Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Process Unit

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Process Overview

Qualified Dividends and Capital Gains Rate Differential Adjustments

The United States (U.S.) taxes its individual residents and citizens on their worldwide income. To prevent double taxation, U.S. taxpayers are allowed a credit for foreign income taxes “paid or accrued” on income that is taxed by both the U.S. and a foreign country. This credit is known as the Foreign Tax Credit (FTC). The FTC, however, has limitations. Under IRC 904, the amount of FTC a taxpayer is allowed in a taxable year is subject to an overall limitation based on the proportion of taxpayer’s foreign source taxable income to the taxpayer’s worldwide taxable income. The purpose of the overall limitation is to ensure that the FTC reduces a taxpayer’s U.S. tax on foreign income but does not reduce the U.S. tax on U.S. income. The overall limitation is expressed as follows:

$$\frac{\text{Foreign Source Taxable Income In Each Basket}}{\text{Worldwide Taxable Income}} \times \text{Pre-Credit US Tax}$$

Further limitations in computing the FTC, such as the rate differential adjustment (which reduces the foreign source qualified dividends and capital gains in the numerator and the denominator of the fractional limitation above), are required.

In this Practice Unit, we will examine the steps necessary to compute the rate differential adjustment for U.S. individual taxpayers.

Qualified Dividends and Capital Gains Rate Differential Adjustments
Analysis
Due to the preferential tax treatment of capital gains and qualified dividends under U.S. tax law, an adjustment is required to reduce the amount of foreign source capital gains and qualified dividends by a rate differential when computing the FTC. See IRC 904(b)(2) and Treas. Reg. 1.904(b)-1. The effect of this adjustment is to only include a portion of capital gains in the IRC 904 fractional limitation since the U.S. tax rate that applies to capital gains is less than the rate that applies to ordinary income. Or stated another way, because taxing capital gains at a low rate is the same as taxing just part of the gains at the full rate, only the part that is theoretically taxed at the full rate should enter the IRC 904 limitation calculation. Under IRC 904(b)(2), a gain from the sale or exchange of capital assets is included in foreign source taxable income only to the extent of foreign source capital gain net income. Because qualified dividend income also receives the preferential tax treatment, the rate differential adjustment is required for qualified dividend income as well. See IRC 1(h)(11) for a definition of qualified dividend income. For a taxpayer other than a corporation (including individuals and trusts), a capital gain rate differential exists for a taxable year when IRC 1(h) applies for that year. See IRC 904(b)(3)(D); Treas. Reg. 1.904(b)-1(b). IRC Section 1(h) provides the preferential rates for the net capital gains of taxpayers other than corporations. If a rate differential exists, the rules of IRC 904(b)(2)(B) require three adjustments to the IRC 904(a) fractional limitation (two apply to the numerator and one applies to the denominator): ▪ IRC 904(b)(2)(B)(i) limits the portion of capital gains that enter the numerator (foreign-source taxable income) to the taxpayer's foreign source capital gain net income reduced by the rate differential portion of the foreign-source net capital gain. The effect of this adjustment is to allow capital gains to enter the numerator only to the extent that the gains are effectively subject to U.S. tax at full rates. ▪ IRC 904(b)(2)(B)(ii) limits the portion of capital gains that enter the denominator (worldwide taxable income) to the taxpayer's worldwide capital gain net income reduced by the rate differential portion of net capital gain. This parallels the reduction that occurs in the numerator under IRC 904(b)(2)(B)(i) and therefore has the effect of allowing capital gains to enter the denominator only to the extent the gains are effectively subject to U.S. tax at full rates.

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Detailed Explanation of the Process (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Analysis
▪ If a foreign source capital loss is taken into account in computing the capital gain net income, a special rule applies to the numerator of the fraction used to compute the credit limitation. IRC 904(b)(2)(B)(iii) may reduce the foreign source net capital loss that enters the numerator. The amount of reduction equals the rate differential portion of the excess of the U.S. net capital gain over worldwide net capital gain.

Summary of Process Steps

Qualified Dividends and Capital Gains Rate Differential Adjustments
Process Steps
These steps presuppose that 1) the taxpayer claims foreign tax credit on a Form 1116, and 2) foreign source net capital gains and/or foreign source qualified dividend income are reported on the tax return.

Step 1	Ascertain that the taxpayer has capital gains and/or qualified dividend income that are subject to the lower tax rate under IRC 1(h).
Step 2	Check if the taxpayer elected to include any qualified dividends and/or net capital gains as investment income on Form 4952.
Step 3	If foreign source capital gain exceeds worldwide capital gain, make any necessary adjustment (U.S. Capital Loss adjustment) before the rate differential adjustment.
Step 4	After the U.S. capital loss adjustment, if any, taxpayers must make the capital gain rate differential adjustment to further reduce foreign long-term (but not short-term) capital gains and also capital losses, by multiplying a portion of them by a percentage.

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Step 1: Determine If Taxpayer is Subject to Preferential Tax Rate Under IRC 1(h)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 1
Ascertain that the taxpayer has capital gains and/or qualified dividend income that are subject to the lower tax rate under IRC 1(h).

Considerations	Resources
▪ Review the tax return and attached schedules (Schedule D, Schedule B) to verify if net capital gains and/or qualified dividends are reported for the tax year. ▪ If neither net capital gains nor qualified dividends is reported on the tax return, IRC 1(h) does not apply and the capital gain rate differential adjustment (step 4) is not necessary. ▪ The capital gain rate differential adjustment is applicable only when the capital gain rate differential exists. A capital gain rate differential exists if 1) the taxpayer has taxable income (excluding net capital gain and qualified dividend income), 2) the taxpayer has a net capital gain, and 3) tax is imposed on the net capital gain at a reduced rate under IRC 1(h) for the taxable year. ! **CAUTION:** For tax years 2018 and later, Form 1040A is obsolete. Taxpayers have a choice to use the Form 1040 or Form 1040-SR.	▪ Form 1040 - *U.S. Individual Income Tax Return* ▪ Schedule B (Form 1040A or 1040) - *Interest and Ordinary Dividends* ▪ Schedule D (Form 1040) - *Capital Gains and Losses* ▪ IRC 1(h) ▪ Treas. Reg. 1.904(b)-1(b)(2)

Step 2: Check If Taxpayer Made an Election on Form 4952

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 2
Check if the taxpayer elected to include any qualified dividends and/or net capital gains as investment income on Form 4952.

Considerations	Resources
▪ In general, qualified dividends and net capital gains from the disposition of property held for investment are excluded from investment income. But taxpayers can elect to include part or all of these amounts in investment income. This election is made on Form 4952, line 4g. ▪ If a taxpayer makes the election to include qualified dividends and/or net capital gains as investment income on Form 4952, the amounts elected are not eligible to be taxed at the qualified dividends or capital gains tax rate under IRC 1(h), and therefore not subject to the rate differential adjustment. In this case, the entire amount elected as investment income is included without adjustment on line 1a of the applicable Form 1116.	▪ 163(d)(4)(B)(iii) ▪ Form 4952 Instructions ▪ Form 1116 Instructions ▪ Pub. 514 - *Foreign Tax Credit for Individuals*

Step 3: Determine If U.S. Capital Loss Adjustment Is Needed

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 3
If foreign source capital gain exceeds worldwide capital gain, make the U.S. Capital Loss adjustment before making the capital gain rate differential adjustment.

Considerations	Resources
▪ The foreign source net capital gain is the excess of foreign source capital gains (sum of short and long-term gains) over foreign source capital losses (sum of short and long-term losses). If foreign source capital gains do not exceed foreign source capital losses, there is no foreign source net capital gain, and the U.S. capital loss adjustment is not necessary. ▪ If there is foreign source net capital gain and it exceeds worldwide net capital gain, the excess is the amount of the U.S. capital loss adjustment. ▪ The U.S. capital loss adjustment reduces foreign source capital gain via a subtraction of an amount based on any U.S. net capital losses. This is a two-step process: − Step 1: Apportion the U.S. capital loss adjustment pro rata among the Form 1116 income categories that have short or long-term net capital gains. − Step 2: Further drill down into each income category that has a net capital gain in more than one rate group and refine the U.S. capital loss adjustment by apportioning it pro rata to the tax rate groups with net capital gains (i.e., the capital gain in that rate group is greater than the capital loss in that rate group).	▪ IRC 904(b)(2)(A) ▪ IRC 904(b)(3)(A) ▪ Rev. Rul. 73-572 ▪ Pub. 514 - *Foreign Tax Credit for Individuals*

Step 3: Determine If U.S. Capital Loss Adjustment Is Needed (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 3

Considerations	Resources
Example 1 D, a U.S. citizen, has a net $300 U.S. source capital loss. D also has foreign source capital gains and losses in the income categories shown in the table below. D's passive category foreign source net capital gain is $200 ($200 - $100 + $100). D's general category foreign net capital gain is $400 ($700 - $300). D's foreign source net capital gain in the aggregate is $600 ($200 + $400). D's worldwide capital gain is $300 (foreign source capital gain of $600 net of the $300 U.S. capital loss).	

D's foreign capital gains and losses by income categories

Income category	28% rate group	15% rate group	Short-term rate group
Passive	$200	$(100)	$100
General	$0	$700 $(300)	$0

The U.S. capital loss adjustment is the amount by which the foreign source net capital gain exceeds the worldwide net capital gain: $600 - $300 = $300.

Step 3: Determine If U.S. Capital Loss Adjustment Is Needed (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 3

Considerations	Resources
Example 1 (cont'd) Step 1: The $300 U.S. capital loss adjustment must be apportioned between the foreign passive and general income categories. D apportions $100 of the $300 U.S. capital loss adjustment to passive category income ($300 x [$200/$600]) and $200 of the U.S. capital loss adjustment to general category income ($300 x [$400/$600]). Step 2: Since D has net capital gain in more than one rate group in the passive category, the $100 apportioned to the passive category must be apportioned again between the short-term rate group and the 28% rate group, based on the amount of net capital gain in those two rate groups: $66.67 to the 28% rate group ($100 x [$200/$300]) and $33.33 to the short-term rate group ($100 x [$100/$300]). See the result below:	

D's capital gains and losses after U.S. capital loss adjustment*

Income category	28% rate group	15% rate group	Short-term rate group
Passive	$200 – **$66.67** = $133.33	$(100)	$100 – **$33.33** = $66.67
General		$700 – $300 – **$200** = $200	

* Note that the boldface amounts add up to the U.S. capital loss adjustment of $300.

Step 3: Determine If U.S. Capital Loss Adjustment Is Needed (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 3

Considerations	Resources
Example 1 (cont'd) ▪ Referring to the table showing the results after the U.S. capital loss adjustment, notice that the $100 capital loss in the passive income category's 15% rate group is not affected by the U.S. capital loss adjustment; only foreign capital gains are offset by the U.S. capital loss adjustment. ▪ Notice also that $266.67 of the $300 U.S. capital loss adjustment was used to reduce only long-term capital gains. This will be important in Step 4 of the process.	

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4
After the U.S. capital loss adjustment, if any, taxpayers must make the capital gain rate differential adjustment, to further reduce foreign long-term (but not short-term) capital gains and capital losses, by multiplying a portion of them by a percentage.

Considerations	Resources
▪ A separate adjustment is required for income category rate groups with a net capital gain and income category rate groups with a net capital loss. The following steps explain the capital gain rate differential adjustment for separate category rate groups that have net capital gain. See slides 18 – 20 for adjustment required for separate category rate groups that have a net capital loss. ▪ If taxpayers have Form 1116 income category rate groups with net long-term capital gains, the following steps are required: − Step 1: Calculate the U.S. long-term loss adjustment. ▪ The U.S. long-term loss adjustment equals the U.S. source net long-term capital loss (U.S. long-term capital losses in excess of U.S. long-term capital gains) minus the amount by which the taxpayer reduced foreign source long-term capital gains under the U.S. capital loss adjustment (if any). Refer to Step 3 of the process (slide 10). − Step 2: Multiply the U.S. long-term loss adjustment by a fraction. The numerator is the net long-term capital gain in the rate group (that remains after the earlier U.S. capital loss adjustment, if any), and the denominator is the total amount of net long-term foreign capital gains in all rate groups (that remain after the earlier U.S. capital loss adjustment, if any).	▪ IRC 904(b)(2)(B) ▪ Treas. Reg. 1.904(b)-1(c) ▪ Pub. 514 - *Foreign Tax Credit for Individuals*

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4

Considerations	Resources
− Step 3: For each rate group, subtract the amount in Step 2 from its net long-term capital gain. − Step 4: Multiply the amount arrived at in Step 3 by the following appropriate percentage, and include that adjusted amount on Form 1116, line 1a: ▪ For net capital gain in the 0% rate group, multiply by zero. ▪ For the 15% rate group, multiply by 0.4054. ▪ For the 20% rate group, multiply by 0.5405. ▪ For the 25% rate group, multiply by 0.6757. ▪ For the 28% rate group, multiply by 0.7568. ▪ The remaining portion of unadjusted net capital gain in each separate category long-term rate group should be entered on line 1a of Form 1116. − If there is no net long-term capital loss from U.S. sources, adjust the entire amount of the long-term net foreign capital gain by multiplying the factors listed in Step 4.	

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4

Considerations	Resources
! **CAUTION:** The multiplication factors shown on slide 15 are based on the 2019 capital gain tax rates. Any tax law changes to the capital gain tax rates could alter these rate group percentages and the multiplication factors. Consult Publication 514. Example 2: Continuing from the fact pattern in Example 1, refer back to the table on slide 12, and start with D's capital gains and losses after the U.S. capital loss adjustment. Step 1: D's U.S. long-term loss adjustment equals total U.S. capital loss adjustment minus the portion of the U.S. capital loss adjustment that was used to reduce foreign long-term capital gain, or \$33.33, which is the \$300 total U.S. capital loss adjustment minus \$266.67 of the adjustment that reduced D's foreign long-term capital gain. Step 2: D's net long-term capital gains for the passive category and general category are \$133.33 and \$200, respectively, for a total of \$333.33. D must allocate the U.S. long-term loss adjustment of \$33.33 (from Step 1) to each of the income category rate groups as follows: ▪ For the passive category 28% rate group: \$13.33 (\$33.33 x [\$133.33 ÷ \$333.33]) ▪ For the general category 15% rate group: \$20 (\$33.33 x [\$200 ÷ \$333.33])	

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4

Considerations	Resources
Example 2 (cont'd) Step 3: Subtracting the U.S. long-term loss adjustment that is allocated to each of the income category rate group (from Step 2) from that group's remaining net long-term capital gain yields the following: ▪ For the passive category 28% rate group: $120 ($133.33 - $13.33) ▪ For the general category 15% rate group: $180 ($200 - $20) Step 4: Multiply the results from Step 3 by a predetermined percentage: ▪ For the passive category 28% rate group: $120 x 0.7568 = $90.82 ▪ For the general category 15% rate group: $180 x 0.4054 = $72.9 ▪ The unadjusted portions from each income category rate group is combined with the adjusted amounts and entered on line 1a of Form 1116. Therefore, the total amount entered on line 1a for the passive category is $104.15 ($13.33 + $90.82), and the total amount entered on line 1a for the general category is $92.97 ($20 + $72.97).	▪ Treas. Reg. 1.904(b)-1(c)(2) ▪ Treas. Reg. 1.904(b)-1(f)(3) ▪ IRC 904(b)(3)(E)

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4

Considerations	Resources
▪ If taxpayers have Form 1116 income category rate groups with a net capital loss, they must adjust that loss by netting it against U.S. and foreign capital gains, as follows: − Determine the rate group of capital gain(s) offset by the net capital loss. − Make the capital gain rate differential adjustment. ▪ To determine which capital gain(s) should be offset by a rate group's net capital loss, use the following steps (the mechanics of how this works will be illustrated in Example 3): − Step 1: Foreign net capital loss from each rate group is netted against any net capital gain in the same rate group in the other foreign income categories. For example, a $200 15% passive loss will be netted against a $150 15% general gain, to leave a $50 15% passive loss. − Step 2: U.S. capital losses are netted against U.S. capital gains in the same rate group. This amount is used in Step 3. For example, a $100 U.S. 15% loss netted against a $300 U.S. 15% gain leaves a $200 U.S. 15% gain.	▪ IRC 904(b)(2)(B) ▪ Treas. Reg. 1.904(b)-1(d) ▪ Pub. 514 - *Foreign Tax Credit for Individuals*

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4

Considerations	Resources
− Step 3: For each foreign rate group, remaining net capital losses after Step 1 are netted against remaining foreign net capital gains and U.S. net capital gains in the following order: ▪ Against U.S. net capital gains in the same rate group (from Step 2). ▪ Against net capital gains in other rate groups (whether these net capital gains are U.S. or foreign), as follows: − A foreign net capital loss in the short-term rate group is first netted against any net capital gain in the 28% rate group, then any excess loss against any net capital gain in the 25% rate group, then the 20% rate group, then the 15% rate group, and finally the 0% rate group. − A foreign net capital loss in the 28% rate group is netted first against any net capital gain in the 25% rate group, then the 20% rate group, then the 15% rate group, and finally the 0% rate group. − A foreign net capital loss in the 20% rate group is netted first against any net capital gain in the 15% rate group, then the 0% rate group, then the 28% rate group, and finally the 25% rate group.	

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4

Considerations	Resources
− A foreign net capital loss in the 15% rate group is netted first against any net capital gain in the 0% rate group, then the 28% rate group, then the 25% rate group, and finally the 20% rate group. ▪ Any net capital losses in a rate group are treated as coming pro rata from the income categories that have net losses in that same rate group, to the extent netted in Step 1 or Step 3. − Step 4: After determining the rate group of capital gain to be offset by the net capital loss, make the capital gain rate differential adjustment: ▪ To the extent the net capital loss in a rate group offsets (equals) a capital gain in the 0% rate group, multiply the offset amount by zero. For example, if the amount of net foreign capital loss in a rate group is $50, and there is a net capital gain of $60 in the offset rate group per the above ordering rules, then $50 × 0 = $0 loss will be included on Form 1116, line 5. The remaining $10 of loss will be reported, as is, on Form 1116, line 5, if there are no other gains to offset it per the above ordering rules. ▪ To the extent the net capital loss in a rate group offsets (equals) a capital gain in the 15% rate group, multiply the offset amount by 0.4054.	

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4

Considerations	Resources
▪ To the extent the net capital loss in a rate group offsets (equals) a capital gain in the 20% rate group, multiply the offset amount by 0.5405. ▪ To the extent the net capital loss in a rate group offsets (equals) a capital gain in the 25% rate group, multiply the offset amount by 0.6757. ▪ To the extent the net capital loss in a rate group offsets (equals) a capital gain in the 28% rate group, multiply the offset amount by 0.7568. Include the results on line 5 (losses from foreign sources) of the applicable Form 1116. The amount of loss that does not offset gains is included, without adjustment, on Form 1116, line 5. ! **CAUTION:** The multiplication factors shown above are based on the 2019 capital gain tax rates. Any tax law changes to the capital gain tax rates could alter these rate group percentages and the multiplication factors. Consult Publication 514 for the applicable year.	

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments

Step 4

Considerations	Resources
Example 3	

Example 3

N has foreign and U.S. capital gains and losses as shown in the table below:

N's foreign and U.S. capital gains and losses

Income category	28% rate	15% rate
Foreign passive	$50	$(20)
Foreign general		$(40)
U.S.		$50

Step 1: The foreign net capital loss from the 15% rate group is $20 + $40 = $60.

Step 2: U.S. capital gain in the 15% rate group is $50.

Step 3: Of the $60 net capital loss in Step 1, $50 is treated as offsetting $50 of U.S. capital gain in the same 15% rate group.

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4

Considerations	Resources
Example 3 (cont'd) Any net capital losses in a rate group are allocated pro rata to the income categories (in this case, passive and general) that have net losses in that rate group; therefore: ▪ $16.67 ($50 × [$20 ÷ $60]) of the $50 is treated as coming from passive category income, and ▪ $33.33 ($50 × [$40 ÷ $60]) of the $50 is treated as coming from general category income. The remaining $10 of foreign net capital loss in the 15% rate group that was not treated as offsetting the $50 U.S. net capital gain in the 15% rate group is treated as offsetting net capital gain in the 28% rate group; therefore: ▪ $3.33 ($10 × [$20 ÷ $60]) is treated as coming from the passive income category, and ▪ $6.67 ($10 × [$40 ÷ $60]) is treated as coming from the general income category. Step 4: Apply the capital gain rate differential adjustment and include on Form 1116, line 5: ▪ From passive income: $6.75 ($16.67 × 0.4054) plus $2.52 ($3.33 × 0.7568) = $9.27. ▪ From general income: $13.51 ($33.33 × 0.4054) plus $5.05 ($6.67 × 0.7568) = $18.56.	

Step 4: Make Capital Gain Rate Differential Adjustment of Long-Term Capital Gain/Loss (cont'd)

Qualified Dividends and Capital Gains Rate Differential Adjustments
Step 4

Considerations	Resources
Example 3 (cont'd) N also includes $37.84 ($50 × 0.7568) of capital gain on Form 1116, line 1a, from the foreign passive income category. Notice a key difference in the adjustment between a net foreign gain in a rate group and a net loss. Taxpayers adjust the amount of the gain that is in excess of the U.S. long-term loss amount, but for a loss, they adjust the amount that is equal to the capital gain that is treated as being offset. In summary, to correctly limit the amount of the foreign tax credit, taxpayers may have to adjust foreign capital gains and losses, because of their lower tax rate, before including them on Form 1116. As part of the computation, foreign capital gains and losses are subject to being differentiated into income categories and tax rate groups. Both U.S. and foreign capital gains and losses might be used to make these adjustments, via either subtraction or multiplication by a percentage.	

Qualified Dividends and Capital Gains Rate Differential Adjustments
Description
▪ Under Treas. Reg. 1.904(b)-1(b)(3), a noncorporate taxpayer who otherwise has a capital gain rate differential may elect not to adjust foreign source capital gain and qualified dividends if all of the following requirements are met: − The taxpayer is not subject to the alterative minimum tax under IRC 55 for the taxable year, or if the rate of tax imposed on such taxpayer's alternative minimum taxable income (excluding net capital gain and any qualified dividend income) under IRC 55 does not exceed 26 percent. − The highest rate of tax imposed on such taxpayer's taxable income (excluding net capital gain and any qualified dividend income) for the taxable year under IRC 1 does not exceed the highest rate of tax in effect under IRC 1(h). − The amount of the taxpayer's net capital gain from sources outside the United States, plus the amount of the taxpayer's qualified dividends from sources outside the United States, is less than $20,000. ▪ A taxpayer makes this election by simply not adjusting any of the foreign source qualified dividends or net capital gains. A taxpayer who meets the requirements above is presumed to have made the election under Treas. Reg. 1.904(b)-1(b)(3).

Qualified Dividends and Capital Gains Rate Differential Adjustments
Description
▪ Rate Differential Portion - equals the foreign-source net capital gain multiplied by a fraction. The denominator of the fraction is the "highest applicable tax rate." The numerator of the fraction is the excess of the highest applicable tax rate over the alternative tax rate. IRC 904(b)(3)(E). ▪ Qualified Foreign Dividends - in general, dividends received from a qualified foreign corporation. A qualified foreign corporation is one that is incorporated in a possession of the United States, or a corporation that is eligible for benefits of a comprehensive income tax treaty with the United States and which includes an exchange of information program. Failing the above requirement, the foreign corporation can still qualify if the stock with respect to which a dividend is paid is readily tradable on an established securities market in the United States. IRC 1(h)(11)(B)-(C).

Other Considerations / Impact to Audit

Qualified Dividends and Capital Gains Rate Differential Adjustments	
Considerations	**Resources**
▪ Foreign source net capital gain can not exceed the taxpayer's overall net capital gain. In other words, foreign source capital gain net income (numerator in IRC 904(a)) is limited to the lesser of 1) the taxpayer's capital gain net income from foreign sources or 2) the taxpayer's capital gain net income. Assume that a taxpayer has a foreign-source capital gain and an equal domestic-source capital loss. The existence of the capital gain allows the taxpayer to deduct the capital loss. Thus, the taxpayer pays no U.S. tax on the capital gain. If the foreign-source capital gain incurs no U.S. tax, that gain arguably should not increase the taxpayer's U.S. foreign tax credit by increasing the numerator of the IRC 904 fraction.	▪ IRC 904(a) ▪ IRC 904(b)(2)(A) ▪ IRC 904(b)(3)(A) ▪ IRC 904(b)(3)(B)
▪ Taxable income before the exemption deduction (line 18 of the 2018 Form 1116) may need to be adjusted by using a worksheet (Worksheet for line 18) if the taxpayer completed the Qualified Dividends and Capital Gain Tax Worksheet when filing Form 1040. Consult with the instructions to Form 1116, line 18.	▪ Form 1116 Instructions

Index of Referenced Resources

Qualified Dividends and Capital Gains Rate Differential Adjustments
IRC 1(h)
IRC 55
IRC 163(d)(4)(B)(iii)
IRC 904
Treas. Reg. 1.904(b)-1
Form 1040 - *U.S. Individual Income Tax Return*
Form 1040A or 1040, Schedule B - *Interest and Ordinary Dividends*
Form 1040, Schedule D - *Capital Gains and Losses*
Form 1116 - *Foreign Tax Credit (Individual, Estate, or Trust)*
Form 1116 Instructions
Form 4952 Instructions
Pub. 514 - *Foreign Tax Credit for Individuals*
Rev. Rul. 73-572

Training and Additional Resources

Qualified Dividends and Capital Gains Rate Differential Adjustments	
Type of Resource	**Description(s)**
Articles	▪ *The Tax Adviser - Adjustments of Foreign Capital Gains and Losses for the Foreign Tax Credit* - July 2017
Databases / Research Tools	▪ *Kuntz & Peroni - U.S. Int'l Tax* Para B4.16

Glossary of Terms and Acronyms

Term/Acronym	Definition
FTC	Foreign Tax Credit
IRC	Internal Revenue Code
Rev. Rul.	Revenue Ruling
Treas. Reg.	Treasury Regulation

Index of Related Practice Units

Associated UIL	Related Practice Unit
9432	*FTC General Principles*