Avoiding the Capital Gain Rate Differential Adjustment

Seth M. Colwell*

When U.S. citizens or residents have foreign-source income, they face the potential of double taxation. The capital gain rate differential adjustment may limit the foreign tax credit for taxpayers with foreign-source qualified dividends and long-term capital gains. To avoid this limitation, taxpayers and their advisers should utilize the elections under Internal Revenue Code Section 904(j) and Treasury Regulation Section 1.904(b)-1(b)(3).

For diversification purposes, many investors have broadened their asset allocations to include international investments. The portfolio income generated by these investments is often subject to foreign taxes. Since United States citizens and residents are taxed on their worldwide income, this income may be subject to double taxation. The foreign tax credit (FTC) can mitigate this potential inequity, but certain limitations apply to foreign taxes paid or accrued on qualified dividends and long-term capital gains (preferential income).

The Foreign Tax Credit Limitation

The creditable amount of foreign income taxes is limited by Internal Revenue Code Section 904(a). This limitation is calculated by multiplying the total tax times the ratio of foreign-source taxable income to worldwide taxable income. The effect of this provision is to establish the U.S. tax on foreign-source income as the limit for the FTC.

Capital Gain Rate Differential Adjustment

The limitation on the FTC is modified in any year in which taxpayers have a "capital gain rate differential." This differential occurs whenever taxpayers benefit from the lower rates on preferential income provided under Section 1(h).[1] Since long-term capital gains and qualified dividends are taxed at

* Seth M. Colwell, CPA, M.Tax., is a lecturer at the University of Texas at Brownsville. He may be contacted by email at seth.colwell@utb.edu.

[1] IRC § 904(b)(3)(D)(i).

a lower tax rate (including certain foreign-source preferential income), Section 904(b)(2)(B) requires taxpayers to reduce (for purposes of the FTC limitation) the amount of their foreign-source preferential income and their worldwide taxable income based on the benefit they received from the lower rates. The effect of this adjustment is to reduce the amount of foreign-source income included in the limitation calculation, thereby potentially reducing the amount of the credit.

Taxpayers make the adjustment by multiplying their net long-term capital gains and qualified dividends by the appropriate factor.[2] The factor is calculated by dividing the preferential rate (0 percent, 15 percent, 20 percent, 25 percent, or 28 percent) by the maximum individual tax rate of 39.6 percent.[3] Since no tax was paid on the 0 percent rate preferential income, the factor is 0 (i.e., 0% ÷ 39.6%) and none of this income is included in the foreign-source or worldwide taxable income. For preferential income taxed at 15 percent, the applicable factor is .3788 (15% ÷ 39.6%); for preferential income taxed at the 20 percent rate, the factor is .5051 (20% ÷ 39.6%); and so on.

Available Relief

Fortunately, taxpayers may be eligible for relief from the FTC limitation and the capital gain rate differential adjustment by qualifying for the exceptions under Section 904(j) or Treasury Regulation Section 1.904(b)-1(b)(3).

Section 904(j) Election. Section 904(j) provides a de minimis rule where qualifying taxpayers can elect to report their foreign taxes directly on Form 1040, page 2, without applying the Section 904(a) limitation. This rule applies for taxpayers with $300 ($600 for a joint return) or less of foreign income taxes.[4] To qualify for the exception, a taxpayer must have only "passive" category foreign-source income reported on a Form 1099 or Schedule K-1.[5] Income generally meeting this criterion includes interest, dividends, and capital gain distributions.

Section 904(j)(1) prohibits taxpayers from carrying back or forward any foreign income taxes paid or accrued in the election year. In addition, no taxes from a previous or succeeding year can be utilized in the election year. No statement is required for this election, and taxpayers are not required to file Form 1116; as noted above, they simply report their foreign taxes on Form 1040, page 2.

---

[2] IRC § 904(b)(2)(B); Form 1116 Instructions, at 7.

[3] Treas. Reg § 1.904(b)-1(f)(3).

[4] IRC § 904(j)(2)(B).

[5] IRC § 904(j)(3).

Treasury Regulation Section 1.904(b)-1(b)(3) Election. Rather than exempting taxpayers from the FTC limitation, Treasury Regulation Section1.904(b)-1(b)(3) exempts taxpayers from applying the capital gain rate differential adjustment. To qualify for this exception, a taxpayer must have less than $20,000 of foreign-source preferential income. In addition, the taxpayer's marginal tax rate for ordinary income cannot exceed the highest tax rate provided for under Section 1(h) (28 percent in 2013). For taxpayers subject to the alternative minimum tax (AMT), there is an additional twist: They must meet the above requirements *and* not have any income taxed at higher than the 26 percent AMT rate.

No statement is required for this election; a taxpayer makes the election by calculating the FTC limitation on Form 1116 without any capital gain rate differential adjustment.

Example: FTC and Treasury Regulation Section 1.904(b)-1(b)(3) Election

To illustrate, assume Jack and Jill, a married couple filing jointly in 2013, have combined wages of $166,400 and foreign-source qualified dividends of $10,000. The couple does not itemize, and they paid $2,000 of foreign income taxes. Exhibits 1-5 show the calculation of the tax and the FTC with and without the Treasury Regulation Section 1.904(b)-1(b)(3) election. As the exhibits illustrate, by making the election, Jack and Jill are able to increase their foreign-source income by $6,212, which increases their current year foreign tax credit by $1,112.

Exhibit 1: Taxable Income	
Wages	$166,400
Qualified Dividends	10,000
Adjusted Gross Income	176,400
Standard Deduction	12,200
Personal Exemption	7,800
Taxable Income	**$156,400**

Exhibit 2: Tax	
(See Exhibit 3 for Tax Rate Schedule)	
Tax on $146,400 Ordinary Income =	$28,457.50
Tax on $10,000 Qualified Dividend at 15% (falls in 28% bracket) =	1,500
Total Tax	**$29,957.50**

Exhibit 3: Tax Rate Schedule					
Schedule Y-1—Use if your 2013 filing status is					
Married filing jointly or Qualifying widow(er)					
If taxable income is:		The tax is:			
Over—	But not over—				*of the* amount over—
$0	$17,850			10%	$0
17,850	72,500	$1,785.00	+	15%	17,850
72,500	146,400	9,982.50	+	25%	72,500
146,400	223,050	28,457.50	+	28%	146,400
223,050	398,350	49,919.50	+	33%	223,050
398,350	450,000	107,768.50	+	35%	398,350
450,000	- - - - - -	125,846.00	+	39.60%	450,000
Adapted from Publication 505, page 36.					

Exhibit 4: Foreign Tax Credit Without Treas. Reg. § 1.904(b)-1(b)(3) Election		
Foreign-Source Income	$10,000	
Capital Gain Rate Differential (CGRD) Adjustment Factor	0.3788	
Foreign-Source Income after CGRD Adjustment	3,788	
Allocable Deductions (Pro Rata portion of Standard Deduction)	692	(12,200 × 10,000/176,400)
Foreign Source Taxable Income	**$3,096**	
Worldwide Taxable Income (excluding foreign income and personal exemption)	$154,200	(166,400 – 12,200)
Foreign Source Income after CGRD Adjustment	3,788	
Worldwide Taxable Income (excluding personal exemption)	**$157,988**	
Total Tax	$29,958	
Ratio of Foreign-Source Taxable Income to Worldwide Taxable Income	0.0196	(3,096/157,988)
Foreign Tax Credit Limitation	587	
Foreign Taxes Paid	2,000	
Foreign Tax Credit (Lesser of Foreign Taxes Paid or FTC Limitation)	**$587**	

Exhibit 5: Foreign Tax Credit With Treas. Reg. § 1.904(b)-1(b)(3) Election		
Foreign-Source Income	$10,000	
Capital Gain Rate Differential (CGRD) Adjustment Factor	N/A	
Foreign-Source Income after CGRD Adjustment	10,000	
Allocable Deductions (Pro Rata portion of Standard Deduction)	692	(12,200 × 10,000/176,400)
Foreign Source Taxable Income	**$9,308**	
Worldwide Taxable Income (excluding foreign income and personal exemption)	$154,200	(166,400 – 12,200)
Foreign-Source Income (no CGRD Adjustment)	10,000	
Worldwide Taxable Income (excluding personal exemption)	**$164,200**	
Total Tax	$29,958	
Ratio of Foreign-Source Taxable Income to Worldwide Taxable Income	0.0567	(9,308/164,200)
Foreign Tax Credit Limitation	1,699	
Foreign Taxes Paid	2,000	
Foreign Tax Credit (Lesser of Foreign Taxes Paid or FTC Limitation)	**$1,699**	

Conclusion

To avoid the limitations associated with the capital gain rate differential adjustment, practitioners should make sure their clients take advantage of the Section 904(j) and Treasury Regulation Section 1.904(b)-1(b)(3) elections.