes to claim the exclusion. It also may be revoked when the taxpayer chooses to claim the foreign tax credit on otherwise excludible income.
4. No, the taxpayer may not claim the exclusion. If temporarily away on business, the tax home has not changed.
5. The period must include an entire tax year.
6. See filled in Exhibit.

Exhibit

Exhibit 5 Form 2555



Part VII **Taxpayers Claiming the Foreign Earned Income Exclusion**

35	Maximum foreign earned income exclusion	35	80,000	00
36	• If you completed Part VI, enter the number from line 29. • All others, enter the number of days in your qualifying period that fall within your 2002 tax year (see the instructions for line 29). 36 341 days			
37	• If line 36 and the number of days in your 2002 tax year (usually 365) are the same, enter "1.000." • Otherwise, divide line 36 by the number of days in your 2002 tax year and enter the result as a decimal (rounded to at least three places).	37	× .934	
38	Multiply line 35 by line 37	38	74,720	00
39	Subtract line 34 from line 27	39	43,000	00
40	**Foreign earned income exclusion.** Enter the **smaller** of line 38 or line 39. Also, complete Part VIII ►	40	43,000	00

STUDENT NOTES

FOREIGN TAX CREDIT

INTRODUCTION

In the introductory lesson, the topic of worldwide income was discussed. U.S. citizens and residents compute their U.S. taxes based on their worldwide income. This sometimes leads to a situation where a U.S. citizen may be paying twice on the same income—once to the government of the foreign country where the income was sourced and once to the U.S. Government. In order to avoid this double taxation, a foreign tax credit was created. This allows an individual to take a tax credit for taxes paid to a foreign government on income from sources in a foreign country. This lesson will address the foreign tax credit only as it applies to U.S. citizens, and residents.

Just like other tax credits, the foreign tax credit is a dollar-for-dollar reduction in the amount of taxes. However, in some cases, not all taxes paid to a foreign government can be used in the computation of the foreign tax credit. In this chapter, we will discuss what taxes are eligible for the foreign tax credit and how to claim the foreign tax credit.

OBJECTIVES

At the end of this lesson, you will be able to:

1. Determine which types of taxes qualify for the foreign tax credit.
2. Correctly complete a Form 1116.

WHAT TAXES QUALIFY FOR THE CREDIT

There are several factors to consider when determining if a tax paid to a foreign government is eligible for the foreign tax credit. They include:

1. Was the income foreign source?
2. What type of tax was paid to the foreign government?
3. Will the taxpayer receive some kind of specific economic benefit from the payment of this tax?

In this part of the lesson, we'll study the criteria for claiming the foreign tax credit.

The taxpayer must have income from a foreign country on which he/she is taxed by a foreign country. The tax imposed on the income must be similar to the income tax imposed in the U.S. This simply means that the income must be from a country other than the U.S. and that the tax paid must be similar to U.S. income tax. Let's look at some examples.

Example 1
Robb and Betty Grant are U.S. citizens who reside in France. The schedule B on their U.S. tax return contains the following:

$500, Lee County National Bank (U.S.)

$600, Banque National de Paris (French)

They paid income taxes on both types of interest to both countries. On their U.S. tax return, they can compute a foreign tax credit against the taxes that they pay 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 for the interest income from the U.S. bank.

Example 2
Marie Elliott is a U.S. citizen who lives in Hong Kong. She owns a house in Hong Kong and paid $2,000 in real estate taxes for her home and $1,000 in personal property taxes. She also paid $300 in income taxes to the government of Hong Kong. She is not able to claim a foreign tax credit for either the real estate taxes paid or the personal property taxes paid since these two taxes are not income taxes. She can, however, use the $300 in income taxes paid to Hong Kong to compute a foreign tax credit. (Note—she can take the real estate taxes that she paid and deduct them as itemized deductions if she itemizes on her U.S. tax return. Foreign personal property taxes are only deductible if they relate to the production of income or a trade/business.)

Exercise 1

The following is a list of the income on Anne's U.S. income tax return. She is a U.S. citizen living in Canada. She also had to pay taxes on each of these types of income to Canada. Indicate on which of the following a foreign tax credit may be computed.

_______ **a.** Wages from her job in the U.S.

_______ **b.** Interest income from a U.S. bank.

_______ **c.** Interest income from a Canadian bank.

_______ **d.** Dividend income from a U.S. corporation.

_______ **e.** Dividend income from a Canadian corporation.

Exercise 2

Determine if the following taxes paid to a foreign government can be used to compute the foreign tax credit. All taxpayers are U.S. citizens.

_______ **a.** Martha pays $1,200 a year in taxes. This tax is based on the number and types of appliances which she owns and uses in her home.

_______ **b.** Jean pays an inheritance tax to the Spanish government. It is based on an inheritance she received upon the death of an uncle.

_______ **c.** Dorothy lives in Jamaica. She paid $1,500 to the Jamaican government for her salaried income which she earned in Jamaica.

_______ **d.** Henry lives in Haiti. He paid $100 in taxes to the Haitian government. This tax was based on his type of living accommodations, the location of his residence and the size of this family.

In addition to the requirements that the tax be paid to the foreign country on income derived from a foreign country and the tax be an income tax similar to the income tax as defined under U.S. law, the tax must also not be payment for a specific economic benefit. Simply put, the "tax" cannot actually be a "payment" that results in an individual receiving goods, services or the right to use certain properties which are not available to others who are subject to the income tax that is generally imposed by the foreign country. A taxpayer cannot receive any specific benefit, directly or indirectly from paying a tax.

Example 3
Bob lives in Country X. He owns and operates his own business in this country. This country has a two tier income tax system. Everyone pays income tax at graduated rates depending upon their income. Bob also pays income tax based upon the profits of his business. This second level of income tax gives Bob the right to reduced fees for telephones, utilities and rents for his business. The government of Country X calls it an income tax because it is based upon the profits of the business. If Bob did not pay this tax, he could not rent a government-owned building and he would pay significantly more for the utilities and his business telephone usage. Since Bob receives a specific economic benefit for the second tier of income tax that he pays, he cannot use those tax payments to compute a foreign tax credit on his U.S. tax return. However, the first tier of income taxes are similar to U.S. income taxes and can be used to figure his foreign tax credit.

Country Restrictions. Aside from the restrictions that we have already discussed, there are also certain countries to which a taxpayer may pay foreign income taxes but cannot claim a foreign tax credit. Generally the reason a credit may not be claimed for tax paid to one of these countries is because the Secretary of State has designated the country as one that repeatedly provides support for acts of international terrorism. The credit can also be denied to countries with which the United States has no diplomatic relations, or countries whose government the United States does not recognize. At the time of this writing, income taxes paid to the following countries are not eligible for the foreign tax credit.

CUBA

IRAN

IRAQ

LIBYA

NORTH KOREA

SYRIA

SUDAN

Example 4
Ralph is a U.S. citizen who has investments in both Belgium and Iran. On these investments Ralph pays income tax to these two countries by withholding tax from his dividend checks. Ralph can claim the taxes paid to Belgium when computing the foreign tax credit. The income taxes paid to Iran do not qualify for a foreign tax credit.

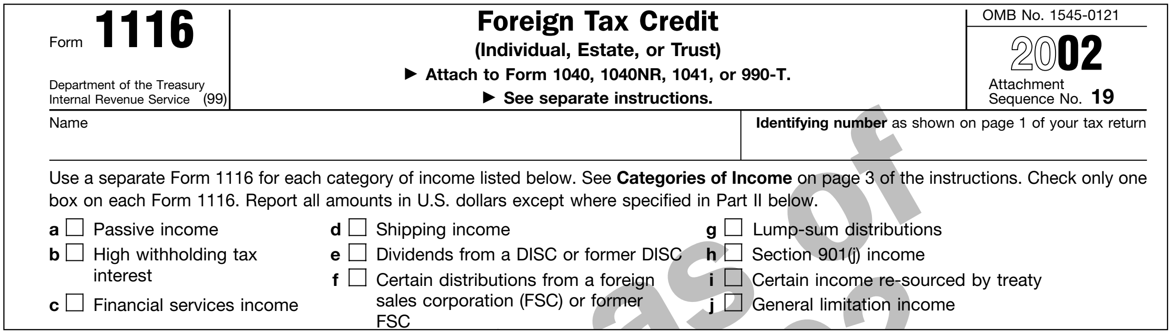
FORM 1116

The foreign tax credit is computed on Form 1116 which is then attached to the Form 1040. We will study the Form 1116 section by section.

TYPES OF INCOME

Let's take a look at the first part of the Form 1116. (See Exhibit 1.) It has no separate number or title. Here the type of income is identified. A separate Form 1116 must be completed for each different type of income category. We will only be studying three income categories: passive income, high withholding tax interest and general limitation income. Remember that you can only check one income category per form and you must fill out separate Forms 1116 if you have more than one income category.

Exhibit 1 Form 1116



Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit
(Individual, Estate, or Trust)
► Attach to Form 1040, 1040NR, 1041, or 990-T.
► See separate instructions.

OMB No. 1545-0121
2002
Attachment Sequence No. **19**

Name

Identifying number as shown on page 1 of your tax return

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of 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 income
b ☐ High withholding tax interest
c ☐ Financial services income
d ☐ Shipping income
e ☐ Dividends from a DISC or former DISC
f ☐ Certain distributions from a foreign sales corporation (FSC) or former FSC
g ☐ Lump-sum distributions
h ☐ Section 901(j) income
i ☐ Certain income re-sourced by treaty
j ☐ General limitation income

Passive Income. Passive income generally includes the following types of income: dividends, interest, royalties, rents and annuities. If you are assisting a person who has one of these types of passive income from a foreign country, and he or she paid income taxes to a foreign country, you would compute a foreign tax credit.

Example 5

Darlene is a U.S. citizen living in Venezuela. She keeps a bank account in the Banco Nacional de Venezuela. In 2002, she received $380 in interest income from the Venezuelan bank. She also paid Venezuelan income taxes on this interest income. On her U.S. return, she would claim a foreign tax credit for the taxes paid to Venezuela on her interest income. She would check the box for the "Passive income" category on Form 1116.

High Withholding Tax Interest. Certain interest income is not included in the passive income category. If the taxpayer you are helping had interest income on which at least 5% foreign gross income tax was withheld, then this income is classified as high withholding tax interest and not passive income.

Example 6

Michael is a U.S. citizen who lives in the United Kingdom. He maintains a bank account in a London bank. According to local law, the bank withholds a mandatory 27.5% of interest income as income tax. Since the withholding rate is at least 5%, the high withholding tax interest category would be checked on his Form 1116.

Example 7

Regina lives in Singapore and is a U.S. citizen. She has both dividend income and interest income from countries outside the United States. Her foreign bank withholds 15% of her interest income for income taxes. She also pays foreign income taxes on her dividend income. Regina must complete two Forms 1116. Her foreign dividend income is "passive income" and indicated as such on one Form 1116. Her foreign interest income is in the "high withholding tax interest" category and is on another Form 1116. The credits on these separate Forms 1116 will eventually be combined. This will be studied later in this lesson.

General Limitation Income. The final income category on Form 1116 is the "general limitation income" category. If the person you are helping has foreign income that does not come under any of the other categories on Form 1116, then that foreign income comes under the general limitation income category. Most often, this would be wages earned in a foreign country that an individual does not exclude, or excludes only part of, under the foreign earned income exclusion.

Example 8

Siegfried lives in Switzerland and is a U.S. citizen. He works in Switzerland and pays income taxes to Switzerland on his earnings. He does not elect to claim a foreign earned income exclusion. He can claim a foreign tax credit for the taxes paid on his earnings to the Swiss government. He checks the box for the general limitation income category on his Form 1116.

High Taxed Income. If the individual you are assisting has passive income which is taxed by a foreign government at a rate that is higher than the highest U.S. income tax rate, then the foreign tax credit for that income would be computed under the general limitation category. (Passive income was discussed earlier in this lesson.) In 2002, the highest U.S. income tax rate is 38.6%. Therefore, if the person pays more than 38.6% on the foreign source passive income for which he or she claimed the credit, then the credit is computed under the "general limitation" category.

Example 9
Maria lives in Brazil and is a U.S. citizen. She has a bank account in Brazil and pays 45% income tax on her interest income. Even though interest income is normally passive income for purposes of the foreign tax credit, this income would be listed under the “general limitation” category on Form 1116 since the rate of income tax she pays on this passive income is higher than the highest U.S. income tax rate.

Example 10
Bernard is a resident of Barbados and a U.S. citizen. He keeps a bank account in Barbados. In 2002 he paid 17% income tax on his interest income from his bank account in Barbados. Since 17% (the tax rate he paid) is not more than 38.6% (the highest U.S. income tax rate) and since the 17% that Bernard paid was not paid by withholding, this income fails into the “passive income” category of Form 1116.

COMPLETING FORM 1116

We have already discussed how to complete the income category section of the Form 1116. A separate Form 1116 must be completed for each income category. In addition, the top of Form 1116 has a line to indicate the name of the country of residence of the taxpayer.

Part I is used to figure the taxable income from foreign sources in each income category. If the person you are helping has one type of foreign income that comes from several foreign countries, you use one Form 1116. You will note that there is room on Form 1116 for up to 3 countries.

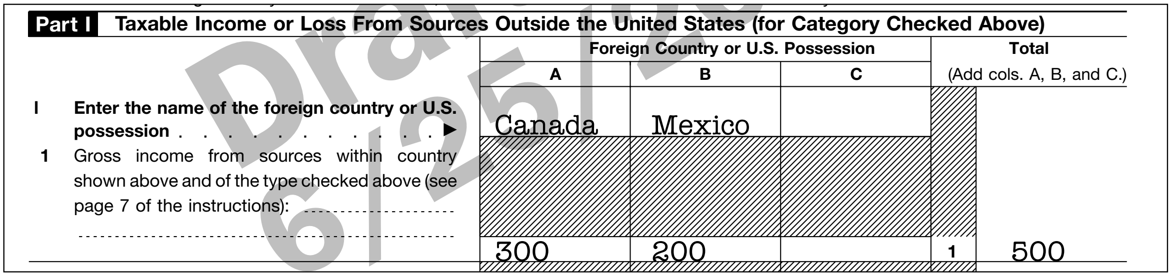
Example 11
George is both a U.S. citizen and resident. He has interest income from both Canada and Mexico, as well as the U.S. He need only complete one Form 1116 since all the interest income is in the passive income category.

On Line 1, list all foreign income that fits under the category checked at the top of Form 1116. You will list that income separately for each foreign country.

Example 12

George had $300 in interest income from his Canadian bank and $200 in interest income from his Mexican bank. See the completed Form 1116, line 1 for his income in Exhibit 2 which follows.

Exhibit 2 Form 1116



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

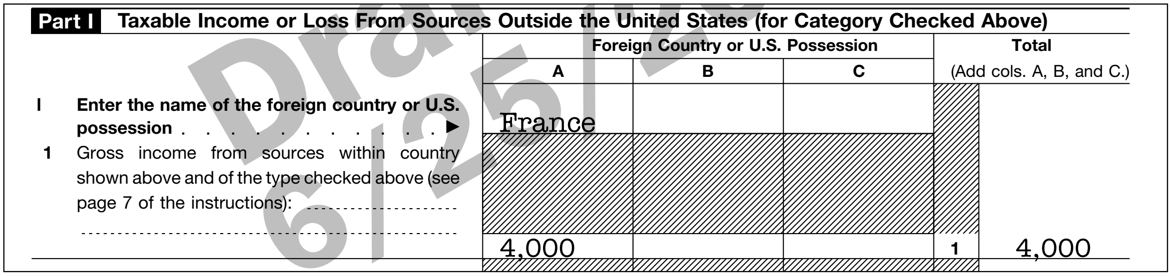
	Foreign Country or U.S. Possession				Total
	A	B	C		(Add cols. A, B, and C.)
I Enter the name of the foreign country or U.S. possession . . . . ▶	Canada	Mexico			
1 Gross income from sources within country shown above and of the type checked above (see page 7 of the instructions):	300	200		1	500

Note: If the taxpayer you are assisting has claimed the foreign earned income exclusion, enter on line 1 of Form 1116 for general limitation income only the amount of earned income not excluded.

Example 13

Monique lives in France and is a U.S. citizen. She earned $84,000 in 2002 in France. Monique claimed the foreign earned income exclusion of $80,000 (discussed in an earlier lesson). As illustrated in Exhibit 3 below, she would only enter $4,000 on line 1 of her Form 1116 ($84,000 earned Income – $80,000 exclusion).

Exhibit 3 Form 1116



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

	Foreign Country or U.S. Possession				Total
	A	B	C		(Add cols. A, B, and C.)
I Enter the name of the foreign country or U.S. possession . . . . ▶	France				
1 Gross income from sources within country shown above and of the type checked above (see page 7 of the instructions):	4,000			1	4,000

Lines 2–5 are probably the hardest and most confusing lines to complete on the Form 1116. Let's review the situations that we will **not** be studying.

1. **Expenses directly allocable to the income.** If the person you are assisting has expenses that are related directly to the income claimed on line 1 such as employee business expenses, and the income claimed on line 1 was earned income, then you may recommend that this person seek professional assistance or contact the IRS.
2. **Investment Interest Expense.** If a person borrowed money in order to purchase investment property such as stock, then some special allocations may need to be done. They may wish to contact the IRS or seek a professional preparer.
3. **Foreign Losses.** If the person you are helping had any type of foreign losses such as net losses from selling capital assets or a net loss from being a limited partner, they may wish to hire a professional preparer or contact the IRS if they wish to prepare their own return.

Now that we have discussed what areas are beyond the scope of VITA, let's continue with the completion of Part I.

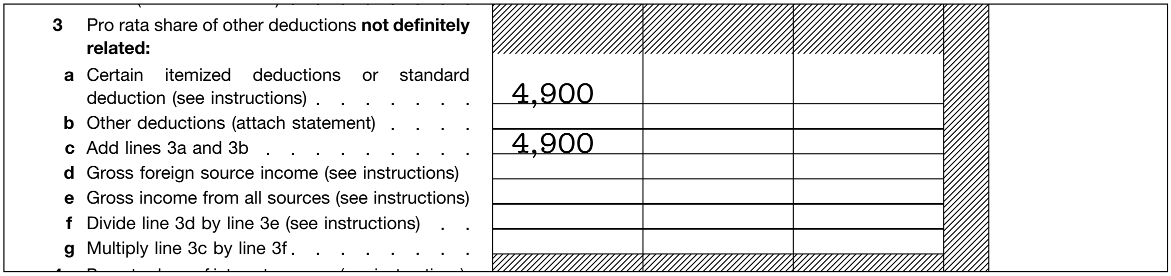
Line 3. You will complete line 3a if you completed a Schedule A for the person you are assisting to itemize his or her deductions. The total of the itemized deductions not directly related to foreign or U.S. income are medical expenses, real estate taxes and gifts to charity.

If the person you are assisting does not itemize deductions, then the standard deduction claimed on line 38 of the Form 1040 would be entered on line 3a. The next two examples and exhibits should help to clarify the entries on this line.

Example 14

Betty is claiming a foreign tax credit. She is single and had itemized deductions of $4,900 for 2002. Her Schedule A includes $4,200 of real estate taxes and $700 of charitable contributions. (See Exhibit 4.)

Exhibit 4 Form 1116



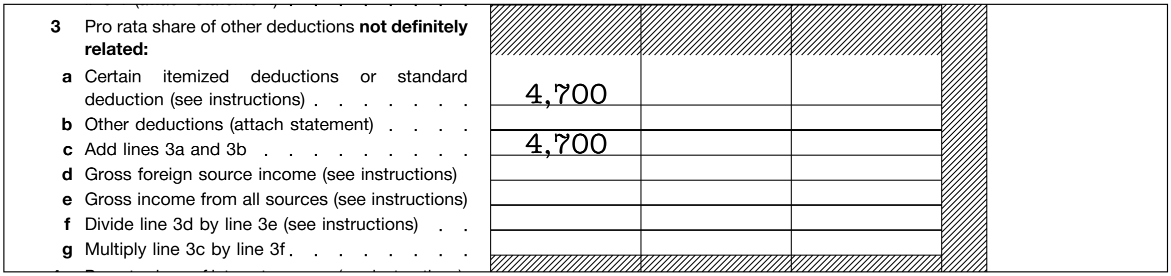
3	Pro rata share of other deductions **not definitely related:**	▨	▨	▨	▨	
a	Certain itemized deductions or standard deduction (see instructions)	4,900			▨	
b	Other deductions (attach statement)				▨	
c	Add lines 3a and 3b	4,900			▨	
d	Gross foreign source income (see instructions)				▨	
e	Gross income from all sources (see instructions)				▨	
f	Divide line 3d by line 3e (see instructions) . .				▨	
g	Multiply line 3c by line 3f				▨	

Example 15

Rebecca wishes to claim a foreign tax credit. She is single and had itemized deductions of $2,500. Since the standard deduction for a single person for 2002, is $4,700, it is more advantageous to take the standard deduction. Rebecca's Form 1116 would therefore have a $4,700 entry on line 3a. (See Exhibit 5.)

Exhibit 5

Form 1116



3	Pro rata share of other deductions **not definitely related:**	▨	▨	▨	▨	
a	Certain itemized deductions or standard deduction (see instructions)	4,700			▨	
b	Other deductions (attach statement)				▨	
c	Add lines 3a and 3b	4,700			▨	
d	Gross foreign source income (see instructions)				▨	
e	Gross income from all sources (see instructions)				▨	
f	Divide line 3d by line 3e (see instructions)				▨	
g	Multiply line 3c by line 3f				▨	

Since we will not be doing tax returns having directly allocable expenses, or expenses other than itemized deductions or the standard deduction, line 3c will be the same as line 3a.

All income from foreign sources in the category checked at the top of Form 1116 is listed on line 3d. If the foreign earned income exclusion was claimed on Form 2555 and if the Form 1116 is for the general limitation category, then the amount of the claimed exclusion is included here as well. For example, on line 3d for Monique from one of our prior examples the entry would be $84,000. That's the sum of $4,000 from line 1 plus the $80,000 exclusion she claimed. Under most circumstances, line 3d and line 1 will be the same.

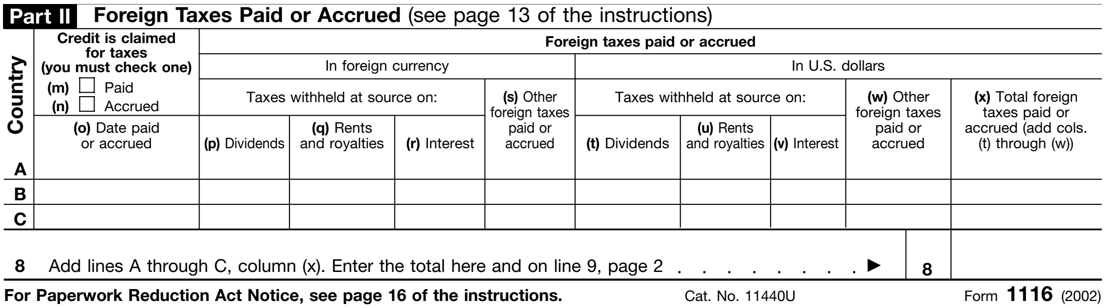
Line 3e is gross income from all sources. Usually, this line will be the same as line 22 of the Form 1040. If a Form 2555 was completed and the Foreign Earned Income Exclusion was claimed, then the amount of the exclusion must be added back to the gross income amount on line 22.

The next step is to determine the percentage of foreign source income to total income. This is done by dividing line 3d by line 3e and entering the answer on line 3f.

Now take line 3c and multiply it by the percentage you determined on line 3f and enter this answer on line 3g. Carry the answer on line 3f to 4 decimal places. For our purposes line 6 will then be the same as line 3g. This number represents the amount of your deductions allocated to foreign income in the given category.

On line 7, you would subtract line 6 from line 1. You would then carry the answer from line 7 to Part III, line 14 of the Form 1116.

Exhibit 6



Part II **Foreign Taxes Paid or Accrued** (see page 13 of the instructions)

Country	Credit is claimed for taxes (you must check one) (m) ☐ Paid (n) ☐ Accrued	Foreign taxes paid or accrued								
		In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			(s) Other foreign taxes paid or accrued	Taxes withheld at source on:			(w) Other foreign taxes paid or accrued	(x) Total foreign taxes paid or accrued (add cols. (t) through (w))
	(o) Date paid or accrued	(p) Dividends	(q) Rents and royalties	(r) Interest		(t) Dividends	(u) Rents and royalties	(v) Interest		
A										
B										
C										

8 Add lines A through C, column (x). Enter the total here and on line 9, page 2 . . . . ▶ 8

For Paperwork Reduction Act Notice, see page 16 of the instructions. Cat. No. 11440U Form **1116** (2002)

Part II. Foreign Taxes Paid or Accrued. Part II of Form 1116 deals with the amount of foreign taxes paid or that may be owed (accrued). Since the foreign tax credit is allowed when a U.S. taxpayer either pays or accrues taxes to a foreign government, the amount paid or owed to a foreign government must be indicated on the tax return in this section.

Before we can discuss how to complete Part II, we need to discuss cash basis and accrual basis taxpayers. A cash basis taxpayer is one who reports income when actually or constructively received, and expenses when they are paid. The majority of people who file individual income tax returns are cash basis taxpayers. If the person is a cash basis taxpayer, he or she has a choice to take foreign tax credit using the cash or accrual method.

Example 16

Marie is a U.S. citizen who resides in Argentina, where she is currently employed. She is paid every week on Thursday. Her last payday for 2002 is December 30th. She is paid based upon the time she worked in the previous week Sunday through Saturday. Since she is a cash basis taxpayer, she claims on her 2002 tax return the income that she was paid from January 1, 2002 through December 31, 2002 no matter when she earned it or when she may have been entitled to it. She also claims as deductions, expenses for which she actually paid in 2002 even though she may have incurred the debt prior to 2002.

An accrual basis taxpayer computes income and deductions differently. A person who is on the accrual basis computes income when he or she actually earned it or became entitled to it. Therefore, his or her deductions are computed based on when those debts were incurred, but not necessarily paid.

Example 17
If Marie was an accrual basis taxpayer instead of a cash basis taxpayer, then she would declare as her 2002 income the money she had earned from her employer through December 31, even though she would not have been paid for her last week's work until early 2003.

When computing the amount of foreign taxes for Part II of Form 1116, you will need to know if the taxpayer is on a cash basis or an accrual basis. If the person you are helping does not know, then he or she is probably on a cash basis. If the person is on a cash basis, the foreign tax credit is figured using the foreign taxes actually paid in 2002. If he or she is on an accrual basis, the credit will be for the foreign taxes accrued for the income earned in 2002.

A taxpayer on the cash basis may choose to use the accrual method to determine the foreign tax credit. However, once this choice has been made the taxpayer must use the accrual method for the foreign tax credit on all future tax returns.

In the U.S., we have a pay-as-you-go system. That means that we pay taxes on taxable income as we make it. When a wage-earner gets a paycheck, an amount has already been withheld by his or her employer for federal income tax. If there has not been withholding on taxable income, then estimated tax payments must be made.

Many foreign countries have a different system. In some cases, the individual simply reports his or her taxable income and the government involved computes the tax and bills the taxpayer. In other instances, taxpayers make payments in one year for income made the previous year. In these instances, a cash basis taxpayer may wish to use the accrual basis for computing the foreign tax credit since his or her U.S. tax would be based on the income made in 2002 but they would not actually pay the taxes or know the actual tax amount until after the end of the tax year. But remember that once the choice to use the accrual method has been made, it must be used on all future tax returns in computing the foreign tax credit.

On Part II of Form 1116, you must indicate if the credit is being claimed for foreign taxes actually paid in 2002 or if it is being claimed for foreign taxes accrued during 2002. Just as there is space in Part I of the form to claim income from 3 different countries, there is space in Part II for claiming payments to these 3 different countries. Part II also has two separate sections in which you indicate the amounts withheld, paid, or accrued in the foreign currency and then convert these amounts into U.S. dollars.

One of the questions that frequently arise is what currency exchange rate should be used. If you are using the cash basis, then the exchange rate that is the most accurate for the date of the payment should be used. If the person you are helping had tax withheld throughout the year, then you can use the annual average exchange rate. If the person you are assisting is using the accrual method to claim his or her foreign taxes paid, you must generally use the average exchange rate for the tax year.

Column (x) of the Form 1116 Part II is a summary (in U.S. dollars) of all the foreign taxes paid or accrued on income in the category checked at the top of Form 1116. Line 8 of Part II is the total of foreign taxes paid or accrued to all foreign countries.

If the foreign taxes are paid or accrued on foreign income that falls into more than one separate category of income, but the tax is not specifically allocable to any one of the items of income, an allocation of the tax to each separate category must be made. This allocation is made by multiplying the total foreign income by a fraction. The numerator of the fraction is the net income of each of the separate categories. The denominator is total net foreign income. Figure the net income by deducting from each any expenses, deductions, etc. that are allocable to the income under the laws of the foreign country. If there is no specific allocation under foreign law, apportion the expenses, deductions, etc. using the principles of U.S. tax law.

In some cases, the rates of foreign tax are different for different types of income. Because the tax for each type of income is readily determined, the allocation is generally not needed.

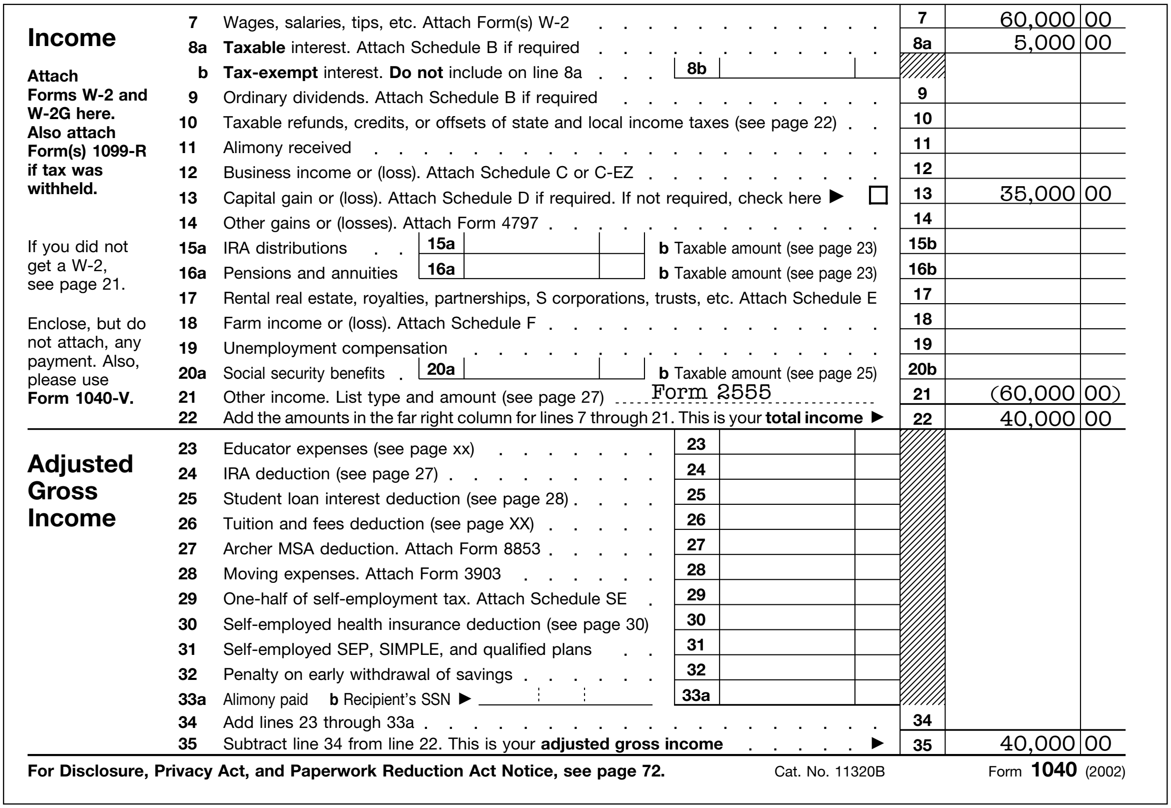
We have now finished studying how to complete the first page of the Form 1116. Let's do some exercises to practice working with the form.

Exercise 3

Charles is a U.S. citizen who lives and works in the United Kingdom. He takes the foreign earned income exclusion for his wages. His only other foreign income is interest income from his London bank. British income taxes were withheld at 27.5%. In 2002, his gross interest income from his London bank was £1,200. The average exchange rate for 2002 for purposes of this exercise was £.6 to the U.S. dollar. Charles uses the single filing status on his tax return and claims a standard deduction for 2002. He had earned income of $60,000 which he excluded. He also had U.S. interest income of $3,000 and his only other income was a short term capital gain of $35,000 from a U.S. source. Since 27.5% is also the tax rate for interest income in the United Kingdom, he had no additional income tax due to Great Britain on his interest income. Parts of Charles' Form 1040 are reproduced below. Compute the first page of the Form 1116 for Charles.

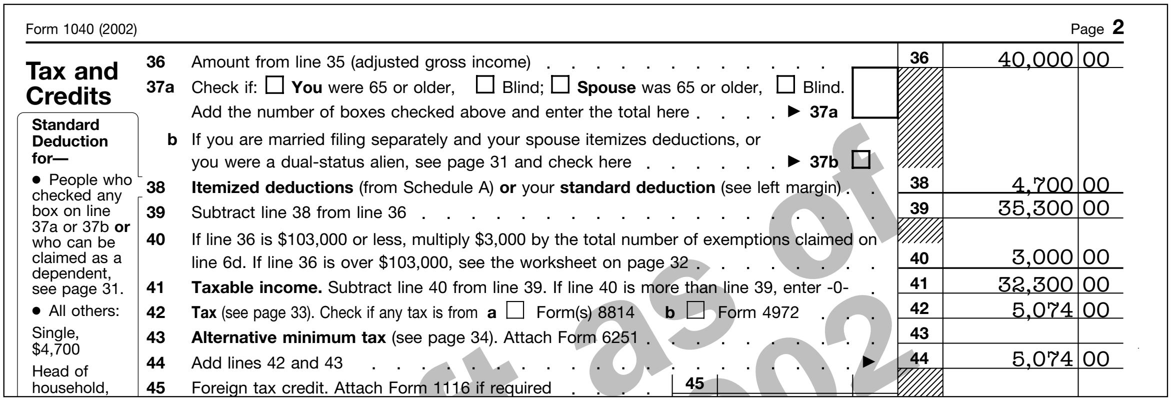
Exhibit 7

Form 1040



Income	7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	60,000 00
Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.	8a	**Taxable** interest. Attach Schedule B if required		8a	5,000 00
	b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
	9	Ordinary dividends. Attach Schedule B if required		9	
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)		10	
	11	Alimony received		11	
	12	Business income or (loss). Attach Schedule C or C-EZ		12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	35,000 00
	14	Other gains or (losses). Attach Form 4797		14	
If you did not get a W-2, see page 21.	15a	IRA distributions	15a	**b** Taxable amount (see page 23) 15b	
	16a	Pensions and annuities	16a	**b** Taxable amount (see page 23) 16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**	18	Farm income or (loss). Attach Schedule F		18	
	19	Unemployment compensation		19	
	20a	Social security benefits	20a	**b** Taxable amount (see page 25) 20b	
	21	Other income. List type and amount (see page 27) Form 2555		21	(60,000 00)
	22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	40,000 00
Adjusted Gross Income	23	Educator expenses (see page xx)	23		
	24	IRA deduction (see page 27)	24		
	25	Student loan interest deduction (see page 28)	25		
	26	Tuition and fees deduction (see page XX)	26		
	27	Archer MSA deduction. Attach Form 8853	27		
	28	Moving expenses. Attach Form 3903	28		
	29	One-half of self-employment tax. Attach Schedule SE	29		
	30	Self-employed health insurance deduction (see page 30)	30		
	31	Self-employed SEP, SIMPLE, and qualified plans	31		
	32	Penalty on early withdrawal of savings	32		
	33a	Alimony paid **b** Recipient's SSN ▶	33a		
	34	Add lines 23 through 33a		34	
	35	Subtract line 34 from line 22. This is your **adjusted gross income** ▶		35	40,000 00

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72. Cat. No. 11320B Form **1040** (2002)



Form 1040 (2002) Page **2**

Tax and Credits	36	Amount from line 35 (adjusted gross income)		36	40,000 00
	37a	Check if: ☐ **You** were 65 or older, ☐ Blind; ☐ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ **37a**	☐		
Standard Deduction for—	b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 31 and check here ▶ **37b** ☐			
• People who checked any box on line 37a or 37b **or** who can be claimed as a dependent, see page 31.	38	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		38	4,700 00
	39	Subtract line 38 from line 36		39	35,300 00
	40	If line 36 is $103,000 or less, multiply $3,000 by the total number of exemptions claimed on line 6d. If line 36 is over $103,000, see the worksheet on page 32		40	3,000 00
	41	**Taxable income.** Subtract line 40 from line 39. If line 40 is more than line 39, enter -0-		41	32,300 00
• All others:	42	**Tax** (see page 33). Check if any tax is from **a** ☐ Form(s) 8814 **b** ☐ Form 4972		42	5,074 00
Single, $4,700	43	**Alternative minimum tax** (see page 34). Attach Form 6251		43	
Head of household,	44	Add lines 42 and 43 ▶		44	5,074 00
	45	Foreign tax credit. Attach Form 1116 if required	45		

Exhibit 8

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

▶ Attach to Form 1040, 1040NR, 1041, or 990-T.

▶ See separate instructions.

OMB No. 1545-0121

2002

Attachment
Sequence No. **19**

Name: Charles Green

Identifying number as shown on page 1 of your tax return: 000 - 00 - 6492

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of 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 income
b ☐ High withholding tax interest
c ☐ Financial services income
d ☐ Shipping income
e ☐ Dividends from a DISC or former DISC
f ☐ Certain distributions from a foreign sales corporation (FSC) or former FSC
g ☐ Lump-sum distributions
h ☐ Section 901(j) income
i ☐ Certain income re-sourced by treaty
j ☐ General limitation income

k Resident of (name of country) ▶

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	
		A	B	C	(Add cols. A, B, and C.)	
I	**Enter the name of the foreign country or U.S. possession** . . . . ▶					
1	Gross income from sources within country shown above and of the type checked above (see page 7 of the instructions):				1	
	Deductions and losses (***Caution:*** *See pages 9, 12, and 13 of the instructions*):					
2	Expenses **definitely related** to the income on line 1 (attach statement)					
3	Pro rata share of other deductions **not definitely related:**					
a	Certain itemized deductions or standard deduction (see instructions)					
b	Other deductions (attach statement)					
c	Add lines 3a and 3b					
d	Gross foreign source income (see instructions)					
e	Gross income from all sources (see instructions)					
f	Divide line 3d by line 3e (see instructions) . .					
g	Multiply line 3c by line 3f					
4	Pro rata share of interest expense (see instructions):					
a	Home mortgage interest (use worksheet on page 12 of the instructions)					
b	Other interest expense					
5	Losses from foreign sources					
6	Add lines 2, 3g, 4a, 4b, and 5				6	
7	Subtract line 6 from line 1. Enter the result here and on line 14, page 2 . . . . ▶				7	

Part II Foreign Taxes Paid or Accrued (see page 13 of the instructions)

Country	Credit is claimed for taxes (you must check one) (m) ☐ Paid (n) ☐ Accrued	Foreign taxes paid or accrued								
		In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			**(s)** Other foreign taxes paid or accrued	Taxes withheld at source on:			**(w)** Other foreign taxes paid or accrued	**(x)** Total foreign taxes paid or accrued (add cols. (t) through (w))
	(o) Date paid or accrued	**(p)** Dividends	**(q)** Rents and royalties	**(r)** Interest		**(t)** Dividends	**(u)** Rents and royalties	**(v)** Interest		
A										
B										
C										

8 Add lines A through C, column (x). Enter the total here and on line 9, page 2 . . . . ▶ **8**

For Paperwork Reduction Act Notice, see page 16 of the instructions. Cat. No. 11440U Form **1116** (2002)

Part III. Now that we have completed the front page of the Form 1116, let's go to the back of the form. Part III is the actual computation of the Foreign Tax Credit. This is relatively simple if you just follow the form line by line.

Line 9. This is the amount you just calculated from Part II, line 8. It's the amount of foreign taxes paid or accrued, depending on the method used.

Line 10. This is beyond the scope of VITA. For information purposes, many countries have a higher tax on income than we do in the United States. That means that a higher tax is paid to a foreign government than would be due on the U.S. tax return attributable to the taxable income in the separate income category. The tax credit on a U.S. return is limited to the amount of U.S. tax. Also, there are separate limits in computing the amount of credit based upon the category checked off on the front page of the Form 1116. These situations result in possible carrybacks and carryovers but the rules can be complex. Individuals may wish to seek the guidance of the IRS before completing this computation. VITA volunteers will not be computing carrybacks and carryovers.

Line 11. A total of lines 9 and 10.

Line 12. A reduction to the foreign taxes paid or accrued has to be made under certain circumstances. For our purpose, we will cover the most common situation. This is the reduction for taxes allocable to income excluded under the foreign earned income exclusion. The formula for this reduction is:

$$\frac{\textit{Excluded Foreign Earned Income}}{\text{Total Foreign Earned Income}} \text{ x Foreign Tax = Reduction}$$

For our purposes, if the foreign law taxes foreign earned income and some other income (for example, earned income from U.S. sources or a type of income not subject to U.S. tax), and the taxes cannot be segregated, then the denominator of this fraction is the total amount of income subject to foreign tax.

Let’s look at an example.

Example 18

Marsha is a U.S. citizen who resides in Germany for all of 2002. She had wages of $85,000, and excluded $80,000 on her U.S. tax return. She also earned $5,000 interest on a German bank account. She paid $2,000 income tax to Germany on this income. She will allocate the $2,000 income tax as follows:

Step 1 — Allocate the tax to Passive and to General Limitation Income.

Passive Income: $\frac{\$5{,}000}{\$90{,}000} \text{ x } \$20{,}000 = \$1{,}111$

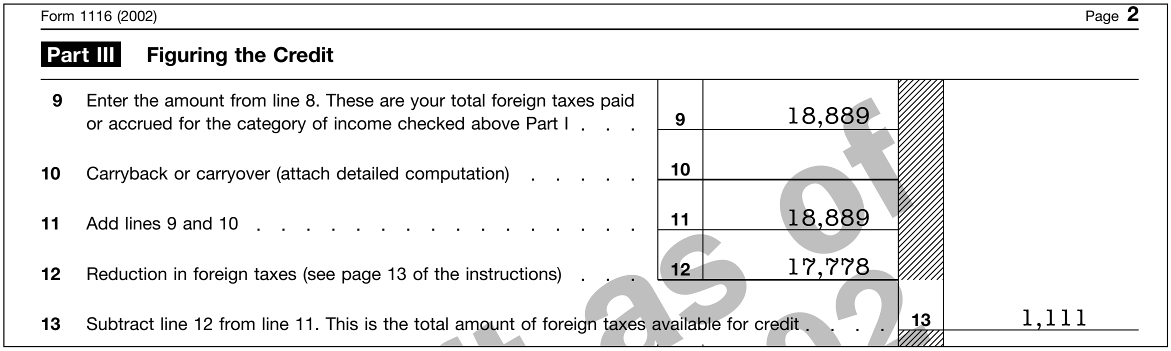
General Limitation Income: $\frac{\$85{,}000}{\$90{,}000} \text{ x } \$20{,}000 = \$18{,}889$

Step 2 — Calculate the credit reduction attributable to excluded income.

$$\frac{\$80{,}000 \text{ (excluded income)}}{\$85{,}000 \text{ (total foreign income)}} \text{ x } \$18{,}889 = \$17{,}778$$

Exhibit 9

Form 1116



Form 1116 (2002) Page 2

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	18,889	▨	
10	Carryback or carryover (attach detailed computation)	10		▨	
11	Add lines 9 and 10	11	18,889	▨	
12	Reduction in foreign taxes (see page 13 of the instructions) . . .	12	17,778	▨	
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit			13	1,111

There are other reductions which can be indicated on line 12. However, they are all beyond the scope of VITA. These include taxes attributable to boycott operations, or certain mineral income. It is suggested that taxpayers with these types of situations may wish to seek professional assistance.

Line 13—This is just a subtraction of line 12 from line 11. This is the amount of foreign taxes paid or accrued which is still available for the credit computation.

We will continue on and discuss the remaining lines in Part III of Form 1116.

Exhibit 10 Lines 13-21 Form 1116

13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit			**13**	
14	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 page 14 of the instructions) . .	**14**		▨	
15	Adjustments to line 14 (see page 14 of the instructions)	**15**		▨	
16	Combine the amounts on lines 14 and 15. 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 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.)	**16**		▨	
17	**Individuals:** Enter the amount from Form 1040, line 39. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	**17**		▨	
	Caution: *If you figured your tax using the special rates on capital gains, see page 15 of the instructions.*				
18	Divide line 16 by line 17. If line 16 is more than line 17, enter “1”			**18**	
19	**Individuals:** Enter the amount from Form 1040, line 42. If you are a nonresident alien, enter the amount from Form 1040NR, line 40. **Estates and trusts:** Enter the total of Form 1041, Schedule G, lines 1a and 1b, or the total of Form 990-T, lines 36 and 37			**19**	
20	Multiply line 19 by line 18 (maximum amount of credit)			**20**	
21	Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 15 of the instructions) . . . . ▶			**21**	

Line 14—This is the amount from Part I, line 7.

Line 15—These adjustments are beyond the scope of VITA.

Line 16—Should be the same as line 14.

Line 17—Enter here the amount on line 39 from the U.S. Form 1040.

Line 18—Divide line 16 by line 17. Go to 4 decimal places. If line 16 is larger than line 17, then enter the whole number 1.

Line 19—Enter the amount from line 42 of the U.S. Form 1040.

Line 20—Multiply line 19 by the percentage arrived at on line 18. This will be the maximum amount of credit which an individual may claim.

Line 21—Compare lines 13 and 20. Enter the smaller of the two amounts on line 21.

If you only have to complete one Form 1116, then enter the same number on line 31 of Part IV.

Exercise 4

Let's complete the Form 1116 for Charles in exercise 3. What is the amount on line 21 of Part III?

Form 1116 (2002) Page **2**

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**

10 Carryback or carryover (attach detailed computation) **10**

11 Add lines 9 and 10 . . . . **11**

12 Reduction in foreign taxes (see page 13 of the instructions) . . . **12**

13 Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit **13**

14 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 page 14 of the instructions) . **14**

15 Adjustments to line 14 (see page 14 of the instructions) **15**

16 Combine the amounts on lines 14 and 15. 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 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.) **16**

17 **Individuals:** Enter the amount from Form 1040, line 39. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption **17**

Caution: *If you figured your tax using the special rates on capital gains, see page 15 of the instructions.*

18 Divide line 16 by line 17. If line 16 is more than line 17, enter "1" **18**

19 **Individuals:** Enter the amount from Form 1040, line 42. If you are a nonresident alien, enter the amount from Form 1040NR, line 40.

Estates and trusts: Enter the total of Form 1041, Schedule G, lines 1a and 1b, or the total of Form 990-T, lines 36 and 37 . . . . **19**

20 Multiply line 19 by line 18 (maximum amount of credit) **20**

21 Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 15 of the instructions) . . . . ▶ **21**

Part IV Summary of Credits From Separate Parts III (see page 16 of the instructions)

22 Credit for taxes on passive income **22**

23 Credit for taxes on high withholding tax interest **23**

24 Credit for taxes on financial services income **24**

25 Credit for taxes on shipping income **25**

26 Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC **26**

27 Credit for taxes on lump-sum distributions **27**

28 Credit for taxes on certain income re-sourced by treaty **28**

29 Credit for taxes on general limitation income **29**

30 Add lines 22 through 29 . . . . **30**

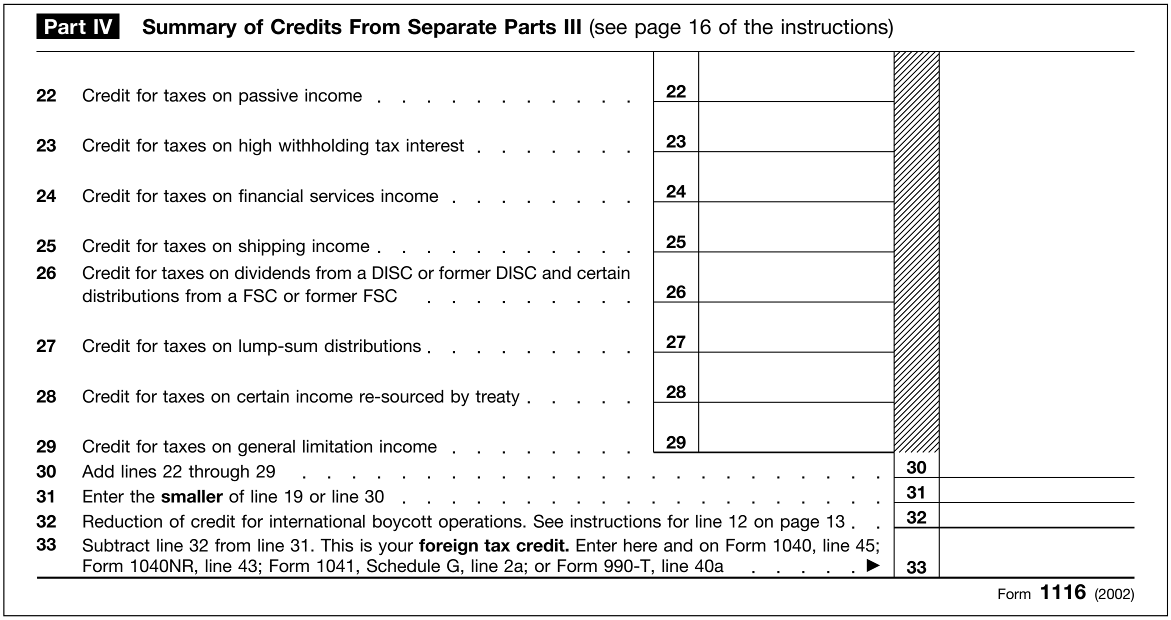
31 Enter the **smaller** of line 19 or line 30 . . . . **31**

32 Reduction of credit for international boycott operations. See instructions for line 12 on page 13 . . **32**

33 Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 45; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a . . . . . . ▶ **33**

Form **1116** (2002)

Exhibit 11 Form 1116



Part IV **Summary of Credits From Separate Parts III** (see page 16 of the instructions)

22	Credit for taxes on passive income	22			
23	Credit for taxes on high withholding tax interest	23			
24	Credit for taxes on financial services income	24			
25	Credit for taxes on shipping income	25			
26	Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC	26			
27	Credit for taxes on lump-sum distributions	27			
28	Credit for taxes on certain income re-sourced by treaty	28			
29	Credit for taxes on general limitation income	29			
30	Add lines 22 through 29			30	
31	Enter the **smaller** of line 19 or line 30			31	
32	Reduction of credit for international boycott operations. See instructions for line 12 on page 13			32	
33	Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 45; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶			33	

Form **1116** (2002)

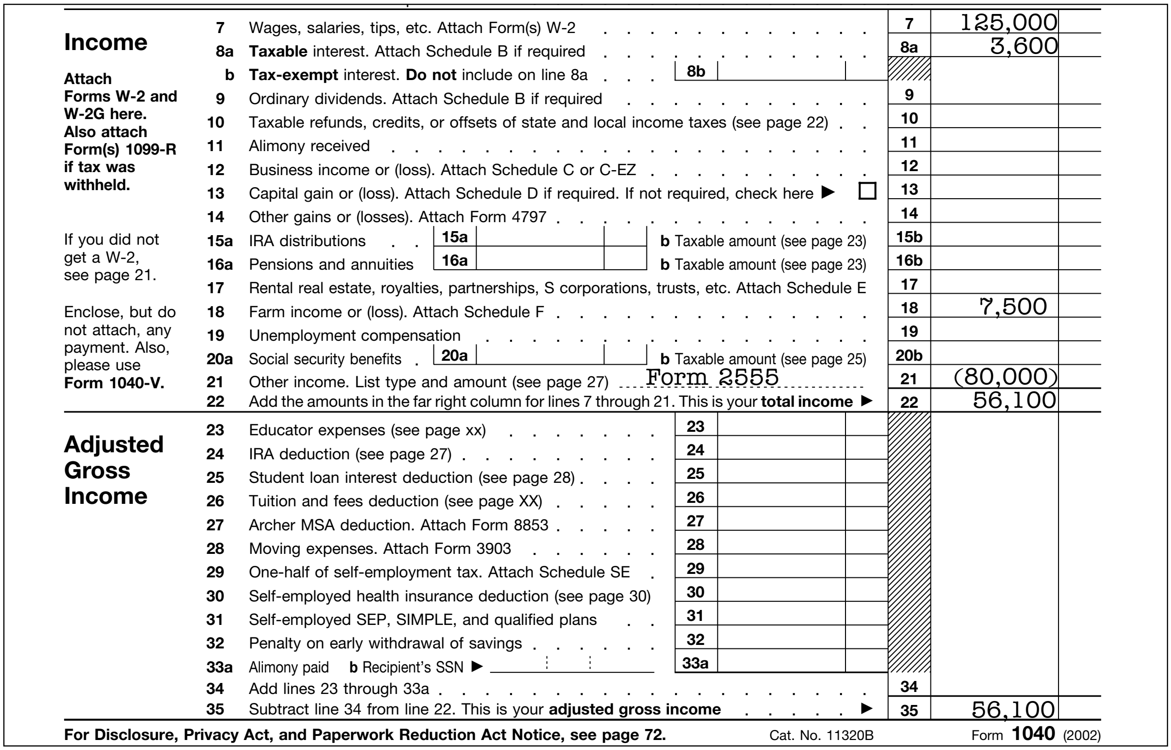
More Than One Form 1116. Part IV of the Form 1116 is used as a summary of the foreign tax credit. As you can tell from our discussion thus far, there may be occasions when you will need to complete more than one Form 1116 for the same taxpayer. If this is the case, you would complete Part IV on only one Form 1116. It does not matter which Form 1116 you choose. You would indicate in Part IV of the summary Form 1116 the amount of the credit computed on line 21 of Part III from each Form 1116. Line 30 is then a total of all Forms 1116 and, for our purposes, line 32 should be the same as line 30. Please note that again the reduction of the credit for international boycott operations (line 31) is beyond the scope of this program and will not be discussed.

Exercise 5

Barry is a U.S. citizen living in France. He will claim a foreign earned income exclusion for the first $80,000 of his wages. He earned $137,500 wages while working in France during 2002. He recieved G1,210 interest on a French savings account and $2,500 in a U.S. savings account. He also had $7,500 U.S. sourced rental income. Barry paid G27,500 French taxes on December 31, 2002. Assume an average conversion rate of G.90909 to $1. (Note G is the currency symbol for the Euro which became the official French currency on January 1, 2002). Do not assume that the French interest income is high withholding tax interest. An extract of Barry's Form 1040 is attached for your convenience. Complete Barry's Forms 1116. (Round all dollar amounts to the nearest dollar and all decimal amounts to four places.)

Exhibit 12

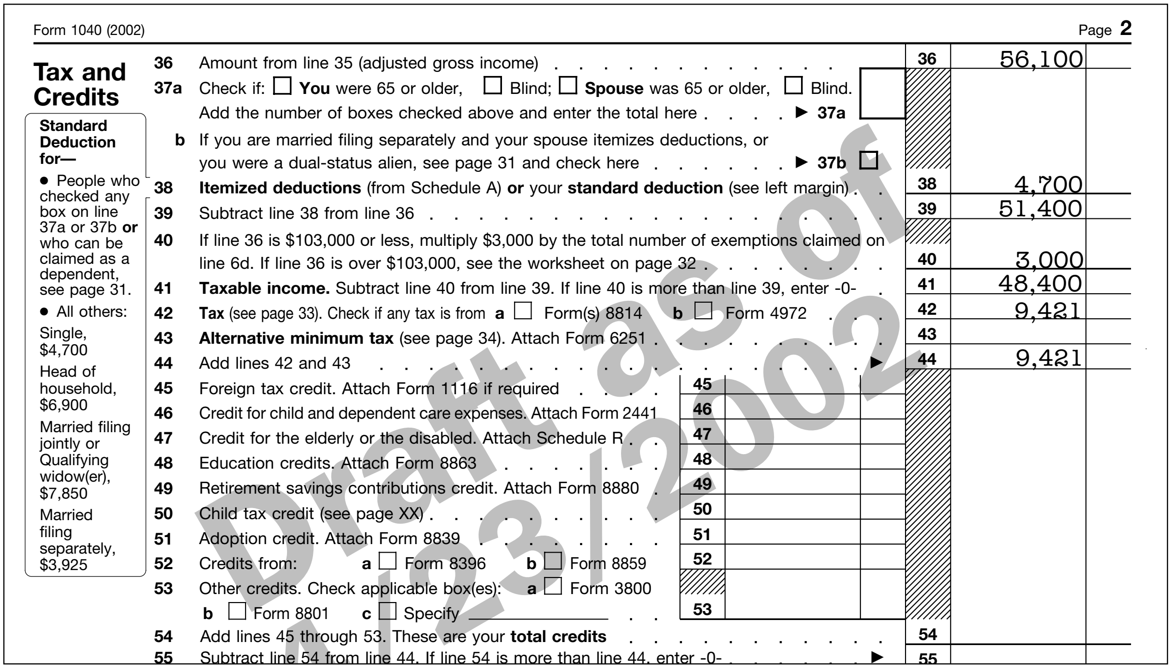
Form 1040



Income	7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	125,000
	8a	**Taxable** interest. Attach Schedule B if required		8a	3,600
Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.	b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
	9	Ordinary dividends. Attach Schedule B if required		9	
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)		10	
	11	Alimony received		11	
	12	Business income or (loss). Attach Schedule C or C-EZ		12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
	14	Other gains or (losses). Attach Form 4797		14	
If you did not get a W-2, see page 21.	15a	IRA distributions	15a	15b	
		b Taxable amount (see page 23)			
	16a	Pensions and annuities	16a	16b	
		b Taxable amount (see page 23)			
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**	18	Farm income or (loss). Attach Schedule F		18	7,500
	19	Unemployment compensation		19	
	20a	Social security benefits	20a	20b	
		b Taxable amount (see page 25)			
	21	Other income. List type and amount (see page 27) Form 2555		21	(80,000)
	22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	56,100
Adjusted Gross Income	23	Educator expenses (see page xx)	23		
	24	IRA deduction (see page 27)	24		
	25	Student loan interest deduction (see page 28)	25		
	26	Tuition and fees deduction (see page XX)	26		
	27	Archer MSA deduction. Attach Form 8853	27		
	28	Moving expenses. Attach Form 3903	28		
	29	One-half of self-employment tax. Attach Schedule SE	29		
	30	Self-employed health insurance deduction (see page 30)	30		
	31	Self-employed SEP, SIMPLE, and qualified plans	31		
	32	Penalty on early withdrawal of savings	32		
	33a	Alimony paid **b** Recipient's SSN ▶	33a		
	34	Add lines 23 through 33a		34	
	35	Subtract line 34 from line 22. This is your **adjusted gross income** ▶		35	56,100

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72. Cat. No. 11320B Form **1040** (2002)

Form 1040



Form 1040 (2002) Page **2**

Tax and Credits	36	Amount from line 35 (adjusted gross income)		36	56,100
	37a	Check if: ☐ **You** were 65 or older, ☐ Blind; ☐ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ **37a**	☐		
Standard Deduction for—	b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 31 and check here ▶ **37b** ☐			
• People who checked any box on line 37a or 37b **or** who can be claimed as a dependent, see page 31.	38	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		38	4,700
	39	Subtract line 38 from line 36		39	51,400
• All others:	40	If line 36 is $103,000 or less, multiply $3,000 by the total number of exemptions claimed on line 6d. If line 36 is over $103,000, see the worksheet on page 32		40	3,000
Single, $4,700	41	**Taxable income.** Subtract line 40 from line 39. If line 40 is more than line 39, enter -0-		41	48,400
Head of household, $6,900	42	**Tax** (see page 33). Check if any tax is from **a** ☐ Form(s) 8814 **b** ☐ Form 4972		42	9,421
Married filing jointly or Qualifying widow(er), $7,850	43	**Alternative minimum tax** (see page 34). Attach Form 6251		43	
Married filing separately, $3,925	44	Add lines 42 and 43 ▶		44	9,421
	45	Foreign tax credit. Attach Form 1116 if required	45		
	46	Credit for child and dependent care expenses. Attach Form 2441	46		
	47	Credit for the elderly or the disabled. Attach Schedule R	47		
	48	Education credits. Attach Form 8863	48		
	49	Retirement savings contributions credit. Attach Form 8880	49		
	50	Child tax credit (see page XX)	50		
	51	Adoption credit. Attach Form 8839	51		
	52	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859	52		
	53	Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify	53		
	54	Add lines 45 through 53. These are your **total credits**		54	
	55	Subtract line 54 from line 44. If line 54 is more than line 44, enter -0- ▶		55	

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

▶ **Attach to Form 1040, 1040NR, 1041, or 990-T.**

▶ **See separate instructions.**

OMB No. 1545-0121

2002

Attachment
Sequence No. **19**

Name: Barry Adams

Identifying number as shown on page 1 of your tax return: 000 - 00 - 5741

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of 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 income
- **b** ☐ High withholding tax interest
- **c** ☐ Financial services income
- **d** ☐ Shipping income
- **e** ☐ Dividends from a DISC or former DISC
- **f** ☐ Certain distributions from a foreign sales corporation (FSC) or former FSC
- **g** ☐ Lump-sum distributions
- **h** ☐ Section 901(j) income
- **i** ☐ Certain income re-sourced by treaty
- **j** ☐ General limitation income

k Resident of (name of country) ▶

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
	A	B	C		(Add cols. A, B, and C.)
l **Enter the name of the foreign country or U.S. possession** . . . . ▶					
1 Gross income from sources within country shown above and of the type checked above (see page 7 of the instructions):				1	
Deductions and losses (***Caution:*** *See pages 9, 12, and 13 of the instructions*):					
2 Expenses **definitely related** to the income on line 1 (attach statement)					
3 Pro rata share of other deductions **not definitely related:**					
a Certain itemized deductions or standard deduction (see instructions)					
b Other deductions (attach statement)					
c Add lines 3a and 3b					
d Gross foreign source income (see instructions)					
e Gross income from all sources (see instructions)					
f Divide line 3d by line 3e (see instructions)					
g Multiply line 3c by line 3f					
4 Pro rata share of interest expense (see instructions):					
a Home mortgage interest (use worksheet on page 12 of the instructions)					
b Other interest expense					
5 Losses from foreign sources					
6 Add lines 2, 3g, 4a, 4b, and 5				6	
7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 . . . ▶				7	

Part II Foreign Taxes Paid or Accrued (see page 13 of the instructions)

Country	Credit is claimed for taxes (you must check one) (m) ☐ Paid (n) ☐ Accrued	Foreign taxes paid or accrued								
		In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			**(s)** Other foreign taxes paid or accrued	Taxes withheld at source on:			**(w)** Other foreign taxes paid or accrued	**(x)** Total foreign taxes paid or accrued (add cols. (t) through (w))
	(o) Date paid or accrued	**(p)** Dividends	**(q)** Rents and royalties	**(r)** Interest		**(t)** Dividends	**(u)** Rents and royalties	**(v)** Interest		
A										
B										
C										

8 Add lines A through C, column (x). Enter the total here and on line 9, page 2 . . . . ▶ **8**

For Paperwork Reduction Act Notice, see page 16 of the instructions. Cat. No. 11440U Form **1116** (2002)

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

10 Carryback or carryover (attach detailed computation) 10

11 Add lines 9 and 10 11

12 Reduction in foreign taxes (see page 13 of the instructions) . . . 12

13 Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit 13

14 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 page 14 of the instructions) . . 14

15 Adjustments to line 14 (see page 14 of the instructions) 15

16 Combine the amounts on lines 14 and 15. 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 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.) 16

17 **Individuals:** Enter the amount from Form 1040, line 39. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption 17

Caution: *If you figured your tax using the special rates on capital gains, see page 15 of the instructions.*

18 Divide line 16 by line 17. If line 16 is more than line 17, enter "1" 18

19 **Individuals:** Enter the amount from Form 1040, line 42. If you are a nonresident alien, enter the amount from Form 1040NR, line 40.

Estates and trusts: Enter the total of Form 1041, Schedule G, lines 1a and 1b, or the total of Form 990-T, lines 36 and 37 19

20 Multiply line 19 by line 18 (maximum amount of credit) 20

21 Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 15 of the instructions) . . . . ▶ 21

Part IV Summary of Credits From Separate Parts III (see page 16 of the instructions)

22 Credit for taxes on passive income 22

23 Credit for taxes on high withholding tax interest 23

24 Credit for taxes on financial services income 24

25 Credit for taxes on shipping income 25

26 Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC 26

27 Credit for taxes on lump-sum distributions 27

28 Credit for taxes on certain income re-sourced by treaty 28

29 Credit for taxes on general limitation income 29

30 Add lines 22 through 29 30

31 Enter the **smaller** of line 19 or line 30 31

32 Reduction of credit for international boycott operations. See instructions for line 12 on page 13 . . 32

33 Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 45; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a . . . . . . ▶ 33

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

► Attach to Form 1040, 1040NR, 1041, or 990-T.

► See separate instructions.

OMB No. 1545-0121

2002

Attachment
Sequence No. **19**

Name: Barry Adams

Identifying number as shown on page 1 of your tax return: 000 - 00 - 5741

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of 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 income
b ☐ High withholding tax interest
c ☐ Financial services income
d ☐ Shipping income
e ☐ Dividends from a DISC or former DISC
f ☐ Certain distributions from a foreign sales corporation (FSC) or former FSC
g ☐ Lump-sum distributions
h ☐ Section 901(j) income
i ☐ Certain income re-sourced by treaty
j ☐ General limitation income

k Resident of (name of country) ►

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**
	A	**B**	**C**	(Add cols. A, B, and C.)
I **Enter the name of the foreign country or U.S. possession** ►				
1 Gross income from sources within country shown above and of the type checked above (see page 7 of the instructions):				**1**
Deductions and losses (***Caution:*** *See pages 9, 12, and 13 of the instructions*):				
2 Expenses **definitely related** to the income on line 1 (attach statement)				
3 Pro rata share of other deductions **not definitely related:**				
a Certain itemized deductions or standard deduction (see instructions)				
b Other deductions (attach statement)				
c Add lines 3a and 3b				
d Gross foreign source income (see instructions)				
e Gross income from all sources (see instructions)				
f Divide line 3d by line 3e (see instructions)				
g Multiply line 3c by line 3f				
4 Pro rata share of interest expense (see instructions):				
a Home mortgage interest (use worksheet on page 12 of the instructions)				
b Other interest expense				
5 Losses from foreign sources				
6 Add lines 2, 3g, 4a, 4b, and 5				**6**
7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ►				**7**

Part II Foreign Taxes Paid or Accrued (see page 13 of the instructions)

Country	Credit is claimed for taxes (you must check one) **(m)** ☐ Paid **(n)** ☐ Accrued	Foreign taxes paid or accrued								
		In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			**(s)** Other foreign taxes paid or accrued	Taxes withheld at source on:			**(w)** Other foreign taxes paid or accrued	**(x)** Total foreign taxes paid or accrued (add cols. (t) through (w))
	(o) Date paid or accrued	**(p)** Dividends	**(q)** Rents and royalties	**(r)** Interest		**(t)** Dividends	**(u)** Rents and royalties	**(v)** Interest		
A										
B										
C										

8 Add lines A through C, column (x). Enter the total here and on line 9, page 2 ► **8**

For Paperwork Reduction Act Notice, see page 16 of the instructions. Cat. No. 11440U Form **1116** (2002)

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

10 Carryback or carryover (attach detailed computation) 10

11 Add lines 9 and 10 11

12 Reduction in foreign taxes (see page 13 of the instructions) . . . 12

13 Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit 13

14 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 page 14 of the instructions) . . 14

15 Adjustments to line 14 (see page 14 of the instructions) 15

16 Combine the amounts on lines 14 and 15. 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 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.) 16

17 **Individuals:** Enter the amount from Form 1040, line 39. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption 17

Caution: *If you figured your tax using the special rates on capital gains, see page 15 of the instructions.*

18 Divide line 16 by line 17. If line 16 is more than line 17, enter “1” 18

19 **Individuals:** Enter the amount from Form 1040, line 42. If you are a nonresident alien, enter the amount from Form 1040NR, line 40.

Estates and trusts: Enter the total of Form 1041, Schedule G, lines 1a and 1b, or the total of Form 990-T, lines 36 and 37 19

20 Multiply line 19 by line 18 (maximum amount of credit) 20

21 Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 15 of the instructions) . . . . ▶ 21

Part IV Summary of Credits From Separate Parts III (see page 16 of the instructions)

22 Credit for taxes on passive income 22

23 Credit for taxes on high withholding tax interest 23

24 Credit for taxes on financial services income 24

25 Credit for taxes on shipping income 25

26 Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC 26

27 Credit for taxes on lump-sum distributions 27

28 Credit for taxes on certain income re-sourced by treaty 28

29 Credit for taxes on general limitation income 29

30 Add lines 22 through 29 30

31 Enter the **smaller** of line 19 or line 30 31

32 Reduction of credit for international boycott operations. See instructions for line 12 on page 13 . . 32

33 Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 45; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a . . . . . ▶ 33

Form **1116** (2002)

ELECTION NOT TO FILE FORM 1116

Finally, if the person you are assisting wishes, the amount paid in foreign taxes may be claimed as an itemized deduction in the taxes portion of Schedule A if he or she itemizes deductions. If the person chooses to claim the foreign taxes paid as an itemized deduction they may not claim the foreign tax credit.

Taxpayers will be able to claim the credit without using Form 1116 if the following requirements are met.

1. The taxpayer is an individual.
2. The only foreign source income for the tax year is passive income (dividends, interest, royalties, etc.) that is reported on a payee statement (such as a Form 1099-DIV or 1099-INT).
3. The qualified foreign taxes for the year are not more than $300 ($600 if filing a joint return) and are reported on a payee statement.
4. The taxpayer elects this procedure for the tax year.

If the taxpayer makes this election, he or she cannot carry back or carry over any unused foreign tax to or from this year.

Most overseas taxpayers will not be eligible to make this election because they will not be able to meet requirement 2 above, no Form 1099 will be available.

▶▶ SUMMING UP THIS LESSON ◀◀

- In order to qualify for a foreign tax credit, income on which the taxes are paid must be foreign source.
- The tax being paid must be similar to U.S. income tax.
- The individual paying the tax cannot derive a specific economic benefit and still claim the foreign tax credit.
- The foreign tax credit is computed on Form 1116.
- A separate Form 1116 must be completed for passive income, interest income which is subject to a gross withholding rate of at least 5%, and other income that falls under the general limitation category.
- If passive income, minus allocations, is subject to tax at a rate that is higher than 38.6%, then it falls into the general limitation category.
- If an individual claims the foreign earned income exclusion, the excluded amount is not shown on line 1 of Part I of the Form 1116.
- A cash basis taxpayer may choose the accrual method to claim the foreign tax credit. Once the choice has been made, the taxpayer must continue to use the accrual method.
- If the accrual method of claiming the foreign tax credit is used, use the average annual currency exchange rate to convert the foreign money into U.S. dollars.
- If all or part of the taxes claimed in Part II of Form 1116 are attributable to income excluded under the foreign earned income exclusion, then the taxes available for credit must be reduced by the taxes paid or accrued on the excluded income. The reduction is entered on Part III, line 12.
- If there is more than one Form 1116 for the same person, Part IV need only be completed on one of the forms.

1. c,e
2. a. no
   b. no
   c. yes
   d. no

Exercise 3 Form 1116

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

▶ Attach to Form 1040, 1040NR, 1041, or 990-T.

▶ See separate instructions.

OMB No. 1545-0121

2002

Attachment Sequence No. **19**

Name: Charles Green

Identifying number as shown on page 1 of your tax return: 000 - 00- 6492

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of 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 income
b ☒ High withholding tax interest
c ☐ Financial services income
d ☐ Shipping income
e ☐ Dividends from a DISC or former DISC
f ☐ Certain distributions from a foreign sales corporation (FSC) or former FSC
g ☐ Lump-sum distributions
h ☐ Section 901(j) income
i ☐ Certain income re-sourced by treaty
j ☐ General limitation income

k Resident of (name of country) ▶ United Kingdom

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 A	B	C		Total (Add cols. A, B, and C.)
l **Enter the name of the foreign country or U.S. possession** ▶	United Kingdom				
1 Gross income from sources within country shown above and of the type checked above (see page 7 of the instructions):	2,000			1	2,000
Deductions and losses (***Caution:*** *See pages 9, 12, and 13 of the instructions*):					
2 Expenses **definitely related** to the income on line 1 (attach statement)					
3 Pro rata share of other deductions **not definitely related:**					
a Certain itemized deductions or standard deduction (see instructions)	4,700				
b Other deductions (attach statement)					
c Add lines 3a and 3b	4,700				
d Gross foreign source income (see instructions)	2,000				
e Gross income from all sources (see instructions)	100,000				
f Divide line 3d by line 3e (see instructions)	.0200				
g Multiply line 3c by line 3f	94				
4 Pro rata share of interest expense (see instructions):					
a Home mortgage interest (use worksheet on page 12 of the instructions)					
b Other interest expense					
5 Losses from foreign sources					
6 Add lines 2, 3g, 4a, 4b, and 5	94			6	94
7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ▶				7	1,906

Part II **Foreign Taxes Paid or Accrued** (see page 13 of the instructions)

Country	Credit is claimed for taxes (you must check one) (m) ☒ Paid (n) ☐ Accrued	Foreign taxes paid or accrued: In foreign currency: Taxes withheld at source on: (p) Dividends	(q) Rents and royalties	(r) Interest	(s) Other foreign taxes paid or accrued	In U.S. dollars: Taxes withheld at source on: (t) Dividends	(u) Rents and royalties	(v) Interest	(w) Other foreign taxes paid or accrued	(x) Total foreign taxes paid or accrued (add cols. (t) through (w))
	(o) Date paid or accrued									
A	12/31/02			330				550		550
B										
C										

8 Add lines A through C, column (x). Enter the total here and on line 9, page 2 ▶ **8** 550

For Paperwork Reduction Act Notice, see page 16 of the instructions. Cat. No. 11440U Form **1116** (2002)

Exercise 4

Form 1116

Form 1116 (2002) Page **2**

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	550		
10	Carryback or carryover (attach detailed computation)	10			
11	Add lines 9 and 10	11	550		
12	Reduction in foreign taxes (see page 13 of the instructions)	12			
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit			13	550
14	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 page 14 of the instructions)	14	1,906		
15	Adjustments to line 14 (see page 14 of the instructions)	15			
16	Combine the amounts on lines 14 and 15. 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 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.)	16	1,906		
17	**Individuals:** Enter the amount from Form 1040, line 39. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	17	35,300		
	Caution: *If you figured your tax using the special rates on capital gains, see page 15 of the instructions.*				
18	Divide line 16 by line 17. If line 16 is more than line 17, enter "1"			18	.0540
19	**Individuals:** Enter the amount from Form 1040, line 42. If you are a nonresident alien, enter the amount from Form 1040NR, line 40. **Estates and trusts:** Enter the total of Form 1041, Schedule G, lines 1a and 1b, or the total of Form 990-T, lines 36 and 37			19	5,074
20	Multiply line 19 by line 18 (maximum amount of credit)			20	274
21	Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 15 of the instructions) ▶			21	274

Part IV Summary of Credits From Separate Parts III (see page 16 of the instructions)

22	Credit for taxes on passive income	22			
23	Credit for taxes on high withholding tax interest	23			
24	Credit for taxes on financial services income	24			
25	Credit for taxes on shipping income	25			
26	Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC	26			
27	Credit for taxes on lump-sum distributions	27			
28	Credit for taxes on certain income re-sourced by treaty	28			
29	Credit for taxes on general limitation income	29			
30	Add lines 22 through 29			30	
31	Enter the **smaller** of line 19 or line 30			31	274
32	Reduction of credit for international boycott operations. See instructions for line 12 on page 13			32	
33	Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 45; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶			33	274

Form **1116** (2002)

Exercise 4 – Calculations

Currency Conversion and U.S. Income

Item	Form 1040 Line #	Pounds £		Conversion Rate		Dollars $
Wages (U.K.)	7	36,000	x	1.6667	=	60,000
Interest (U.K.)	8a	1,200	x	1.6667	=	2,000
Interest (U.S.)	8a					3,000
Short Term Capital Gain (U.S.)	13					35,000
Foreign Income Exclusion	21					(60,000)
Total Income and AGI	22, 33, 34					40,000
Less - Standard Deduction	36					(4,700)
Balance	37					35,300
Less - Exemption	38					(3,000)
Taxable Income	39					32,300
Tax	40					5,074

Tax Allocation

			£		Rate		$
Wages	£36,000 x 27.5%	=	9,900	x	1.6667	=	16,500
Interest	£1,200 x 27.5%	=	330	x	1.6667	=	550
Total Foreign Taxes Paid			10,230				17,050

Taxes allocated to Wages	(60,000 ÷ {60,000 + 2,000}) x 17,050	=	16,500
Taxes allocated to Interest	(1,100 ÷ {125,000 + 1,100}) x 25,000	=	550
Total Allocated Taxes			17,050

Exercise 5

Form 1116

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

► Attach to Form 1040, 1040NR, 1041, or 990-T.

► See separate instructions.

OMB No. 1545-0121

2002

Attachment Sequence No. **19**

Name: Barry Adams

Identifying number as shown on page 1 of your tax return: 000 - 00 - 5741

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of 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 income
b ☐ High withholding tax interest
c ☐ Financial services income
d ☐ Shipping income
e ☐ Dividends from a DISC or former DISC
f ☐ Certain distributions from a foreign sales corporation (FSC) or former FSC
g ☐ Lump-sum distributions
h ☐ Section 901(j) income
i ☐ Certain income re-sourced by treaty
j ☒ General limitation income

k Resident of (name of country) ► France

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
		A	B	C		(Add cols. A, B, and C.)
I	**Enter the name of the foreign country or U.S. possession** ►	France				
1	Gross income from sources within country shown above and of the type checked above (see page 7 of the instructions):	45,000			1	45,000
	Deductions and losses (***Caution:*** *See pages 9, 12, and 13 of the instructions*):					
2	Expenses **definitely related** to the income on line 1 (attach statement)					
3	Pro rata share of other deductions **not definitely related:**					
a	Certain itemized deductions or standard deduction (see instructions)	4,700				
b	Other deductions (attach statement)					
c	Add lines 3a and 3b	4,700				
d	Gross foreign source income (see instructions)	125,000				
e	Gross income from all sources (see instructions)	136,100				
f	Divide line 3d by line 3e (see instructions)	.9184				
g	Multiply line 3c by line 3f	4,316				
4	Pro rata share of interest expense (see instructions):					
a	Home mortgage interest (use worksheet on page 12 of the instructions)					
b	Other interest expense					
5	Losses from foreign sources					
6	Add lines 2, 3g, 4a, 4b, and 5	4,316			6	4,316
7	Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ►				7	40,684

Part II Foreign Taxes Paid or Accrued (see page 13 of the instructions)

Country	Credit is claimed for taxes (you must check one) (m) ☒ Paid (n) ☐ Accrued	Foreign taxes paid or accrued								
		In foreign currency				In U.S. dollars				
		Taxes withheld at source on:			(s) Other foreign taxes paid or accrued	Taxes withheld at source on:			(w) Other foreign taxes paid or accrued	(x) Total foreign taxes paid or accrued (add cols. (t) through (w))
	(o) Date paid or accrued	(p) Dividends	(q) Rents and royalties	(r) Interest		(t) Dividends	(u) Rents and royalties	(v) Interest		
A	12/31/02				27,260				24,782	24,782
B										
C										

8 Add lines A through C, column (x). Enter the total here and on line 9, page 2 ► 8 24,782

For Paperwork Reduction Act Notice, see page 16 of the instructions. Cat. No. 11440U Form **1116** (2002)

Exercise 5 Form 1116

Form 1116 (2002) Page **2**

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	24,782		
10	Carryback or carryover (attach detailed computation)	10			
11	Add lines 9 and 10	11	24,782		
12	Reduction in foreign taxes (see page 13 of the instructions)	12	15,860		
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit			13	8,922
14	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 page 14 of the instructions)	14	40,684		
15	Adjustments to line 14 (see page 14 of the instructions)	15			
16	Combine the amounts on lines 14 and 15. 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 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.)	16	40,684		
17	**Individuals:** Enter the amount from Form 1040, line 39. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	17	51,400		
	Caution: *If you figured your tax using the special rates on capital gains, see page 15 of the instructions.*				
18	Divide line 16 by line 17. If line 16 is more than line 17, enter "1"			18	.7915
19	**Individuals:** Enter the amount from Form 1040, line 42. If you are a nonresident alien, enter the amount from Form 1040NR, line 40. **Estates and trusts:** Enter the total of Form 1041, Schedule G, lines 1a and 1b, or the total of Form 990-T, lines 36 and 37			19	9,421
20	Multiply line 19 by line 18 (maximum amount of credit)			20	7,457
21	Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 15 of the instructions) ▶			21	7,457

Part IV Summary of Credits From Separate Parts III (see page 16 of the instructions)

22	Credit for taxes on passive income	22	195		
23	Credit for taxes on high withholding tax interest	23			
24	Credit for taxes on financial services income	24			
25	Credit for taxes on shipping income	25			
26	Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC	26			
27	Credit for taxes on lump-sum distributions	27			
28	Credit for taxes on certain income re-sourced by treaty	28			
29	Credit for taxes on general limitation income	29	7,457		
30	Add lines 22 through 29			30	7,652
31	Enter the **smaller** of line 19 or line 30			31	7,652
32	Reduction of credit for international boycott operations. See instructions for line 12 on page 13			32	
33	Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 45; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶			33	7,652

Form **1116** (2002)

Exercise 5 Form 1116

Form **1116**

Department of the Treasury
Internal Revenue Service (99)

Foreign Tax Credit

(Individual, Estate, or Trust)

▶ **Attach to Form 1040, 1040NR, 1041, or 990-T.**

▶ **See separate instructions.**

OMB No. 1545-0121

2002

Attachment Sequence No. **19**

Name: Barry Adams

Identifying number as shown on page 1 of your tax return: 000 - 00 - 5741

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of 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 income
- **b** ☐ High withholding tax interest
- **c** ☐ Financial services income
- **d** ☐ Shipping income
- **e** ☐ Dividends from a DISC or former DISC
- **f** ☐ Certain distributions from a foreign sales corporation (FSC) or former FSC
- **g** ☐ Lump-sum distributions
- **h** ☐ Section 901(j) income
- **i** ☐ Certain income re-sourced by treaty
- **j** ☐ General limitation income

k Resident of (name of country) ▶ France

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
	A	B	C		(Add cols. A, B, and C.)
l **Enter the name of the foreign country or U.S. possession** ▶	France				
1 Gross income from sources within country shown above and of the type checked above (see page 7 of the instructions):	1,100			1	1,100
Deductions and losses (***Caution:*** *See pages 9, 12, and 13 of the instructions*):					
2 Expenses **definitely related** to the income on line 1 (attach statement)					
3 Pro rata share of other deductions **not definitely related:**					
a Certain itemized deductions or standard deduction (see instructions)	4,700				
b Other deductions (attach statement)					
c Add lines 3a and 3b	4,700				
d Gross foreign source income (see instructions)	1,100				
e Gross income from all sources (see instructions)	136,100				
f Divide line 3d by line 3e (see instructions)	.0081				
g Multiply line 3c by line 3f	38				
4 Pro rata share of interest expense (see instructions):					
a Home mortgage interest (use worksheet on page 12 of the instructions)					
b Other interest expense					
5 Losses from foreign sources					
6 Add lines 2, 3g, 4a, 4b, and 5	38			6	38
7 Subtract line 6 from line 1. Enter the result here and on line 14, page 2 ▶				7	1,062

Part II Foreign Taxes Paid or Accrued (see page 13 of the instructions)

Country	Credit is claimed for taxes (you must check one) (m) ☐ Paid (n) ☐ Accrued	Foreign taxes paid or accrued								
		In foreign currency				In U.S. dollars				
		Taxes withheld at source on:				Taxes withheld at source on:				
	(o) Date paid or accrued	**(p)** Dividends	**(q)** Rents and royalties	**(r)** Interest	**(s)** Other foreign taxes paid or accrued	**(t)** Dividends	**(u)** Rents and royalties	**(v)** Interest	**(w)** Other foreign taxes paid or accrued	**(x)** Total foreign taxes paid or accrued (add cols. (t) through (w))
A	12/31/02				240				218	218
B										
C										

8 Add lines A through C, column (x). Enter the total here and on line 9, page 2 ▶ **8** 218

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Exercise 5 Form 1116

Form 1116 (2002) Page **2**

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	218		
10	Carryback or carryover (attach detailed computation)	10			
11	Add lines 9 and 10	11	218		
12	Reduction in foreign taxes (see page 13 of the instructions)	12			
13	Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit			13	218
14	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 page 14 of the instructions)	14	1,062		
15	Adjustments to line 14 (see page 14 of the instructions)	15			
16	Combine the amounts on lines 14 and 15. 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 17 through 21. However, if you are filing more than one Form 1116, you must complete line 19.)	16	1,062		
17	**Individuals:** Enter the amount from Form 1040, line 39. If you are a nonresident alien, enter the amount from Form 1040NR, line 37. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	17	51,400		
	Caution: *If you figured your tax using the special rates on capital gains, see page 15 of the instructions.*				
18	Divide line 16 by line 17. If line 16 is more than line 17, enter "1"			18	.0207
19	**Individuals:** Enter the amount from Form 1040, line 42. If you are a nonresident alien, enter the amount from Form 1040NR, line 40. **Estates and trusts:** Enter the total of Form 1041, Schedule G, lines 1a and 1b, or the total of Form 990-T, lines 36 and 37			19	9,421
20	Multiply line 19 by line 18 (maximum amount of credit)			20	195
21	Enter the **smaller** of line 13 or line 20. If this is the only Form 1116 you are filing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV (see page 15 of the instructions) ▶			21	195

Part IV **Summary of Credits From Separate Parts III** (see page 16 of the instructions)

22	Credit for taxes on passive income	22			
23	Credit for taxes on high withholding tax interest	23			
24	Credit for taxes on financial services income	24			
25	Credit for taxes on shipping income	25			
26	Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC	26			
27	Credit for taxes on lump-sum distributions	27			
28	Credit for taxes on certain income re-sourced by treaty	28			
29	Credit for taxes on general limitation income	29			
30	Add lines 22 through 29			30	
31	Enter the **smaller** of line 19 or line 30			31	195
32	Reduction of credit for international boycott operations. See instructions for line 12 on page 13			32	
33	Subtract line 32 from line 31. This is your **foreign tax credit.** Enter here and on Form 1040, line 45; Form 1040NR, line 43; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a ▶			33	195

Form **1116** (2002)

Exercise 5 – Calculations

Euro Conversion and U.S. Income

	Form 1040 Line #	Euros £		Conversion Rate		Dollars $
Item						
Wages (France)	7	137,500	x	0.90909	=	125,000
Interest (France)	8a	1,210	x	0.90909	=	1,100
Interest (U.S.)	8a					2,500
Net Rents (U.S.)	17					7,500
Foreign Income Exclusion	21					(80,000)
Total Income and AGI	22, 33, 34					56,100
Less - Standard Deduction	36					(4,700)
Balance	37					51,400
Less - Exemption	38					(3,000)
Taxable Income	39					48,400
Tax	40					9,421

Tax Allocation

	£	Rate	$
Taxes Paid	27,500	0.90909	25,000

Taxes allocated to Wages	(125,000 ÷ {125,000 + 1,100}) x 25,000	=	24,782
Taxes allocated to Interest	(1,100 ÷ {125,000 + 1,100}) x 25,000	=	218
Total Allocated Taxes			25,000

Reduction (Form 1116, Part III, Line 12)

(80,000 ÷ 125,000) x 24,782 $15,860

STUDENT NOTES

SELF EMPLOYMENT TAX

INTRODUCTION

The rules for paying self-employment tax are generally the same whether the taxpayer lives in the U.S. or abroad. This lesson covers who is considered to be a self-employed individual and who is subject to self-employment tax when abroad.

OBJECTIVES

At the end of this lesson you will be able to:

1. Determine who is a self-employed individual.
2. Compute the self-employment tax for a U.S. citizen or resident abroad.
3. Compute the deduction for self-employment tax.

EMPLOYEE OR SELF-EMPLOYED

A self-employed person is generally one who either:

1. Carries on a trade or business as a sole proprietor or independent contractor.
2. Is a member of a partnership that carries on a trade or business.
3. Otherwise in business for himself or herself.

SELF-EMPLOYMENT TAX

The self-employment tax is a social security tax for individuals who work for themselves. It is similar to the social security tax withheld from the pay of wage earners.

Social security benefits are available to individuals who are self-employed just as they are to wage earners. Payments of self-employment tax contribute to an individual’s coverage under the social security system.

Income Limits. You must pay self-employment tax if you have net earnings from self-employment of $400 or more a year.

Self-employment tax consists of two parts, social security and medicare. For 2002, social security tax is paid on the first $84,900 of net income. The medicare tax is imposed on the full amount of net income.

Note: If your self-employment income is $400 or more, you must file a return even though your income is below the minimum amount for income tax filing purposes.

Effect of Foreign Earned Income Exclusion. You must take all of your earned income into account in figuring your self-employment tax, even though the income is exempt from income tax because of the foreign earned income exclusion.

Example 1
You are in business abroad as a consultant and qualify for the foreign earned income exclusion. Your foreign earned income is $70,000, business expenses $20,000, resulting in net earnings of $50,000. You must pay self-employment tax on the net income even though you excluded all of your earned income.

Exemption from U.S. Self-Employment Tax. The United States may reach agreements with foreign countries to eliminate dual coverage and dual contributions (taxes) to social security systems for the same work. As a general rule, self-employed persons who are subject to dual taxation will only be covered by the social security system of the country where they reside.

For more information, consult Publication 54, "Tax Guide for U.S. Citizens and Resident Aliens Abroad."

TAX FORMS

Form 1040, U.S. Individual Income Tax Return, is used to report self-employment tax. Both income tax and self-employment tax are due at the same time. Schedule SE, Social Security Self-Employment Tax, is used to figure the tax. Even if the taxpayer is not otherwise required to file an income tax return, he or she must file both Form 1040 and Schedule SE to pay self-employment tax.

The Schedule SE includes a flowchart to determine if the short or long form is required.

REGULAR METHOD

Although there are three methods available to compute self-employment tax, VITA volunteers will only use the regular method. Taxpayers who wish to use the other methods should seek paid professional assistance. There are no limits on who may use the regular method. Most taxpayers use this method.

Under the regular method, the net income from your business or profession is generally your net self-employment earnings from Schedules C, C-EZ, F. and K-1 (Form 1065).

If you have more than one trade or business, your net earnings from self-employment are the combined net earnings from each of your businesses. A loss in one business will reduce the income earned in another. You must claim all allowable deductions including depreciation when figuring your net earnings from self-employment.

Even though the income may be exempt from income tax because of foreign earned income exclusion, you must take all of your earned income into account in figuring your self-employment tax. Refer to Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, regarding the effect of the foreign earned income exclusion on U.S. self-employment tax.

Example 1
Susan J. Brown is sole proprietor of a dress shop, “Milady Fashions.” Her Schedule C shows a net profit of $35,100. Susan’s completed Schedule SE is shown at the end of this section.

If Susan were the proprietor of more than one business, she would have combined the profits and losses from all of them and filled out only one Schedule SE. If, in addition to operating her dress shop, Susan had worked for wages totaling $84,900 or more, she would have already paid the maximum amount of social security tax owed on her wages, but she would still be subject to the medicare portion (2.9%) of self employment tax. In this case, she would use the long Schedule SE.

The line numbers shown below in bold type refer to the line numbers on the sample filled-in Schedule SE on the following page.

Line 1. Since Susan has no earnings from farm self-employment, she leaves line 1 blank.

Line 2. Susan enters the net profit from her Schedule C, $35,100.

Line 3. Since Susan has no farm income, she enters the same amount on line 3.

Line 4. Multiply the amount of line 3 by .9235 and enter the result.

Line 5. Susan determines her self-employment tax by using the first option on Line 5. She multiplies $32,415 on Line 4 by 15.3%. She enters $4,959 on Line 5. This is her self-employment tax. She also enters this amount on Line 47 of Form 1040.

SCHEDULE SE
(Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule SE (Form 1040).**

OMB No. 1545-0074
2002
Attachment
Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040): Susan Brown

Social security number of person with **self-employment** income ▶ 000 00 6193

Who Must File Schedule SE

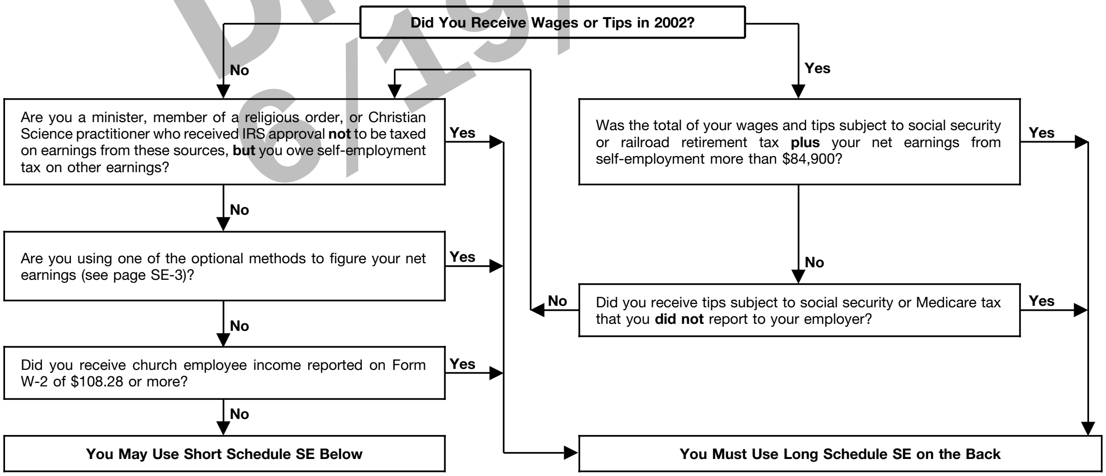
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 56.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a		1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report		2	35,100
3	Combine lines 1 and 2		3	35,100
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶		4	32,415
5	**Self-employment tax.** If the amount on line 4 is: • $84,900 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 56.** • More than $84,900, multiply line 4 by 2.9% (.029). Then, add $10,527.60 to the result. Enter the total here and on **Form 1040, line 56.**		5	4,959
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 29**	6 2,480		

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This deduction for one-half of the SE tax will reduce Susan's income subject to income tax. However, if all of Susan's self-employment income qualifies for the foreign earned income exclusion, this deduction is allocable to the excluded income and must be included on line 42 the Form 2555. This prevents the deduction from reducing other taxable income. See the earlier chapter on foreign earned income exclusion for additional information.

►► SUMMING UP THIS LESSON ◄◄

- As a volunteer assisting taxpayers abroad, you may be asked questions regarding self-employment tax. In this lesson you have learned how to determine if you are considered a self-employed individual and how to compute the self-employment tax.

SUMMARY EXERCISES

Exercise 1

You must pay self-employment tax if you have net earnings from self-employment of $________ or more year.

Exercise 2

John has a business abroad in 2002, as a private contractor and his self-employed income qualifies for the foreign earned income exclusion. His foreign earned income is $64,000, business expenses $19,000, and net earnings $45,000. Since his foreign earned income is completely excluded, is he liable for self-employment tax? If yes, what amount of income is subject to self-employment tax?

Exercise 3

The United States may reach agreements with foreign countries to eliminate dual coverage and dual contributions (taxes) to social security systems for the same work. These agreements may be applicable to self-employed persons.

True/False

Exercise 4

Janice Thompson is a self-employed baby-sitter overseas. She is a U.S. citizen living with her husband. He is a U.S. Army officer and also a U.S. citizen. She operates her sole proprietor babysitting service out of their off base apartment. She has no wage income. Her Schedule C shows a net profit of $9,500 in 2002. She qualifies for the foreign earned income exclusion. She receives no exemption from any agreement to exclude her self-employment tax.

Compute her self-employment tax for 2002 on the blank Schedule SE.

SCHEDULE SE
(Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

▶ Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).

OMB No. 1545-0074
2002
Attachment
Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040): Janice Thompson

Social security number of person with **self-employment** income ▶ 000 00 4921

Who Must File Schedule SE

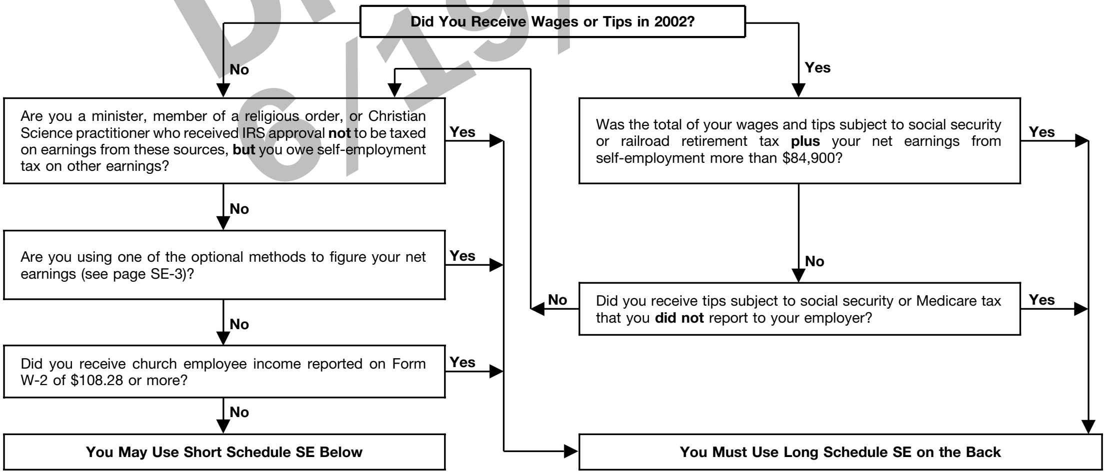
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 56.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1 Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a **1**

2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report **2**

3 Combine lines 1 and 2 . . . . **3**

4 **Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax . . . . ▶ **4**

5 **Self-employment tax.** If the amount on line 4 is:
- $84,900 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 56.**
- More than $84,900, multiply line 4 by 2.9% (.029). Then, add $10,527.60 to the result. Enter the total here and on **Form 1040, line 56.**

} . . . **5**

6 **Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 29** **6**

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2002**

SELF EMPLOYMENT TAX ANSWERS TO EXERCISES

Exercise 1

$400

Exercise 2

Yes

John must take all of his earned income into account in figuring his self-employment tax, even though the income is exempt from income tax because of the foreign earned income exclusion. John's $45,000 net earnings are subject to self-employment tax in 2002.

Exercise 3

True. Agreements may apply to self-employed persons.

SCHEDULE SE
(Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

▶ **Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).**

OMB No. 1545-0074
2002
Attachment
Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040): Janice Thompson

Social security number of person with **self-employment** income ▶ 000 00 4921

Who Must File Schedule SE

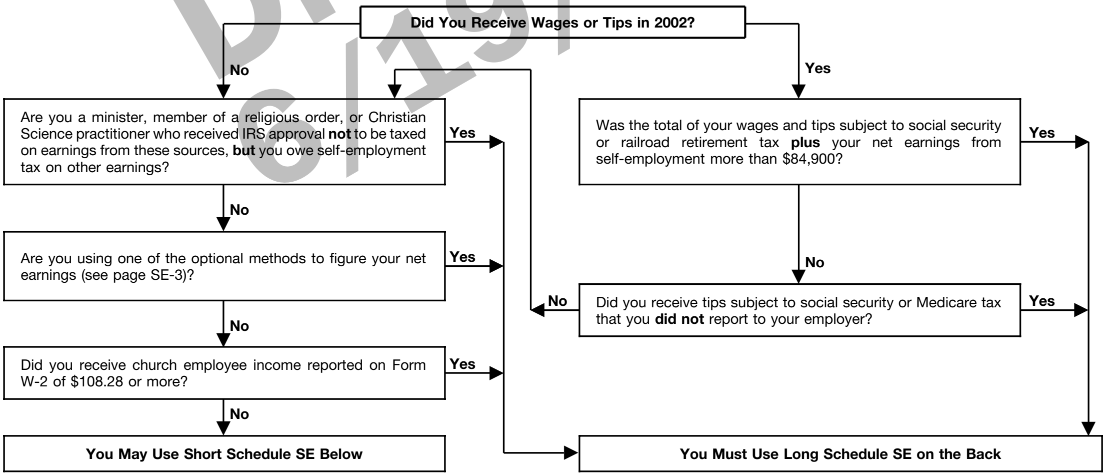
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 56.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	9,500	00
3	Combine lines 1 and 2	3	9,500	00
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	8,773	00
5	**Self-employment tax.** If the amount on line 4 is: • $84,900 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 56.** • More than $84,900, multiply line 4 by 2.9% (.029). Then, add $10,527.60 to the result. Enter the total here and on **Form 1040, line 56.**	5	1,342	00
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 29** — 6 — 671 00			

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2002**

TRAVEL EXPENSES

INTRODUCTION

This section will deal with the expenses of an individual who is an employee and who has incurred employee business expenses.

OBJECTIVES

1. Determine when employee business expenses are deductible.
2. Determine what expenses are deductible.
3. Determine how to report the expenses.
4. Complete Form 2106 "Employee Business Expenses".
5. Determine how to complete the expenses when the taxpayer is eligible and elects to take the foreign earned income exclusion.

TRAVEL EXPENSES

Travel expenses incurred must be ordinary and necessary when carrying out the duties of your employer while away from your home, for your job. Ordinary expenses are those that are customary for the type of travel being done. Necessary expenses are those that are appropriate and helpful to achieving the purpose of the travel. Treatment of the various expenses, allowances, and reimbursements depends on whether allowances and reimbursements were received and whether the expenses were more than allowances and reimbursements, or whether the allowances and reimbursements were more than the expenses. It also depends on whether or not your employer included these allowances and reimbursements as income on Form W-2. These situations will be discussed in this lesson.

Away from Home Overnight. For costs other than transportation the taxpayer must be "away from his tax home overnight". "Tax Home" is defined as the taxpayer's main place of business. "Overnight" is defined as a period substantially longer than an ordinary day's work during which the taxpayer would need time off for sleep or rest.

Example 1
You live with your family in Manchester, England, but work in London where you have lodging and meal expenses during the week. You travel back and forth from London to Manchester on weekends. You may not deduct any of your expenses for travel, meals, and lodging in London because that is your main place of business and the travel on weekends is not for business reasons.

DEDUCTIBLE EXPENSES

Travel expenses that are ordinary and necessary while traveling away from your home for business purposes include such things as:

1. Air, rail and bus transportation,
2. Operating and maintaining your car,
3. Taxi fares or other costs of transportation between the airport or station and your hotel, from one customer to another, or from one place of business to another.
4. Transportation from the place where you eat and sleep to your temporary work assignment,
5. Baggage and charges and transportation costs for sample and display material,
6. Meals and lodging when you are away from home on business.
7. Cleaning and laundry expenses,
8. Telephone and telegraph expenses,
9. Public stenographer's fees,
10. Operating and maintaining house trailers,
11. Tips that are incidental to any of these expenses, and
12. Other ordinary and necessary expenses related to travel.

Car Expenses. If you use your car for business purposes you are entitled to the actual expenses which would include such things as gas, oil, repairs, insurance and depreciation on your car or, you can use the standard mileage rate. The standard mileage rate is 36.5 cents per mile for 2002. If you use the car for both business and personal mileage you should maintain a log book. You will have to allocate the expenses between business and personal use. If you lease a car to use for qualified business expenses you may have to include an amount called the inclusion amount in your income, depending on the FMV of the vehicle (for more information on deducting actual car expenses see Publication 463).

Meal Expense. Expenses for meals claimed on a taxpayer's return are only 50% deductible. When an employee is reimbursed for substantiated meal expenses, the reimbursement will generally be nontaxable and the expenses will not be claimed.

HOW TO REPORT

The following discusses how the taxpayer should report his/her allowable expenses for travel, meals & lodging. Self-employed individuals must report their expenses on the appropriate form used to report their business income and expenses by using Schedule C, Form 1040. Employees, including outside sales persons, must complete Form 2106, Employee Business Expenses, and attach it to their Form 1040 to claim these expenses.

Expenses paid by an employee under a "reimbursement or other expense allowance arrangement" with an employer generally do not need to be claimed and the employer will not include the reimbursement as taxable income on the employee's Form W-2. To qualify as nontaxable reimbursements, the arrangement must require that the employee substantiate the expenses to the employer and return any excess reimbursements. Per Diem or other fixed allowance reimbursements that are similar to allowances specified by the Federal government will also be nontaxable to the extent that the amounts do not exceed government rates.

Form 2106 needs to be completed if:

1. The taxpayer received a reimbursement or an allowance and the employer included the amount on Form W-2, or a Form 1099 as taxable income,
2. The taxpayer seeks to deduct expenses in excess of the amounts paid under a reimbursement allowance arrangement,
3. The taxpayer received no reimbursement for his or her employee business expenses, or,
4. The taxpayer received reimbursement or an allowance and did not account to his or her employer for the expenses.

If the expenses equal the reimbursements and the taxpayer accounted to his or her employer, the taxpayer does not have to complete Form 2106 unless item (1) above applies.

Example 2

George Grant has incurred qualified employee business expenses. His company's policy is that all employees must turn in a travel voucher showing all expenses incurred and the company reimburses the employee an amount equal to the expenses. George does not have to file a Form 2106 because he reports directly to his employer and is reimbursed in full.

Example 3

Judy Coe incurred employee business expenses of $1,500. Her W-2 shows that her employer reimbursed Judy $2,000. Judy will have to file Form 2106 and claim $1,500.00 as an employee business expense on Form 2106 subject to the 50% meals limitation and 2% limitation on Schedule A. The entire $2,000 reimbursement must be reported as income on line 7, Form 1040.

Claiming Employee Business Expenses on Form 1040. The taxpayer can only claim employee business expenses on Form 1040 as a miscellaneous itemized deduction subject to the overall 2% limitation. Exceptions are provided for certain government officials, qualified performing artists, and individuals with a disability. For more information on these exceptions see the instructions for Form 2106.

Example 4

Frank Falls has a total of $2,000 of unreimbursed employee business expenses after reducing meals by 50% and no other miscellaneous itemized deductions. His total adjusted gross income is $52,000. Frank is entitled to a total of $960 as a miscellaneous itemized deduction. (2,000 – [52,000 x .02] = $960)

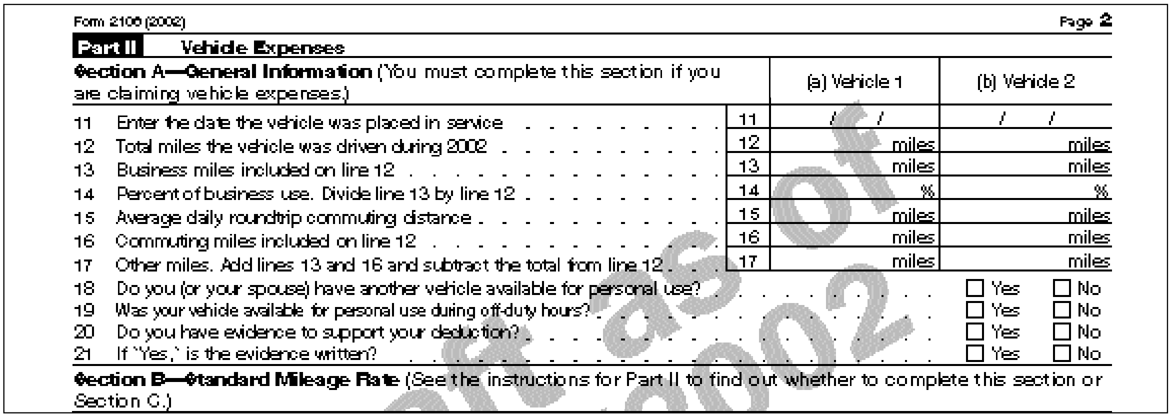
FORM 2106

Form 2106 is divided into 2 parts. Part I deals with all the expenses and Part II deals specifically with car expenses. Part II should be completed, if applicable, before entering an amount in Line 1, Part I.

Look at Part II section A. This section deals with general information about the vehicle and is self-explanatory. The taxpayer should have this information from his or her records to assist you in preparing the form.

Exhibit 1

Form 2106, Part II



Form 2106 (2002) Page **2**

Part II **Vehicle Expenses**

	Section A—General Information (You must complete this section if you are claiming vehicle expenses.)		(a) Vehicle 1	(b) Vehicle 2
11	Enter the date the vehicle was placed in service	11	/ /	/ /
12	Total miles the vehicle was driven during 2002	12	miles	miles
13	Business miles included on line 12	13	miles	miles
14	Percent of business use. Divide line 13 by line 12	14	%	%
15	Average daily roundtrip commuting distance	15	miles	miles
16	Commuting miles included on line 12	16	miles	miles
17	Other miles. Add lines 13 and 16 and subtract the total from line 12	17	miles	miles

18 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

19 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

20 Do you have evidence to support your deduction? ☐ Yes ☐ No

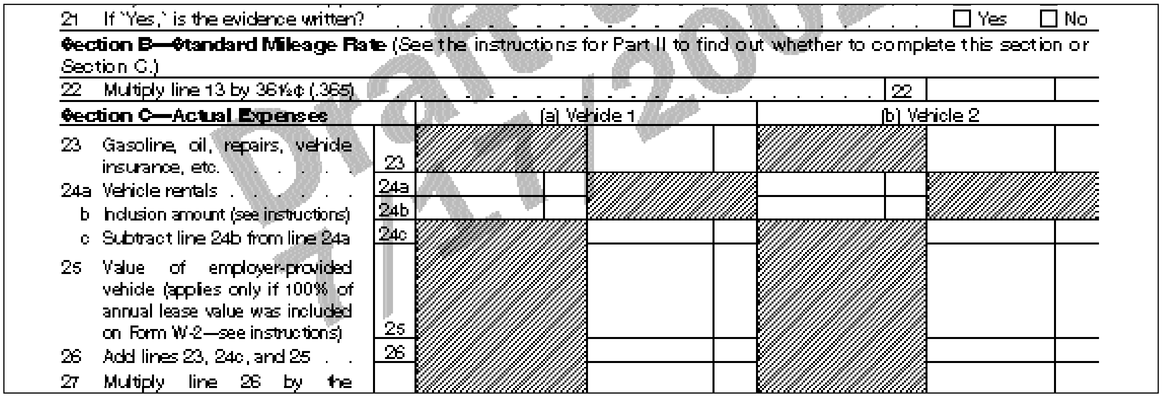
21 If "Yes," is the evidence written? ☐ Yes ☐ No

Section B—Standard Mileage Rate (See the instructions for Part II to find out whether to complete this section or Section C.)

Part II, section B. of Form 2106 will be used if the taxpayer owns the vehicle and chooses, or has previously chosen, to use the standard mileage rate for the same vehicle.

Exhibit 2

Form 2106, Part II



21 If "Yes," is the evidence written? . . . . ☐ Yes ☐ No

Section B—Standard Mileage Rate (See the instructions for Part II to find out whether to complete this section or Section C.)

22 Multiply line 13 by 36½¢ (.365) 22

Section C—Actual Expenses		(a) Vehicle 1		(b) Vehicle 2	
23 Gasoline, oil, repairs, vehicle insurance, etc.	23	▨		▨	
24a Vehicle rentals	24a		▨		▨
b Inclusion amount (see instructions)	24b		▨		▨
c Subtract line 24b from line 24a	24c	▨		▨	
25 Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions)	25	▨		▨	
26 Add lines 23, 24c, and 25 . .	26	▨		▨	
27 Multiply line 26 by the		▨		▨	

As mentioned previously the taxpayer is entitled to 36.5¢ per mile for business mileage. The business standard mileage rate may not be used to compute the deductible expenses of vehicles used for hire, such as taxicabs, two or more automobiles used simultaneously (such as fleet operations), or any vehicle that is leased, rather than owned, by the taxpayer. The business standard mileage rate may not be used if the automobile has previously been depreciated using a method other than straight-line for its estimated useful life. The standard rate may not be used if additional first-year depreciation has been claimed, or if the taxpayer used ACRS or MACRS depreciation.

For those taxpayers who are using the actual expense method, vehicles placed in service after September 10, 2001 are eligible for the additional 30% depreciation and an increased first year deduction. Property placed in service outside of the U.S. must be depreciated using the straight-line method.

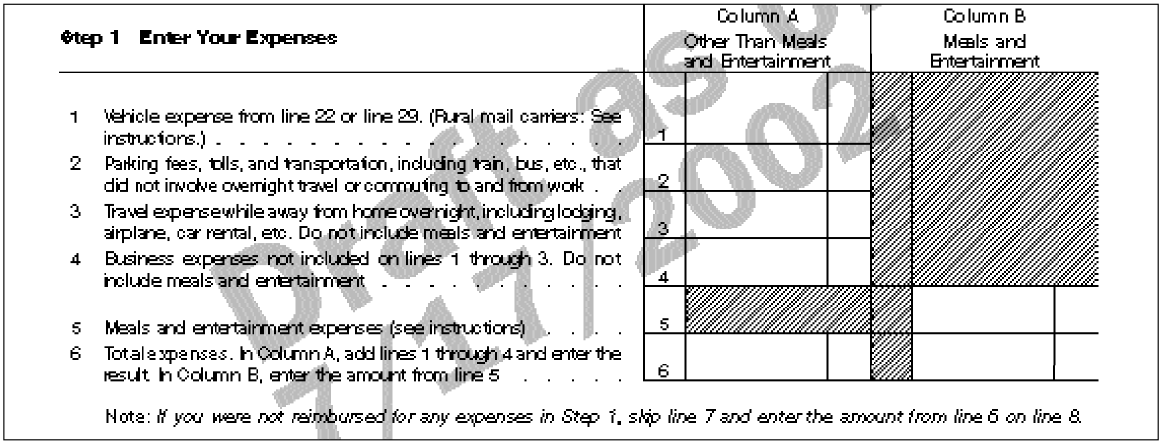
If, after using the business standard mileage rate, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's estimated useful life.

Section C of Part II, Form 2106 deals with the actual expenses incurred. The taxpayer would have to give you this information from his or her records for you to assist in preparing the Form 2106. Since this section deals with depreciation you should advise the taxpayer to seek professional assistance. The amount from line 29 Part II is carried to the front of Form 2106 and placed on line 1.

The front side of Form 2106 is divided into 3 steps, Let's look at each step and how it will apply to the taxpayer.

Exhibit 3

Form 2106



Step 1 Enter Your Expenses		Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1		▨
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2		▨
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3		▨
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4		▨
5 Meals and entertainment expenses (see instructions)	5	▨	
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6		

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 1 of Form 2106 is used to summarize the employee business expenses of the taxpayer. Column A is used for all expenses except meals and entertainment. Column B is used only for meals and entertainment expenses. Step 1 must always be filled out. (Note: If the employer did not reimburse the employee for any of the expenses, skip Step 2 and go directly to Step 3 to figure the amount deductible.

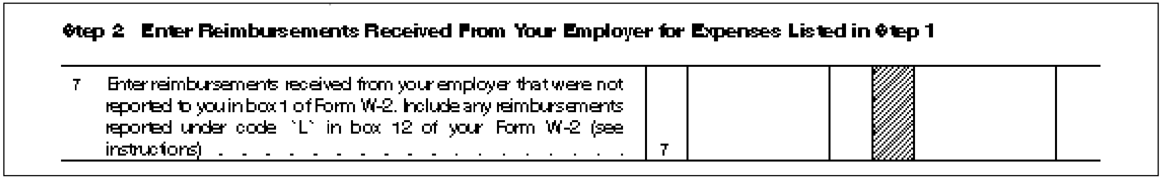
Step 2 is filled out only if the taxpayer is reimbursed by the employer and the reimbursement is not shown as income to the taxpayer on a Form W-2 or Form 1099, and the employee seeks a deduction for additional expenses not paid by the employer. On line 7, only include amounts from Box 13 of Form W-2 identified as code "L".

Many overseas employees will receive Forms W-2 reflecting only a portion of their total compensation while others will receive no Form W-2 at all.

Reimbursements received under a reimbursement arrangement described above need not be shown as income on Form 1040 and will be reflected on Form 2106, line 7 only if additional expenses are claimed. Reimbursements for the unsubstantiated travel expenses must be included as income on Form 1040 and will not be included in Step 2 of Form 2106.

Exhibit 4

Form 2106, Step 2

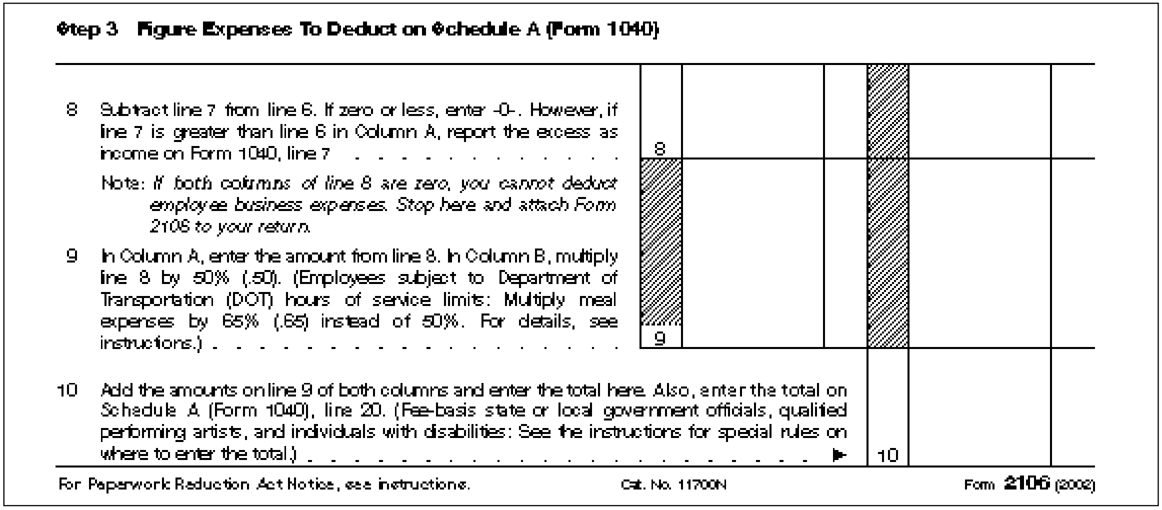


Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1			
7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7		▨

Step 3 is used when the employer did not reimburse the employee in full. This section will show how much the taxpayer is allowed as a miscellaneous itemized deduction on the taxpayer's Schedule A Form 1040. This amount will be reduced by 2% of the taxpayer's adjusted gross income unless the taxpayer is a qualified performing artist.

Exhibit 5

Form 2106 Step 3



Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 8

Note: *If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*

9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) instead of 50%. For details, see instructions.) 9

10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter the total.) . . . . ▶ 10

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (2002)

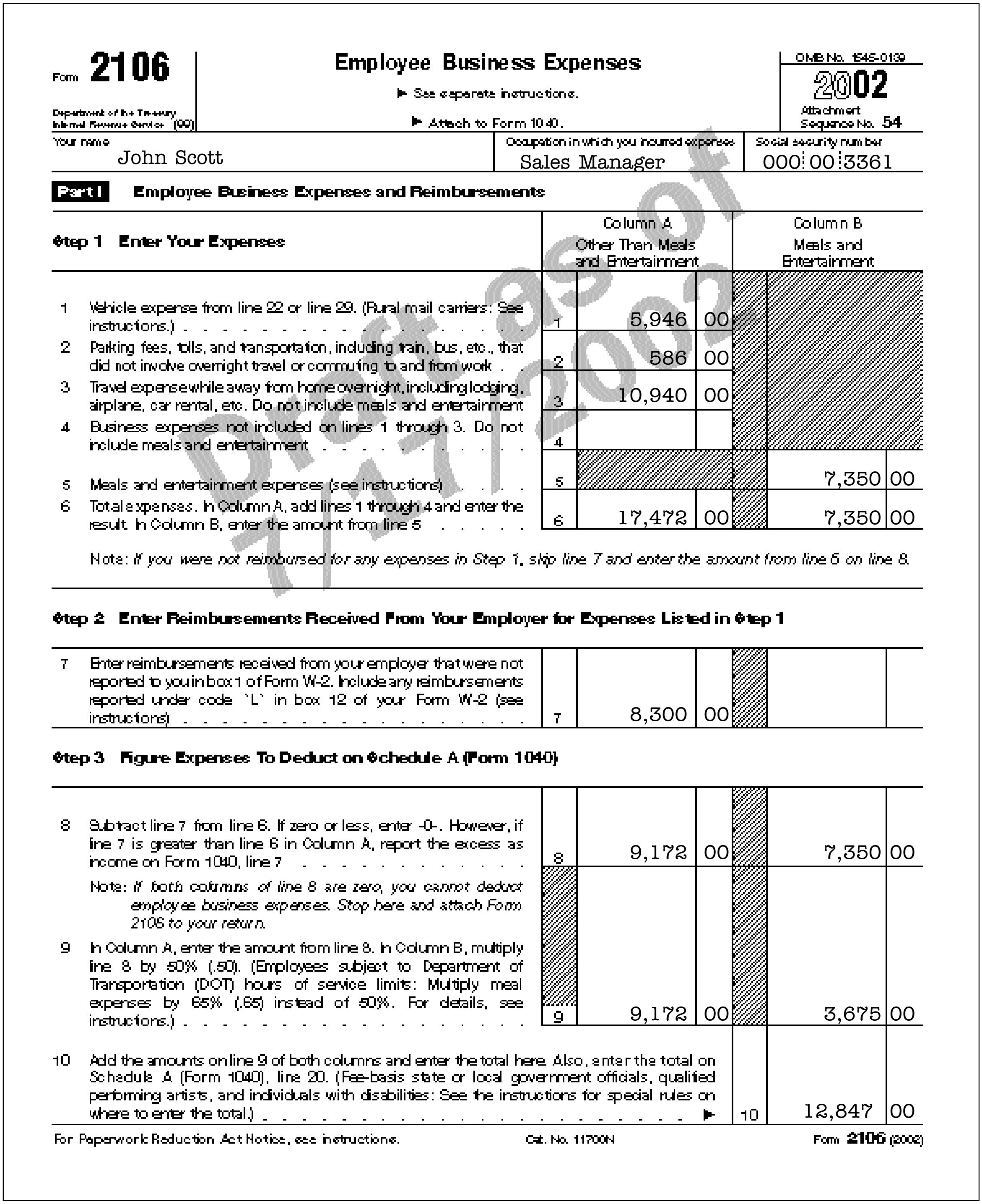
Example 5

John Scott is a U.S. citizen and an employee for an English company. He normally works out of their London office. However, John was temporarily assigned to the Paris office for the last 7 months of 2002. He had his car sent there so he can carry out his duties. He purchased the car on 6-1-2001, and did incur employee business expenses for that year. He elected in 2001 to use the standard mileage rate on his 2001 tax return. While in France he did some sight-seeing and had recorded personal mileage. John incurred the following expenses during 2002:

Lodging—$10,640
Meals—$7,350
Transportation to & from Paris office from London office—$300
Total mileage on car for 2002—23,720
Average daily roundtrip commute—10 miles
Commuting mileage for 2002—1,530
Business mileage—16,290
Parking fees & tolls—$586

John is reimbursed $8,300 for lodging and $4,000 for meals. The $4,000 for the meals is shown as income on John's W-2 Form. The $8,300 is not shown as taxable income on John's Form W-2 because the lodging expenses were properly accounted for. See Exhibit 1 for how the Form 2106 would be filled out.

Exhibit 6 Form 2106



Form **2106**

Department of the Treasury
Internal Revenue Service (99)

Employee Business Expenses

▶ See separate instructions.

▶ Attach to Form 1040.

OMB No. 1545-0139

2002

Attachment Sequence No. **54**

Your name	Occupation in which you incurred expenses	Social security number
John Scott	Sales Manager	000 00 3361

Part I **Employee Business Expenses and Reimbursements**

Step 1 Enter Your Expenses		Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1	5,946 00	▨
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	586 00	▨
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	10,940 00	▨
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4		▨
5 Meals and entertainment expenses (see instructions)	5	▨	7,350 00
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	17,472 00	7,350 00

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7	8,300 00	

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8	9,172 00	7,350 00
Note: *If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*			
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) instead of 50%. For details, see instructions.)	9	9,172 00	3,675 00
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10		12,847 00

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (2002)

Form 2106 (2002) Page **2**

Part II Vehicle Expenses

Section A—General Information (You must complete this section if you are claiming vehicle expenses.)

			(a) Vehicle 1	(b) Vehicle 2
11	Enter the date the vehicle was placed in service	11	6 / 1 / 01	/ /
12	Total miles the vehicle was driven during 2002	12	23,720 miles	miles
13	Business miles included on line 12	13	16,290 miles	miles
14	Percent of business use. Divide line 13 by line 12	14	64 %	%
15	Average daily roundtrip commuting distance	15	10 miles	miles
16	Commuting miles included on line 12	16	1,530 miles	miles
17	Other miles. Add lines 13 and 16 and subtract the total from line 12	17	5,900 miles	miles

18 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☒ No

19 Was your vehicle available for personal use during off-duty hours? ☒ Yes ☐ No

20 Do you have evidence to support your deduction? ☒ Yes ☐ No

21 If "Yes," is the evidence written? ☒ Yes ☐ No

Section B—Standard Mileage Rate (See the instructions for Part II to find out whether to complete this section or Section C.)

22 Multiply line 13 by 36½¢ (.365) 22 5,946 00

Section C—Actual Expenses

			(a) Vehicle 1		(b) Vehicle 2	
23	Gasoline, oil, repairs, vehicle insurance, etc.	23				
24a	Vehicle rentals	24a				
b	Inclusion amount (see instructions)	24b				
c	Subtract line 24b from line 24a	24c				
25	Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions)	25				
26	Add lines 23, 24c, and 25	26				
27	Multiply line 26 by the percentage on line 14	27				
28	Depreciation. Enter amount from line 38 below	28				
29	Add lines 27 and 28. Enter total here and on line 1	29				

Section D—Depreciation of Vehicles (Use this section only if you owned the vehicle and are completing Section C for the vehicle.)

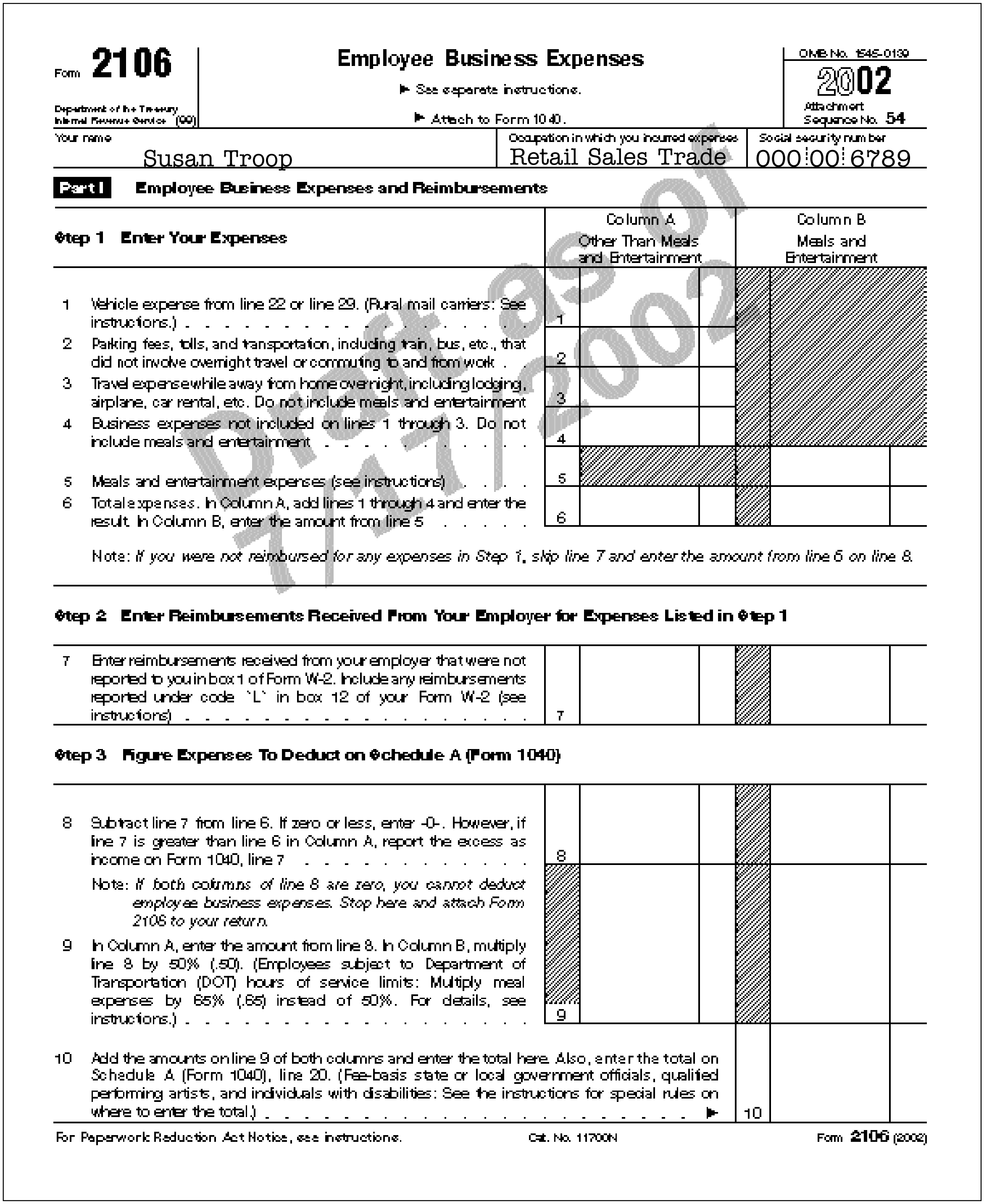
			(a) Vehicle 1		(b) Vehicle 2	
30	Enter cost or other basis (see instructions)	30				
31	Enter section 179 deduction and special allowance (see instructions)	31				
32	Multiply line 30 by line 14 (see instructions if you claimed the section 179 deduction or special allowance)	32				
33	Enter depreciation method and percentage (see instructions)	33				
34	Multiply line 32 by the percentage on line 33 (see instructions)	34				
35	Add lines 31 and 34	35				
36	Enter the limit from the table in the line 36 instructions	36				
37	Multiply line 36 by the percentage on line 14	37				
38	Enter the smaller of line 35 or line 37. Also enter this amount on line 28 above	38				

Form **2106** (2002)

As you can see from the exhibit, the total expenses in Column A are reduced by the $8,300 reimbursement not included as taxable income on John's W-2. He will be entitled to an itemized miscellaneous deduction of $12,847. If John's adjusted gross income was $60,000, John would have to reduce the $12,847 by $1,200 ($60,000 x .02) giving him a total of $11,674 as a net miscellaneous deduction if John had no other miscellaneous deductions.

Exercise 1

Susan Troop, social security number 000-00-6789, works in Manila and is temporarily assigned to her company's Tokyo, Japan office. Her round trip air fare is $375. She also incurred lodging expenses of $2,760 and meal expenses of $1,420. She used mass transportation while in Tokyo and spent $357. Her employer, who is in the retail sales trade, did not reimburse her for any of the expenses. Complete the Form 2106 for Susan Troop.



Form **2106**

Department of the Treasury
Internal Revenue Service (99)

Employee Business Expenses

► See separate instructions.

► Attach to Form 1040.

OMB No. 1545-0139

2002

Attachment Sequence No. **54**

Your name: Susan Troop

Occupation in which you incurred expenses: Retail Sales Trade

Social security number: 000 00 6789

Part I **Employee Business Expenses and Reimbursements**

Step 1 Enter Your Expenses		Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1		▨
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2		▨
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3		▨
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4		▨
5 Meals and entertainment expenses (see instructions)	5	▨	
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6		

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1			
7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7		

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)			
8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8		
Note: *If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.* 9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) instead of 50%. For details, see instructions.)	9		
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ►	10		

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11700N Form **2106** (2002)

FOREIGN EARNED INCOME EXCLUSION

If the taxpayer is eligible and elects the foreign earned income exclusion he or she must adjust the amount of the business deductions related to the income excluded. The disallowed portion of the expenses is calculated by dividing the excluded foreign earned income by total foreign earned income.

Example 6
Harold Will is a U.S. citizen, employed as a salesperson in a foreign country and is eligible and elects to exclude $78,000 of his $98,500 a year salary. His AGI is $30,000. He had a total of $2,000 of unreimbursed employee business expenses of which $500 was for meals; these expenses are deductible only as miscellaneous itemized deductions on Schedule A (Form 1040). First, it is necessary to complete Form 2106. On that form Harold reduces the meal expenses by 50% of the $500 amount spent, yielding a total of $1,750 ($250 & $1,500).

Harold must reduce the $1,750 by 79% (78,000/98,500) because he excluded 79% of his earned income. Thus $1,383 of his expenses are not deductible. Harold carries the $367 ($1,750 – $1,383) deductible amount to Schedule A.

Harold also has $500 of other miscellaneous deductions subject to the 2% of AGI limit. He adds the $367 from Form 2106 plus the $500 for a total of $867 miscellaneous expenses. 2% of Harold's AGI is $600 (.02 x 30,000). Harold's deductible miscellaneous itemized deductions are $267 ($867 – $600).

If Harold did not have the other miscellaneous expenses of $500 he would not have been able to claim any miscellaneous deductions. His remaining expenses ($367) would have been less than 2% of his AGI ($600).

SUMMARY EXERCISES

1. Which of the following taxpayers would be entitled to employee business expenses and if so indicate the type of expense?

Vehicle expenses
Lodging
Meals
Travel

a. Joseph Fulton works in London and drives from and to his house every day.

Answer____

b. Mary Banks works in Paris and had to go to Lyon for the day to conduct business. She returns home to Paris that evening. She used her car.

Answer____

c. Alice Canton is a nurse working in Rome, Italy. Her employer gives her a temporary assignment for 2 months in Oslo, Norway.

Answer____

2. What form do you use to calculate a taxpayer's employee business expenses?

Answer____

3. When are employee business expense reimbursements not included in gross income?

Answer____

4. When are the employee business expenses itemized miscellaneous deductions?

Answer____

5. How are reimbursements that are more than expenses incurred treated?

Answer____

►► SUMMING UP THIS LESSON ◄◄

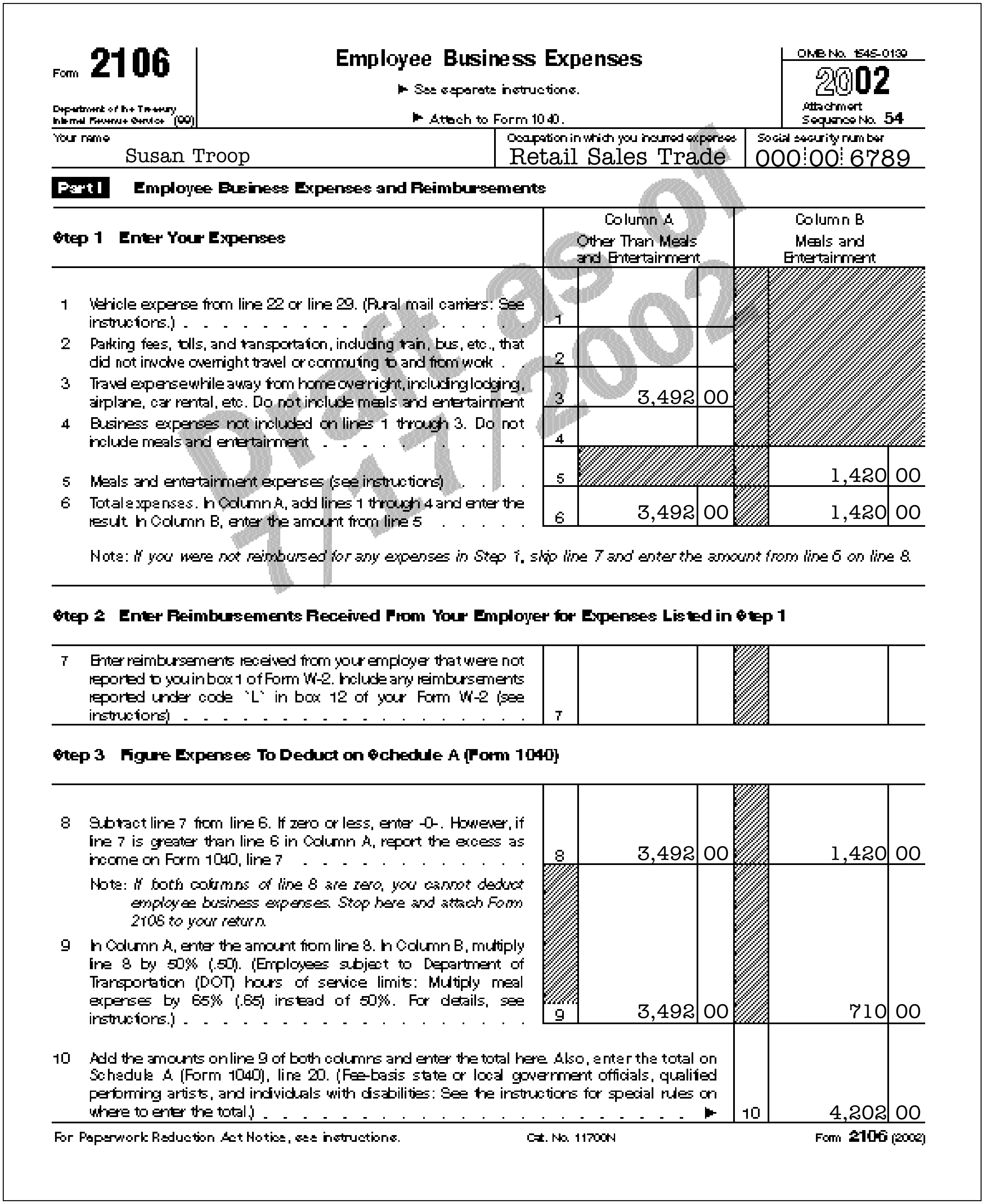
Reimbursements from an accountable plan for substantiated employee business expenses are not included as income on the employee's return if the employee is required to return, and does return, any excess reimbursements.

- ▶ If the reimbursements are included as income, deductible expenses are allowed as miscellaneous itemized deductions subject to the 2% limitation.
- ▶ Travel expenses for meals, lodging and incidentals must be incurred while "away from home overnight" to be deductible.
- ▶ Form 2106 is used to calculate the amount of itemized deductions that are in excess of reimbursements.
- ▶ If reimbursements exceed expenses, the excess is income to the employee and must be reported on Form 1040. (If reimbursements exceed expenses it is probably a nonaccountable plan, and therefore the entire reimbursement is taxable).
- ▶ If it is the company's policy for the employees to account for business expenses to the employer by supplying the employer with documented evidence and the employer reimburses the employee for the amount in full, Form 2106 is not required.

If the taxpayer is eligible for and elects the foreign earned income exclusion, certain adjustments must be made to the gross amount deductible as employee business expenses.

Answer to Exercise 1

Form 2106



Form **2106**

Department of the Treasury
Internal Revenue Service (99)

Employee Business Expenses

▶ See separate instructions.

▶ Attach to Form 1040.

OMB No. 1545-0139

2002

Attachment
Sequence No. **54**

Your name: Susan Troop

Occupation in which you incurred expenses: Retail Sales Trade

Social security number: 000 00 6789

Part I **Employee Business Expenses and Reimbursements**

Step 1 Enter Your Expenses		Column A Other Than Meals and Entertainment		Column B Meals and Entertainment	
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1			▨	▨
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2			▨	▨
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	3,492	00	▨	▨
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4			▨	▨
5 Meals and entertainment expenses (see instructions)	5	▨	▨	1,420	00
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	3,492	00	1,420	00

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7				

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8	3,492	00	1,420	00
Note: *If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*					
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) instead of 50%. For details, see instructions.)	9	3,492	00	710	00
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶			10	4,202	00

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TRAVEL EXPENSES
ANSWERS TO SUMMARY EXERCISES

1. **a.)** No (They are commuting expenses)

   b.) Yes. Vehicle expense

   c.) Yes. Travel, lodging, meals.

2. Form 2106

3. When the employee is required to substantiate his business expenses under a reimbursement arrangement and return any excess allowance to his employer. Also, Per Diem reimbursements that are similar to allowances specified by the Federal government will be nontaxable to the extent that the amounts do not exceed government rates.

4. When the expenses are more than the amount reimbursed. Itemized deductions are also created in the case of an employee reimbursed under a nonaccountable plan.

5. They are treated as income and shown on line 7 of Form 1040. If reimbursement in excess of expenses exists, the plan is probably a nonaccountable one, and therefore the entire reimbursement is taxable—not just the excess.

HOME LEAVE

INTRODUCTION

In a previous lesson you learned that employees are entitled to deduct certain expenses for conducting business while away from their main place of work. This lesson will deal with certain business expenses while traveling at home in the United States.

OBJECTIVES

1. Determine who is eligible for home leave expenses.
2. Determine what expenses are deductible.

HOME LEAVE

Section 903 of the Foreign Service Act of 1980 provides that the head of a Foreign Affairs Agency may order a member of the Service who is a citizen of the United States to take home leave upon completion of 18 months of continuous service abroad; and shall so order as soon as possible after completion of 3 years of continuous service abroad. The intent of this legislation is to "re-Americanize" foreign service employees.

Because members of the foreign service are required by law to take a leave of absence, they are allowed to deduct amounts paid for travel, meals, and lodging while on home leave as employee business expenses. The taxpayers who are eligible for this leave will deduct these expenses on a Form 2106 just like an employee that is conducting business away from the home.

As with all deductible employee business expenses, records and receipts must be maintained to support the deductions that are taken. The deductible expenses are those we discussed in the previous lesson and these expenses are subject to the same limitations.

Any expenses paid for on behalf of a foreign service member's family are personal expenses and therefore are not deductible.

►► SUMMING UP THIS LESSON ◄◄

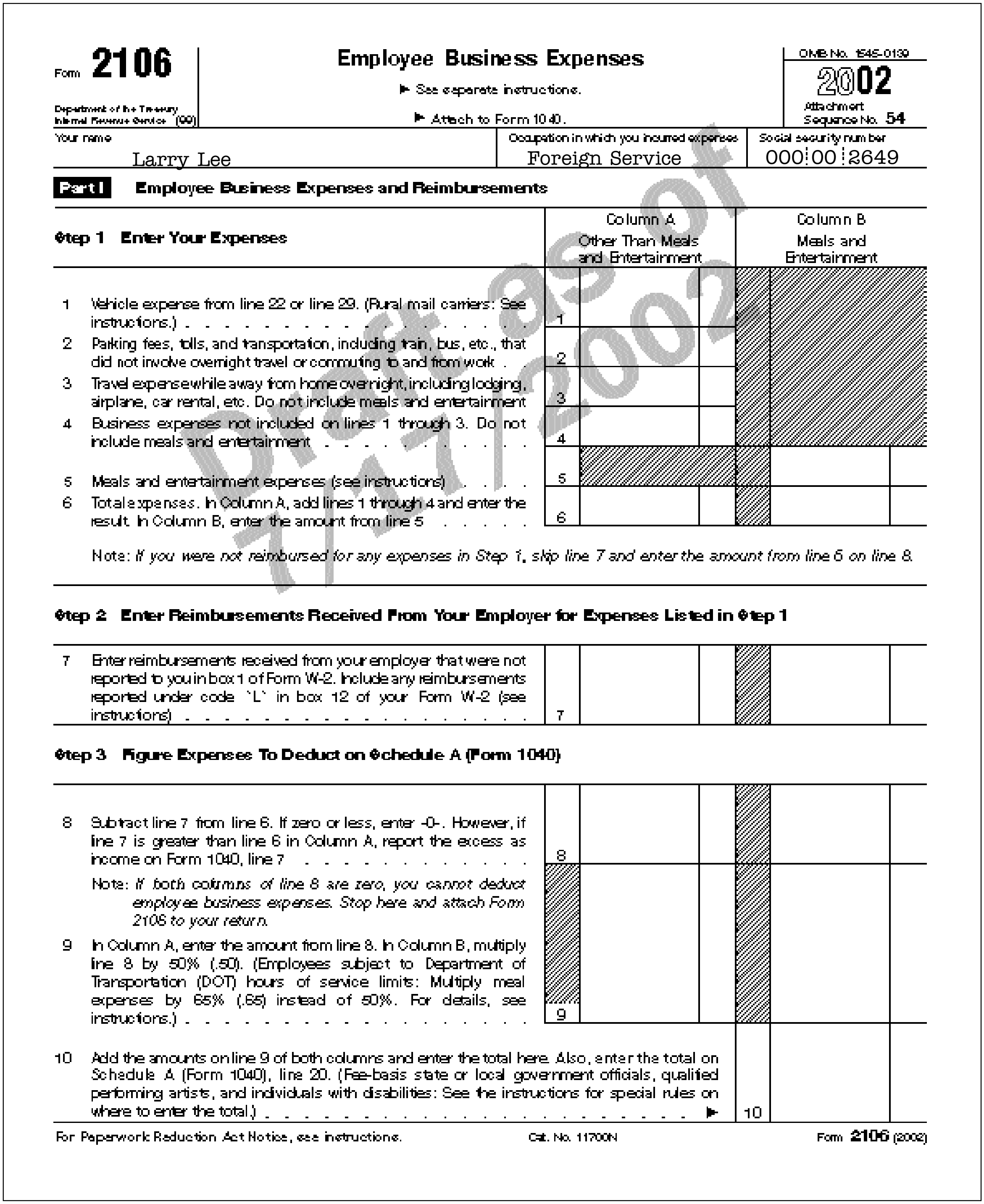
- ▶ Taxpayers who are U.S. citizens and members of the foreign service can deduct travel, meals and lodging expenses, while on home leave, as employee business expenses by using Form 2106.
- ▶ Expenses incurred by members of the family are personal expenses and therefore they are not deductible.

SUMMARY EXERCISE

1. Larry Lee is a foreign service employee. He has been stationed in a foreign country for 3 years and comes back to the United States for 4 weeks on home leave. His family accompanies him. He incurred expenses for travel of $1,500; meals $850; and lodging $1,400. His family incurred expenses for travel of $2,500; meals $1,700; and lodging $2,200 Larry was reimbursed $450 for his travel to and from his post of duty and did not show it as income. (Larry rented a car. He did not use his own car.)

   a. Is Larry eligible for a home leave deduction? Yes or No.
   b. Can Larry deduct the expenses that this family members incur? Yes or No.
   c. Complete Form 2106.

Answer to Exercise 1



Form **2106**

Department of the Treasury
Internal Revenue Service (99)

Employee Business Expenses

▶ See separate instructions.

▶ Attach to Form 1040.

OMB No. 1545-0139

2002

Attachment Sequence No. **54**

Your name: Larry Lee

Occupation in which you incurred expenses: Foreign Service

Social security number: 000 00 2649

Part I **Employee Business Expenses and Reimbursements**

Step 1 Enter Your Expenses		Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1		
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2		
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3		
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4		
5 Meals and entertainment expenses (see instructions)	5		
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6		

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7		

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8		
Note: *If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*			
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) instead of 50%. For details, see instructions.)	9		
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶		10	

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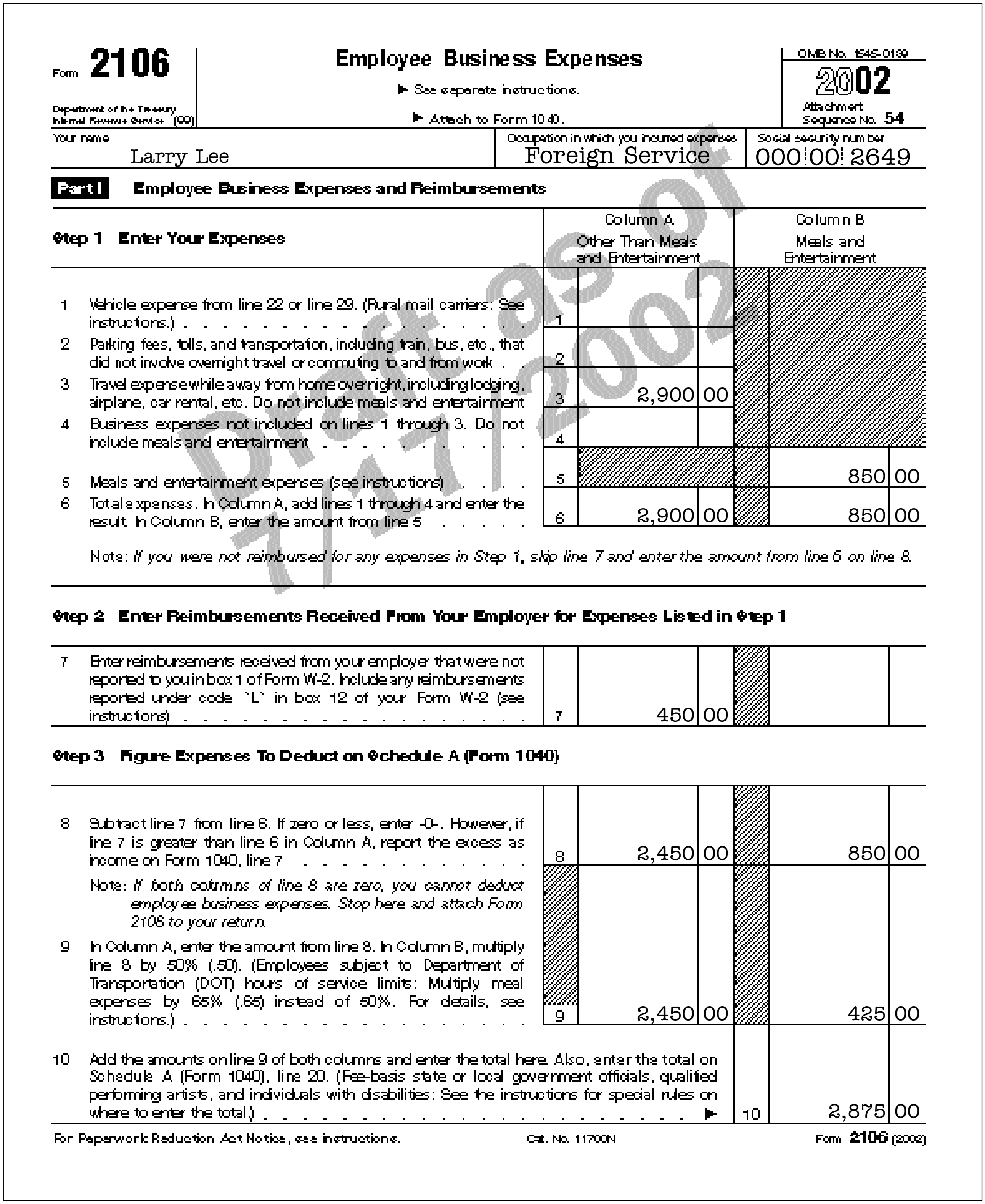
HOME LEAVE

ANSWERS TO EXERCISES

1. **a.** Yes
   b. No
   c. See completed Form 2106



Form **2106**

Department of the Treasury
Internal Revenue Service (99)

Employee Business Expenses

► See separate instructions.

► Attach to Form 1040.

OMB No. 1545-0139

2002

Attachment Sequence No. **54**

Your name: Larry Lee

Occupation in which you incurred expenses: Foreign Service

Social security number: 000 00 2649

Part I **Employee Business Expenses and Reimbursements**

			Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
Step 1 Enter Your Expenses				
1	Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1		▨
2	Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2		▨
3	Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	2,900 00	▨
4	Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4		▨
5	Meals and entertainment expenses (see instructions)	5	▨	850 00
6	Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	2,900 00	850 00

Note: *If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.*

Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1				
7	Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions)	7	450 00	
Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)				
8	Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7	8	2,450 00	850 00
	Note: *If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.*			
9	In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) instead of 50%. For details, see instructions.)	9	2,450 00	425 00
10	Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20. (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ►	10		2,875 00

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STUDENT NOTES

LESSON 10

RENTAL INCOME AND EXPENSES

INTRODUCTION

Generally, you must include in gross income all amounts received from rental properties, including rental receipts received from your former residence. Both United States citizens and resident aliens must report rental income, regardless whether the rental property is located in the United States or in a foreign country. Rental income and expenses are reported on Schedule E (Form 1040), Supplemental Income Schedule, Part 1. Additional information on rental income can be found in Publication 527, "Residential Rental Property," and Publication 946, "How to Depreciate Property." The lesson, "Rental Income and Expenses," defines rental income, discusses rental expenses, and how to report these items on the return.

OBJECTIVES

At the end of this lesson you will be able to:

1. Determine how to report rental income.
2. Determine how to report rental expenses.
3. Determine how to report rental income when property is used for personal purposes either part of the year or during the entire year.
4. Determine how to compute deductible depreciation expense.
5. Identify the application of at-risk and passive activity rules.

RENTAL INCOME

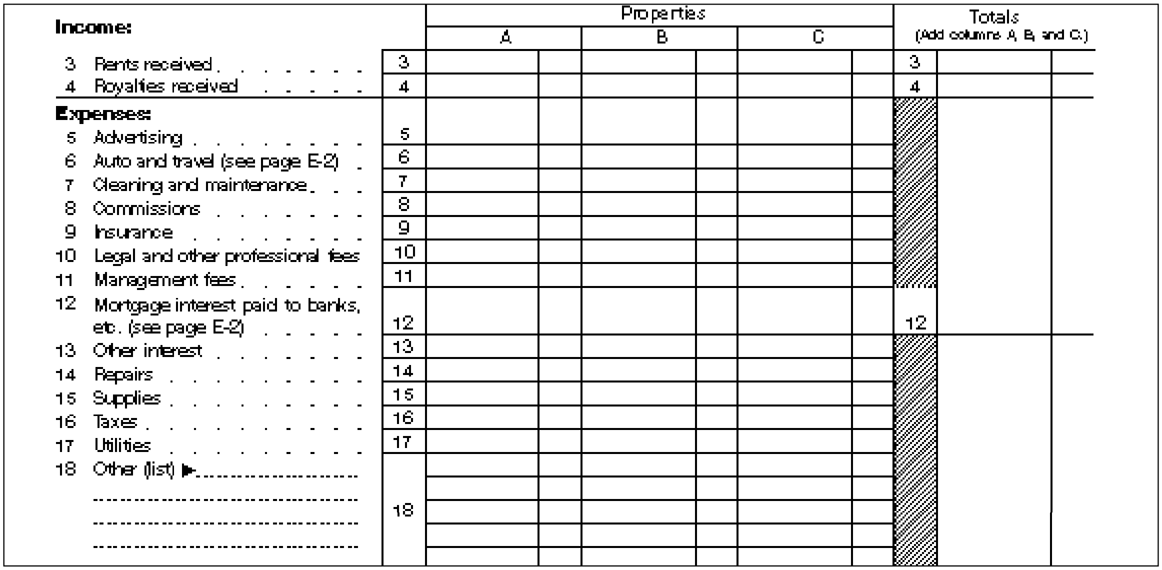
Rental income may include other payments in addition to the normal and ordinary rents received. Include in gross rental income advance rent, security deposits, payments for canceling a lease, expenses paid by the tenant, and the fair market value of property or services received in exchange for rental payments. The security deposit is not included when the taxpayer plans on returning the deposit at the end of the lease. A taxpayer using the cash basis of accounting, reports the income when actually received. Taxpayers using the accrual accounting method report the income in the year they are entitled to receive payments.

RENTAL EXPENSES

The deductible rental expenses are reported on the Schedule E, Part I, (see Exhibit 1) lines 5 through 18.

Exhibit 1

Schedule E



Income:		Properties A	Properties B	Properties C	Totals (Add columns A, B, and C.)
3 Rents received	3				3
4 Royalties received	4				4
Expenses:					
5 Advertising	5				▨
6 Auto and travel (see page E-2) .	6				▨
7 Cleaning and maintenance . . .	7				▨
8 Commissions	8				▨
9 Insurance	9				▨
10 Legal and other professional fees	10				▨
11 Management fees	11				▨
12 Mortgage interest paid to banks, etc. (see page E-2)	12				12
13 Other interest	13				▨
14 Repairs	14				▨
15 Supplies	15				▨
16 Taxes	16				▨
17 Utilities	17				▨
18 Other (list) ▶	18				▨

Deductible expenses include any ordinary and necessary expenses, such as expenses for repairs, maintenance, certain operating expenses and depreciation.

Repairs and Improvements. A deduction for a repair is a current year deduction, however, the cost of an improvement must be depreciated over the useful life of the improvement. The distinction between a repair and an improvement is that a repair keeps the property in good operating condition, whereas an improvement adds to the life or value of the property or adapts it to new uses. The following chart helps illustrate the difference between repairs and improvements.

REPAIRS	IMPROVEMENTS
Painting	Adding a Room
Fixing Gutters	Putting up a Fence
Repairing Driveways	Putting in plumbing or wiring
Replacing Window Glass	Replacing hot water tank
Mending Leaks	Putting on a new roof

Since an improvement is a capital expenditure and must be depreciated, the total cost including material, labor, and installation increases the basis of the property. Depreciation will be discussed later in this chapter.

Other Expenses. Some of the other expenses that may be deducted from gross rental income include salary and wages, utilities, rental of equipment, insurance premiums, interest expense (mortgage interest), advertising, taxes, and commissions paid for rental income. If any part of the property tax is for local benefits, such as putting in streets and sidewalks, that portion of the property tax is added to the basis of the property rather than deducted as an ordinary expense. Insurance premiums paid in advance must be prorated over the period covered by the policy by both the cash basis and accrual basis taxpayer. If the rental is a condominium or cooperative, the maintenance fee is deductible. See Publication 527, Residential Rental Property, for taxes and interest deductions on cooperatives. Generally, mortgage interest expense is fully deductible. However, if the taxpayer has interest expense other than mortgage interest, refer him or her to the Internal Revenue Service or a professional preparer.

Ordinary and necessary travel and transportation expenses attributable to the production of income are deductible. If a personal automobile is used, the taxpayer may use the standard mileage rate for business mileage. The standard mileage rate is 36.5 cents per mile for the year 2002. When using the standard mileage rate, parking fees and tolls may also be deducted. The standard mileage rate method may be selected on a yearly basis. However, if changing to actual expense after using the standard mileage method, accelerated depreciation may not be used. In order to claim depreciation under the actual expense method for transportation expenses, the vehicle must be used more than 50 percent for business, including for the production of rental income. If the travel incurred on behalf of a rental property is into or outside of the United States, the trip may have a dual purpose. Substantiation of the pleasure and business purpose and allocation of the expenses may be required. When a tenant does not pay the rent, the cash-basis landlord cannot take a deduction for the unpaid rent, since a deduction can never be taken for a payment that has never been included in income.

SPECIAL ALLOCATION

Special rules apply when rental property is used for personal purposes, or as a rental without the intent to make a profit. When renting part of the property, certain expenses must be divided between rental use and personal use. When figuring the division of expenses, the taxpayer may use any reasonable method. The most common methods used are based on the number of rooms in the dwelling or on the total area of the dwelling.

Example 1
Mary Alma rents one room in her house. The total square footage of her house is 1,000 square feet. The rental room measures 10 feet by 10 feet (100 square feet). She may deduct 10% of any allowable expense that benefited the renter. She may deduct 100% of any expenses that relate only to the rental portion of the house, such as painting the rented room.

Exercise 1

Mary Alma, in the example above, has the following expenses attributable to the entire property:

Taxes	$1,000
Utilities	$ 600
Mortgage Interest	$ 800
Depreciation	$ 500

Also wallpapering expense of $100 for the tenant's room only.

a. What is the allowable expense deduction on Schedule E?

Answer:____

b. What is the allowable expense deduction on Schedule A?

Answer:____

For property changed to rental use in the tax year other than the beginning of the year, the allocation of expenses should be made between the number of days in the year for personal use and the number of days for rental use.

Example 2
John Princeton is transferred overseas and begins renting out his residence on October 1, 2002. For 2002, he may deduct three-twelfths (25 percent) of his yearly expenses such as taxes, interest and utilities as rental expenses.

Vacation Home and Other Dwelling Units. Certain limitations apply to rental expenses for vacation homes or other dwellings that are used by the taxpayer for personal use during the year. A dwelling unit for this purpose includes a house, apartment, condominium, mobile home, boat or similar property. However, the limitation does not apply to hotel, motel, inn or similar dwelling unit. The limitation on deductions applies if a dwelling unit is used as a residence during the tax year for personal purposes for greater than:

1. 14 days or
2. 10 percent of the number of days during the tax year the property is rented at fair market value.

See Publication 527 for a discussion of the limitations.

Use as home before or after renting. If you use a dwelling unit as your main home before or after renting it, or trying to rent it, you may not have to count the days you use it as your main home as days of personal use.

12 months or more. If for 12 or more consecutive months, you rent or try to rent a dwelling unit at a fair rental price, some of the days on which you use the property as your main home are not counted as days of personal use.

Do not count as days of personal use the days you used the property as your main home.

a) During the year in which you began renting it or offering it for rent, but before you began renting it or offering it for rent, or

b) During the year in which you stopped renting it or offering it for rent, but after you stopped renting it or offering it for rent.

Example 3

On February 28, 2000, you moved out of the house you had lived in for 6 years because you accepted a job in another town. You rent your house at a fair rental price from March 15, 2000, to May 14, 2002. On June 1, 2002, you move back to town and move back into your house.

Your use of the house as your main home from January 1 to February 28, 2000, and from June 1 to December 31, 2002, is not counted as personal use.

Since these days are not counted as days of personal use the limitations on deductions discussed above do not apply.

Depreciation

The cost of property with a useful life of one year or more and used in a trade or business or held for the production of income is recovered by allowing an annual deduction called depreciation. The most common methods for the depreciation are called ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 and before 1987 and MACRS (modified ACRS) for property placed in service after 1986. Both of these depreciation methods have an alternative method that may be chosen that generally increases the number of years the property is depreciated over and therefore decreases the annual deduction. The method used for property placed in service before 1981 is referred to as straight line or declining balance.

Depreciable property includes buildings, machinery, furniture, equipment and vehicles. As discussed earlier any cost for additions or improvements must also be depreciated. Depreciation is allowed or allowable. What this means is, if you did not claim depreciation that you were entitled to claim in an earlier year you must still reduce your basis in the property by the amount of depreciation that you did not deduct. The depreciation deduction is determined by considering several factors. These factors are discussed next in this chapter. When depreciating real property the value of land is not depreciable.

Basis. The total of the yearly deductions for depreciation can never be more than the cost or other basis. Generally, the cost (purchase price) of the property including the cost of improvements is the basis for depreciation. However, if the taxpayer acquired the property, other than buying it, the basis may be figured differently than using the original cost. An example is an acquisition through inheritance or gift. For further information on the basis of inherited or gifted property refer to Publication 551, Basis of Assets. When property is converted from personal use to rental use the basis is the **lesser** of the adjusted basis or fair market value (FMV) at the time of conversion.

Example 4
Jen and Tom purchased a house in 1985 for $85,000. In 2002, they were transferred overseas and decided to rent out their personal residence. The value in 2002 was $125,000. The basis for depreciation is $85,000. Assume that the value of land was excluded in determining the cost of the house.

Adjusted Basis. The basis of property must be increased or decreased to reflect certain adjustments before the depreciation deduction is computed. For example, to the purchase price of a home add the cost of any improvements, minus any casualty losses or depreciation previously deducted and minus the land value to find the adjusted basis. Since land can never be depreciated, an allocation between land and building must be done based generally on assessed value. Where property is acquired in a purchase along with a trade-in, the basis must be adjusted.

Example 5
Neil Bates traded in old appliances for his rental property with an adjusted basis of $500 and got new appliances with a fair market value of $2,000. He paid $1,000.00 in cash, his basis for depreciation in the new appliances is $1,500 (the $500 adjusted basis plus the $1,000 cash).

Placed in Service. For depreciation purpose, property is considered placed in service when it is in a condition or state of readiness and availability for use. However, a depreciation deduction may not be claimed until the property is used in business or for the production of income.

Property Classes and Recovery Periods. The Accelerated Cost Recovery System (ACRS) and Modified Accelerated Cost Recovery System (MACRS) use the class life of depreciable property to determine the recovery period. If property is used as a personal residence before 1987 and converted to rental property after 1986, use the MACRS method to figure depreciation. Under MACRS, tangible property used in a rental activity generally falls into a 5-, 7-, or 27.5-year recovery period.

A home converted in 1998 to a rental property would be depreciated over a recovery period of 27.5 years. A stove also used in this same rental would be assigned a 7 year recovery period. Property, both real and personal, located outside the United States has a longer recovery period. Although the true physical life of the property may be less, under MACRS the recovery period is fixed. MACRS requires that a convention for half-year or mid-quarter be used. Under this special rule, in the year the property is placed in service the depreciation deduction is prorated. Publication 946, How to Depreciate Property, contains tables of depreciation with the conventions already incorporated. Examples of the tables are shown below.

MACRS charts

Table A

MACRS 5-Year Property

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	3.68

Table B

MACRS 7-Year Property

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06

Table 1, Table II

Table 1

Residential Rental Property (27.5-year)

	Use the column for the month of taxable year placed in service											
Year	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485%	3.182%	2.879%	2.576%	2.273%	1.970%	1.667%	1.364%	1.061%	0.758%	0.455%	0.152%
2	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%
3	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%
4	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%	3.636%

Table 2

Residential Rental Property (31.5-year)

	Use the column for the month of taxable year placed in service											
Year	1	2	3	4	5	6	7	8	9	10	11	12
1	3.042%	2.778%	2.513%	2.249%	1.984%	1.720%	1.455%	1.190%	0.926%	0.661%	0.397%	0.132%
2	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%
3	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%
4	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%	3.175%

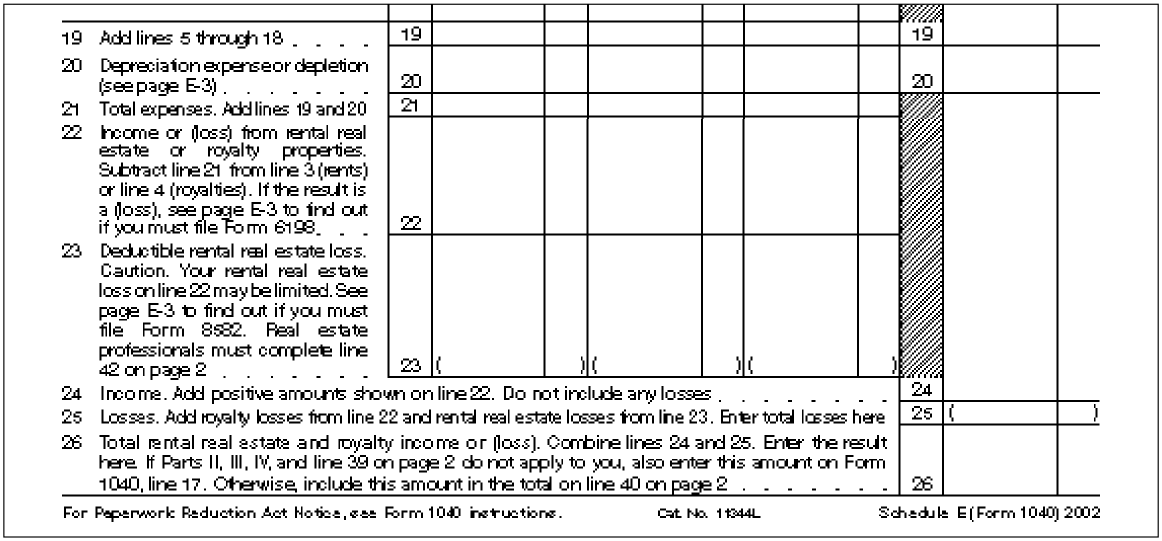
For property located outside of the United States, the taxpayer must use an alternative method of depreciation under MACRS. Therefore, residential rental property located in a foreign country would be depreciated over a 40-year recovery period.

REPORTING DEPRECIATION

The depreciation deduction is shown on line 20 of Schedule E (see Exhibit 2). Use Form 4562, Depreciation and Amortization only if you placed an asset in service in the current year, you depreciate listed property or you claim a Section 179 expense.

Exhibit 2

Schedule E



19 Add lines 5 through 18	19				19	
20 Depreciation expense or depletion (see page E-3)	20				20	
21 Total expenses. Add lines 19 and 20	21				▨	
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-3 to find out if you must file Form 6198	22				▨	
23 Deductible rental real estate loss. Caution. Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file Form 8582. Real estate professionals must complete line 42 on page 2	23	( )	( )	( )	▨	
24 Income. Add positive amounts shown on line 22. Do not include any losses					24	
25 Losses. Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here					25	( )
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2					26	

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AT-RISK AND PASSIVE LOSS

Very often rental property shows a net loss because the rental expenses are greater than the rental income. In this situation there are two potential restrictions on how much of the loss can offset other sources of income.

The first restriction is the at-risk rule. This rule provides that you can claim a loss for no more than you could actually lose from the activity. That is, you can claim a loss only up to the amount for which you are personally at-risk in the activity. Generally you are considered at-risk for the amount of cash and property contributed to the activity from which you are not protected against personal liability with the exception of casualty insurance.

The Tax Reform Act of 1986 added other limitations to deducting rental losses. Prior to the law, losses from passive activities could offset all other income (for example wages, interest, and dividends) without any restrictions. Rental activities, by definition of the law, are always considered to be a passive activity. The passive activity law states that passive activity losses can only be deducted from passive activity income. A passive activity is a trade or business being conducted without that taxpayer materially participating. Material participation may be defined by the regular continuous and substantial involvement of the taxpayer in the operation of the trade or business, whereas, active participation does not require regular, continuous and substantial involvement. Active participation requires that the taxpayer participate in making management decisions or arranging for others to provide services in a significant and bona fide sense. Management decisions include approving new tenants, setting rental terms, approving capital or repair expenditures and similar decisions. It is important to understand the difference between active and material participation as it pertains to rentals, because of a special $25,000 offset allowed for certain rental losses. Up to $25,000 of rental losses ($12,500 for married taxpayers filing separate and living apart for the entire year) may be used to offset any and all nonpassive income if the taxpayer actively participates in the residential rental activity. The following list is an example of nonpassive income.

1. Salaries, wages, commissions or tips.
2. Self-Employment income from a trade or business in which the taxpayer materially participates (may be partnership, but not limited partnership income).
3. Distributive shares of income through pass-through entities (such as S corporations) that is not income from a passive activity.
4. Portfolio income (gross income from interest, dividends, annuities, or some royalties).

Example 6
Lynn Ferris, a United States citizen, lives in Europe and has wages paid by the U.S. Government of $25,000 and interest income of $100. She rented out her home located in the United States in 2002, and incurred $1,000 in rental loss. Although her sister collects the rent, Lynn makes all of the bottom line decisions as to whom, and, for what amount, the property will be rented. While Lynn is outside of the United States, she pays her sister to manage the property. The rental loss of $1,000 may be offset against her gross income of $25,100 because she is considered to be an active participant in the rental activity.

Phase-Out of Offset. The amount allowed to offset nonpassive income is reduced once the taxpayer's adjusted gross income exceeds $100,000 ($50,000 for married filing separately). It is completely phased out when AGI exceeds $150,000 ($75,000 for married filing separately). Refer taxpayers with an AGI over $100,000 to the Internal Revenue Service or a professional preparer.

REPORTING RENTAL LOSSES

Form 8582, Passive Activity Loss Limitations is filed to summarize losses and income from all passive activities. Check the instructions for Form 1040 to determine if the taxpayer is required to file Form 8582 when he or she has rental losses. Generally, taxpayers who have only one passive loss generated from a rental activity and an adjusted income of less than $100,000 will not be required to file Form 8582. If any questions arise beyond the scope of this lesson regarding filing Form 8582, refer the taxpayer to the Internal Revenue Service or a professional preparer.

SELLING RENTAL PROPERTY

The sale of rental property is reported on Form 4797, Sales of Business Property. A gain is the amount realized minus the adjusted basis of the property.

Example 7
Pat Drake sold her rental property for $60,000. She had purchased the house for $30,000 and had claimed $10,000 for depreciation. Her gain is $40,000

The gain is figured as follows:

1. Selling price		$60,000
2. Less selling expenses		0
3. Amount realized		$60,000
4. Basis	$30,000	
5. Less depreciation	$10,000	
6. Adjusted basis	$20,000	$20,000
7. Gain (line 3 minus 6)		$40,000

The gain may be either capital gain or ordinary gain depending on the depreciation claimed. If part of the property was also used for personal uses, the sale is reported as two separate sales. A loss is the adjusted basis of the property minus the amount realized. A loss for any personal use of property cannot be deducted.

▶▶ SUMMING UP THIS LESSON ◀◀

As a volunteer, you will assist taxpayers who have rental properties. In this lesson you learned what qualified as rental income and rental expenses. You studied how to figure and report the following:

- ▶ The proration needed when the property is used both for personal and rental purposes.
- ▶ Depreciation expense.
- ▶ Rental losses.

ANSWERS

Exercise 1

a. $390 (10% of total expenses of $2,900=$290 plus 100 for wallpaper)

b. $1,620 (90% of mortgage interest and taxes)

STUDENT NOTES