Instructions for Form 1118
(Rev. January 2006)

Department of the Treasury
Internal Revenue Service

(Use with the December 2004 revision of Form 1118)

Foreign Tax Credit—Corporations

Section references are to the Internal Revenue Code, unless otherwise noted.

What's New

- If the corporation is claiming a dividends-received deduction under section 965 for the current tax year, see the instructions for Form 8895, One-Time Dividends Received Deduction for Certain Cash Dividends from Controlled Foreign Corporations. The Form 8895, Part IV, instructions list the steps needed to compute the corporation's foreign tax credit for the current tax year.
- Changes to the instructions were made to reflect amendments to the foreign tax credit rules made by the American Jobs Creation Act of 2004 and the Gulf Opportunity Zone Act of 2005.

General Instructions

Purpose of Form

Use Form 1118 to compute a corporation's foreign tax credit for certain taxes paid or accrued to foreign countries or U.S. possessions. See *Taxes Eligible for a Credit* on page 3.

Who Must File

Any corporation that elects the benefits of the foreign tax credit under section 901 must complete and attach Form 1118 to its income tax return.

When to Make the Election

The election to claim the foreign tax credit (or a deduction in lieu of a credit) for any tax year may be made or changed at any time before the end of a special 10-year period described in section 6511(d)(3) (or section 6511(c) if the period is extended by agreement).

Computer-Generated Form 1118

The corporation may submit a computer-generated Form 1118 and schedules if they conform to the IRS version. However, if a software program is used, it must be approved by the IRS for use in filing substitute forms. This ensures the proper placement of each item appearing on the IRS version. For more information, see Pub. 1167, General Rules and Specifications for Substitute Forms and Schedules.

How To Complete Form 1118

Important: Complete a separate Schedule A; Schedule B, Parts I & II; Schedules C through G; and Schedule I for each applicable separate category of income. See *Categories of Income* below. Complete Schedule B, Part III; Schedule H; and Schedule J only once.

- Use **Schedule A** to compute the corporation's income or loss before adjustments for each applicable category of income.
- Use **Schedule B** to determine the total foreign tax credit after certain limitations.
- Use **Schedule C** to compute taxes deemed paid by the domestic corporation filing the return.
- Use **Schedules D** and **E** to compute taxes deemed paid by lower-tier foreign corporations.
- Use **Schedule F** to report gross income and definitely allocable deductions from foreign branches.
- Use **Schedule G** to report required reductions of tax paid, accrued, or deemed paid.
- Use **Schedule H** to apportion deductions that cannot be definitely allocated to some item or class of income.
- Use **Schedule I** (a separate schedule) to compute reductions of taxes paid, accrued, or deemed paid on foreign oil and gas extraction income.
- Use **Schedule J** (a separate schedule) to compute adjustments to separate limitation income or losses in determining the numerators of limitation fractions, year-end recharacterization balances, and overall foreign loss account balances.

Categories of Income

Compute a separate foreign tax credit for each applicable separate category described below.

Passive Income

Generally, passive income is:

- Any income received or accrued that would be foreign personal holding company income (defined in section 954(c)) if the corporation were a controlled foreign corporation (CFC) (defined in section 957). This includes any gain on the sale or exchange of stock that is more than the amount treated as a dividend under section 1248. However, in determining if any income would be foreign personal holding company income, the rules of section 864(d)(6) will apply only for income of a CFC.
- Any amount includible in gross income under sections 551 (which relates to foreign personal holding companies prior to its repeal effective for tax years of foreign corporations beginning after December 31, 2004) and 1293 (which relates to certain passive foreign investment companies).

Passive income does **not** include:

- Any income that belongs in one of the other separate categories described below,
- Any export financing interest unless it is also related person factoring income (see section 904(d)(2)(G) and Regulations section 1.904-4(h)(3)),
- Any high-taxed income (see *General Limitation Income* on page 2), or
- Any active rents or royalties received from an unrelated person and active rents or royalties received from a related person that were paid or accrued after September 20, 2004. See Regulations section 1.904-4(b)(2) for definitions and exceptions.

Note. Certain income received from a CFC and certain dividends from a 10/50 corporation that would otherwise be passive income may be assigned to another separate category under the look-through rules. See *Look-Through Rules* on page 3.

High Withholding Tax Interest

High withholding tax interest is any interest subject to a withholding tax or other gross basis tax of a foreign country or U.S. possession at a rate of 5% or more.

High withholding tax interest does **not** include export financing interest (section 904(d)(2)(B)(ii)).

Financial Services Income

Financial services income is income received or accrued while the corporation was a financial services entity if the income is:

- Described in section 904(d)(2)(C)(ii),
- Passive income (determined without regard to section 904(d)(2)(A)(iii)(I) and (III)),
- Export financing interest (section 904(d)(2)(G)) that would be high withholding tax interest but for section 904(d)(2)(B)(ii), or
- Incidental income described in Regulations section 1.904-4(e)(4).

Financial services income does **not** include:

- Any high withholding tax interest, or
- Any export financing interest not described in section 904(d)(2)(C)(i)(III).

Special rules apply for affiliated groups. See Regulations section 1.904-4(e)(3)(ii).

Shipping Income

Shipping income is any income the corporation receives or accrues that is of a kind that would be foreign base company shipping income as defined in section 954(f) as in effect before its repeal by the American Jobs Creation Act of 2004.

Shipping income does **not** include:

- Financial services income,
- High withholding tax interest, or
- Foreign trade income.

Dividends From 10/50 Corporations

The American Jobs Creation Act of 2004 eliminated the separate categories of income for dividends received from noncontrolled section 902 corporations (10/50 corporations). The change is generally effective for tax years beginning after December 31, 2002. Dividends paid by 10/50 corporations in post-2002 tax years are generally eligible for look-through treatment (see *Look-Through Rules* on page 3). Corporations that filed a tax return in which they claimed a foreign tax credit with respect to dividends paid by 10/50 corporations in post-2002 tax years that were reported in the following separate categories of income should file an amended return and revised Form(s) 1118:

- Certain dividends from 10/50 corporations.
- Certain dividends from **each** 10/50 PFIC.

Transition rule. The corporation may elect **not** to apply the look-through treatment referred to in the previous paragraph for tax years beginning after December 31, 2002, and before January 1, 2005. If the corporation makes this election, in the case of tax years beginning after December 31, 2004, the corporation should apply section 904(d)(4)(C)(iv) by substituting “January 1, 2005” for “January 1, 2003” in both places it appears. The Treasury Department will issue guidance regarding the manner in which this election is to be made subsequent to the issuance of these instructions.

Dividends From a DISC or Former DISC

This category includes dividends from a DISC or former DISC (as defined in section 992(a)) that are treated as income from sources outside the United States.

Taxable Income Attributable to Foreign Trade Income

No credit is allowed for foreign taxes paid or accrued by a FSC on its taxable income attributable to foreign trade income within the meaning of section 923(b), as in effect before its repeal. However, this type of income is subject to a separate foreign tax credit limitation. See section 906(b)(5) and Temporary Regulations section 1.921-3T(d)(3).

Certain Distributions From a FSC or Former FSC

This category includes:

- Distributions from a FSC (or former FSC) out of E&P attributable to foreign trade income and
- Interest or carrying charges from a transaction that results in foreign trade income.

Section 901(j) Income

No credit is allowed for foreign taxes imposed by and paid or accrued to certain sanctioned countries. However, income derived from **each** such country is subject to a separate foreign tax credit limitation. Therefore, the corporation must use a separate Form 1118 for income derived from each such country. On each Form 1118, check the box for section 901(j) income at the top of page 1 and identify the applicable country in the space provided.

Sanctioned countries are those designated by the Secretary of State as countries that repeatedly provide support for acts of international terrorism, countries with which the United States does not have diplomatic relations, or countries whose governments are not recognized by the United States. As of the date these instructions were revised, section 901(j) applied to income derived from Cuba, Iran, North Korea, Sudan, and Syria. For more information, see section 901(j).

Note. The President of the United States has the authority to waive the application of section 901(j) with respect to a foreign country if it is (a) in the national interest of the United States and will expand trade and investment opportunities for U.S. companies in such foreign country and (b) the President reports to the Congress, not less than 30 days before the waiver is granted, the intention to grant such a waiver and the reason for such waiver.

Note. Effective December 10, 2004, the President waived the application of section 901(j) with respect to Libya.

If the corporation paid taxes to a country that ceased to be a sanctioned country during the tax year, see Rev. Rul. 92-62, 1992-2 C.B. 193, for details on how to figure the foreign tax credit for the period that begins after the end of the sanctioned period.

Note. Iraq ceased to be a sanctioned country on June 27, 2004.

Income Re-sourced by Treaty

If a sourcing rule in an applicable income tax treaty treats any of the income described below as foreign source, and the corporation elects to apply the treaty, the income will be treated as foreign source.

- Dividends eligible for the dividends received deduction (section 245(a)(10)).
- Certain gains (section 865(h)).
- Certain income from a U.S.-owned foreign corporation (section 904(g)(10)). See Regulations section 1.904-5(m)(7) for an example.

Important: The corporation must compute a separate foreign tax credit limitation for any such income for which it claims benefits under a treaty, using a separate Form 1118 for each amount of re-sourced income from a treaty country. On each Form 1118, check the box for income re-sourced by treaty at the top of page 1 and identify the applicable country in the space provided.

General Limitation Income

This category includes all income not described above. This includes high-taxed income that would otherwise be passive income. Usually, income is high-taxed if the total foreign income taxes paid, accrued, or deemed paid by the corporation for that income exceed the highest rate of tax specified in section 11 (and with reference to section 15, if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). For more information, see Regulations section 1.904-4(c).

Special Rules

Source Rules for Income

Determine income or (loss) for each separate category on Schedule A using the general source rules of sections 861 through 865 and related regulations; the special source rules of section 904(g) described below; and any applicable source rules contained in any applicable tax treaties.

Special source rules of section 904(g). Usually, the following income from a U.S.-owned foreign corporation, otherwise treated as foreign source income, must be treated as U.S. source income under section 904(g):

- Any subpart F income, foreign personal holding company income, or income from a qualified electing fund that a U.S. shareholder is required to include in its gross income, if such amount is attributable to the U.S.-owned foreign corporation’s U.S. source income;
- Interest that is properly allocable to the U.S.-owned foreign corporation’s U.S. source income; and
- Dividends equal to the U.S. source ratio (defined in section 904(g)(4)(B)).

The rules regarding interest and dividends described above do not apply to a U.S.-owned foreign corporation if less than 10% of its E&P for the tax year is from U.S. sources.

Amounts That Do Not Constitute Income Under U.S. Tax Principles

For taxes paid or accrued in tax years beginning after December 31, 2004, and before January 1, 2007, the corporation may elect to treat creditable foreign taxes that are imposed on amounts that do not constitute income under U.S. tax principles as imposed on either general limitation income or financial services income. An election to treat such taxes as imposed on financial services income is made by attaching a statement to a timely-filed (including extensions) Form 1118 that indicates that the corporation is making this election under section 904(d)(2)(H)(ii) and including the foreign taxes on the separate Form 1118 filed with respect to financial services income. No separate statement is required to elect to treat such taxes as imposed on general limitation income. See Regulations section 1.904-6(a)(1)(iv). Once made, this election applies to all such taxes for the tax years described above and is revocable only with the consent of the IRS.

Look-Through Rules

CFCs. Generally, dividends, interest, rents, and royalties received or accrued by the taxpayer are passive income. However, if these items are received or accrued by a 10% U.S. shareholder from a CFC, they may be assigned to other separate categories under the look-through rules of section 904(d)(3). This includes:

- Interest, rents, and royalties based on the amount allocable to E&P of the CFC in a separate category and
- Dividends paid out of the E&P of a CFC in proportion to the ratio of the CFC's E&P in a separate category to its total E&P. Dividends include any amount included in gross income under section 951(a)(1)(B).

Look-through rules also apply to subpart F inclusions under section 951(a)(1)(A) to the extent attributable to E&P of the CFC in a separate category.

For more information and examples see section 904(d)(3), Regulations section 1.904-4(g)(3), and Regulations section 1.904-5.

10/50 corporations. Generally, dividends received or accrued by the taxpayer are passive income. However, dividends received or accrued from a 10/50 corporation may be assigned to other separate categories under the look-through rules of section 904(d)(4). A 10/50 corporation is any foreign corporation in which the taxpayer (domestic corporation) meets the stock ownership requirements of section 902.

Certain amounts paid by a U.S. corporation to a related corporation. Look-through rules also apply to foreign source interest, rents, and royalties paid by a U.S. corporation to a related corporation. See Regulations section 1.904-5(g).

Other Rules

Certain transfers of intangible property. See section 367(d)(2)(C) for a rule that clarifies the treatment of certain transfers of intangible property.

Reporting Foreign Tax Information From Partnerships

If you received a Schedule K-1 from a partnership that includes foreign tax information, use the rules below to report that information on Form 1118.

Gross income sourced at partner level. This includes income from the sale of most personal property other than inventory, depreciable property, and certain intangible property sourced under section 865. This gross income will generally be U.S.-source and therefore will not be reported on Form 1118.

The remaining lines of the foreign tax section of the Schedule K-1 are reported on Form 1118 as follows:

Foreign gross income sourced at partnership level.
Report on Schedule A.

Deductions allocated and apportioned at partner level and partnership level.
Report on Schedule A or Schedule H.

Total foreign taxes paid or accrued.
Report on Schedule B.

Reduction in taxes available for credit.
Report on Schedule G.

Capital Gains

Foreign source taxable income or (loss) before adjustments in all separate categories in the aggregate should include gain from the sale or exchange of capital assets only up to the amount of foreign source capital gain net income (which is the smaller of capital gain net income from sources outside the United States or capital gain net income). Therefore, if the corporation has capital gain net income from sources outside the United States in excess of the capital gain net income reported on its tax return, enter a pro rata portion of the net U.S. source capital loss as a negative number on Schedule A, column 9(d) for each separate category with capital gain net income from sources outside the United States. To figure the pro rata portion of the net U.S. source capital loss attributable to a separate category, multiply the net U.S. source capital loss by the amount of capital gain net income from sources outside the United States in the separate category divided by the aggregate amount of capital gain net income from sources outside the United States in all separate categories with capital gain net income from sources outside the United States.

See section 904(b)(2)(B) for special rules regarding adjustments to account for capital gain rate differentials (as defined in section 904(b)(3)(D)) for any tax year. At the time these instructions went to print, there was no capital gain rate differential for corporations.

Coordination with Section 936

In computing the foreign tax credit limitation, exclude from taxable income any income taken into account in computing the possessions corporation tax credit under section 936 (without regard to sections 936(a)(4) and 936(i)) or section 30A.

Credit Limitations

Taxes Eligible for a Credit

Domestic corporations. Generally, a domestic corporation may claim a foreign tax credit (subject to the limitation of section 904) for the following taxes:

- Income, war profits, and excess profits taxes (defined in Regulations section 1.901-2(a)) paid or accrued during the tax year to any foreign country or U.S. possession;
- Taxes deemed paid under sections 902 and 960; and
- Taxes paid in lieu of income taxes as described in section 903 and Regulations section 1.903-1.

Some foreign taxes that are otherwise eligible for the foreign tax credit must be reduced. These reductions are reported on Schedule G.

Note. A corporation may not claim a foreign tax credit for foreign taxes paid to a foreign country that the corporation does not legally owe, including amounts eligible for refund by the foreign country. If the corporation does not exercise its available remedies to reduce the amount of foreign tax to what it legally owes, a credit is not allowed for the excess amount.

Foreign corporations. Foreign corporations are allowed (under section 906) a foreign tax credit for income, war profits, and excess profits taxes paid or accrued (or deemed paid under section 902) to any foreign country or U.S. possession for income effectively connected with the conduct of a trade or business within the United States. The credit is not applicable, however, if a foreign country or U.S. possession imposes the tax on income from U.S. sources solely because the foreign corporation was created or organized under the law of the foreign country or U.S. possession or is domiciled there for tax purposes.

The credit may not be taken against any tax imposed on income not effectively connected with a U.S. business.

In computing the foreign tax credit limitation, the foreign corporation's taxable income includes only the taxable income that is effectively connected with the conduct of a trade or business within the United States.

A foreign corporation claiming a foreign tax credit will be treated as a domestic corporation in computing tax deemed paid (section 902(a)) and dividend gross-up (section 78).

Definition of foreign corporation for purposes of the deemed paid credit. In computing the deemed paid credit on Schedules C, D, and E, the term “foreign corporation” includes:
- A DISC or former DISC, but only for dividends from the DISC or former DISC that are treated as income from sources outside the United States and
- A contiguous country life insurance branch that has made an election to be treated as a foreign corporation under section 814(g).

Credit or Deduction

A corporation may choose to take either a credit or a deduction for eligible foreign taxes paid or accrued. The choice is made annually. Generally, if a corporation elects the benefits of the foreign tax credit for any tax year, no portion of the foreign taxes will be allowed as a deduction in that year or any subsequent tax year.

Exceptions. However, a corporation that elects the credit for eligible foreign taxes may be allowed a deduction for certain taxes for which a credit was not allowed. These include:
- Taxes for which the credit was denied because of the boycott provisions of section 908.
- Certain taxes on foreign oil related income under section 907(b).
- Certain taxes on the purchase or sale of oil or gas (section 901(f)).
- Certain taxes used to provide subsidies (section 901(i)).
- Taxes paid to certain foreign countries for which a credit was denied under section 901(j).
- Certain taxes paid on dividends if the minimum holding period is not met with respect to the underlying stock, or if the corporation is obligated to make related payments with respect to positions in similar or related property (section 901(k)).
- Certain taxes paid on gain and income other than dividends if the minimum holding period is not met with respect to the underlying property, or if the corporation is obligated to make related payments with respect to positions in similar or related property (see section 901(l)).

No Credit or Deduction

No foreign tax credit (or deduction) is allowed for certain taxes including:
- Taxes on mineral income that were reduced under section 901(e).
- Certain taxes paid on distributions from possessions corporations (section 901(g)).
- Taxes attributable to foreign trade income (other than section 923(a)(2) non-exempt income) distributed to a shareholder of a FSC (section 901(h)).
- Taxes of a FSC on foreign trade income (section 906(b)(5)).
- Taxes on foreign oil and gas extraction income that were reduced under section 907(a).
- Taxes paid or accrued to a foreign country or U.S. possession on taxable income that is taken into account in computing the possessions corporation tax credit (section 936(c) or section 30A).
- Taxes attributable to income excluded under section 814(a) (relating to contiguous country branches of domestic life insurance companies).
- Taxes paid or accrued to a foreign country or U.S. possession with respect to income excluded from gross income on Form 8873, Extraterritorial Income Exclusion. However, see section 943(d) for an exception for certain withholding taxes.
- Taxes paid, accrued, or deemed paid that are attributable to the deductible portion of any cash dividend described in section 965(a).

Carryback and Carryforward of Excess Foreign Taxes

If the allowable foreign taxes paid, accrued, or deemed paid in a tax year in a separate category exceed the foreign tax credit limitation for the tax year for that separate category, the excess may be:
- Carried back 2 years to offset taxes imposed in the same category. (For excess foreign taxes arising in tax years beginning after October 22, 2004, the excess may be carried back 1 year.)
- Carried forward 5 years to offset taxes imposed in the same category (and 10 years for excess foreign taxes which may be carried to any tax year ending after October 22, 2004).

The excess is applied first to the earliest of the years to which it may be carried, then to the next earliest year, etc. The corporation may not carry a credit to a tax year for which it claimed a deduction, rather than a credit, for foreign taxes paid or accrued. Furthermore, the corporation must reduce the amount of any carryback or carryforward by the amount it would have used if it had chosen to claim a credit rather than a deduction in that tax year. See section 904(c) and Regulations section 1.904-2 for more details.

How to claim the excess credit. If the corporation is carrying back the excess credit to an earlier year, file an amended tax return with a revised Form 1118. Attach the statement described in Regulations section 1.904-2(f) for each tax year to which the corporation is carrying back or carrying forward the excess credit.

Special rules apply to:
- The carryback and carryover of foreign taxes paid or accrued on foreign oil and gas extractions or related taxes (see section 907(f)) and
- An excess foreign tax credit carried to a tax year beginning after September 30, 1993, if an excess limitation account was established under section 960(b)(2).

Treaty-Based Return Positions

Corporations that adopt a return position that any U.S. treaty overrides or modifies any provision of the Internal Revenue Code, and causes (or potentially causes) a reduction of any tax incurred at any time, generally must disclose this position. Complete Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or Section 7701(b), and attach it to Form 1118. See section 6114 and Regulations section 301.6114-1 for details.

Failure to make such a report may result in a $10,000 penalty.

Proof of Credits

Form 1118 must be carefully filled in with all the information called for and with the calculations of credits indicated.

Important: Documentation (e.g., receipts of payments or a foreign tax return for accrued taxes) is not required to be attached to Form 1118. However, proof **must** be presented upon request by the IRS to substantiate the credit. See Regulations section 1.905-2.

If the corporation claims a foreign tax credit for tax accrued but not paid, the IRS may require a bond to be furnished on Form 1117, Income Tax Surety Bond, before the credit is allowed. See Regulations section 1.905-2(c).

Foreign Tax Credit Redeterminations

The corporation’s foreign tax credit must be redetermined if:
- Accrued foreign taxes when paid differ from the amounts claimed as credits;
- Accrued foreign taxes that relate to tax years beginning after 1997 are not paid within 2 years after the close of the tax year to which they relate; or
- Any foreign tax paid is fully or partially refunded.

Reporting Requirements

If any of the above occurs, the corporation generally must redetermine its U.S. tax liability. To do this, the corporation must:
- File an amended return and Form 1118 with the Service Center where it filed the tax return on which it claimed the affected foreign tax credit and
- Provide identifying information such as the corporation’s name, address, employer identification number (EIN), and the tax year or years that are affected by the redetermination.

Additional information required. If the redetermination was because of one of the following, the corporation must provide the additional information as indicated.
- **Refund of foreign taxes paid—**

1. The date or dates on which the foreign taxes were paid;

2. The amount of foreign taxes paid on each date (in foreign currency);

3. The exchange rate on each date the foreign taxes were paid; and

4. The amount of foreign taxes refunded (in foreign currency).

- **Foreign taxes that when paid differ from the accrued amounts claimed as credits for a year beginning before 1998—**

1. The date on which the foreign taxes were accrued;

2. The dates on which the foreign taxes were paid;

3. The exchange rate for each date the foreign taxes were accrued and paid; and

4. The amount of foreign taxes accrued or paid on each such date (in foreign currency).

- **Foreign taxes that when paid differ from accrued amounts claimed as credits for a tax year beginning after 1997 because the corporation paid more or less foreign tax than was originally accrued or failed to pay accrued taxes within 2 years—**

1. The date on which the foreign taxes were accrued;

2. The dates on which the foreign taxes were paid;

3. The average exchange rate for the year for which the foreign taxes were accrued;

4. For taxes paid more than 2 years after the year to which they relate, the exchange rate at the time of payment; and

5. The amount of tax accrued or paid for each such date, and the amount of accrued tax that was not paid within 2 years (in foreign currency).

- **Foreign taxes deemed paid under section 902 or 960—**If the corporation is required to make a redetermination under Temporary Regulations section 1.905-3T(d)(4), include the following basic information as an attachment to the tax return for the year for which the redetermination applies:

1. The dates and amounts of any dividend distributions or other inclusions from E&P for the affected year or years;

2. The amount of E&P from which such dividends were paid for the affected year or years; and

3. The information described above for foreign taxes paid or accrued, as applicable.

If foreign taxes deemed paid under sections 902 or 960 are adjusted and the corporation is not required to redetermine its U.S. tax liability, adjust the appropriate pools of foreign taxes and E&P using the rules outlined in Temporary Regulations section 1.905-3T(d)(2)(ii).

If an adjustment to the appropriate pools of foreign taxes and E&P is required, attach a notice of the adjustment to the tax return for the tax year during which the foreign tax adjustment occurs. Provide the following information:

- The corporation's name and EIN;
- The foreign corporation's name, address, and EIN (if any);
- The amount of any refunds of foreign taxes and the exchange rate originally used to translate the refunded foreign taxes;
- The amounts of unrefunded foreign taxes when paid and when accrued in foreign currency, the exchange rates applicable to the unrefunded foreign taxes, and the dollar amounts of unrefunded foreign taxes paid and accrued; and
- The current balances of the pools of E&P and foreign taxes before and after the foreign tax adjustment.

If an adjustment relates to a foreign tax overaccrual of 2% or more, identify each such adjustment and include a complete factual description justifying the reasons for the overaccrual (Temporary Regulations section 1.905-3T(d)(2)(iii)).

If the corporation fails to attach the required notice, to provide the necessary information, or to make the required adjustments, it must provide notification of the foreign tax changes under Temporary Regulations section 1.905-4T. The notification must include a complete factual description justifying the reasons for the failure to attach the required notification or make the required adjustments. The IRS may, in its discretion, make a redetermination of the corporation's U.S. tax liability and apply the interest provisions of section 6601 and the penalty provisions of section 6689.

Important: Temporary Regulations section 1.905-3T(d)(2)(ii)(A) has been suspended, as well as that portion of Regulations section 1.905-3T(d)(2)(ii)(C) that refers to Regulations section 1.905-3T(d)(2)(ii)(A). These suspensions are effective for taxes deemed paid or accrued for E&P of a foreign corporation accumulated in tax years beginning after 1986.

Until final regulations are issued under section 905(c), redeterminations otherwise subject to those regulations sections must be accounted for through adjustment to the appropriate pools of E&P and foreign taxes as described in Temporary Regulations section 1.905-3T(d)(3) and subject to the exceptions in Temporary Regulations section 1.905-3T(d)(4). See Notice 90-26, 1990-1 C.B. 336, for details.

Interest and Penalties

In most cases, interest is computed on the deficiency or overpayment that resulted from the foreign tax adjustment (sections 6601 and 6611 and the related regulations). See Temporary Regulations section 1.905-4T(c) for additional information.

If the corporation does not comply with the requirements discussed above within the time for filing specified, the penalty provisions of section 6689 (and the related regulations) will apply.

Specific Instructions

Report all amounts in U.S. dollars unless otherwise specified. If it is necessary to convert from a foreign currency, attach a statement explaining how the conversion rate was determined.

Separate category of income boxes. The corporation must complete a separate Form 1118 for each applicable category of income. See *Categories of Income* beginning on page 1.

Schedule A

Report gross income or (loss) from sources outside the United States for the applicable separate category in columns 2 through 7. Gross income equals gross receipts reduced by cost of goods sold. Report the applicable deductions to this gross income in columns 9 and 10. Be sure to include in all columns the gross income and deductions that pertain to foreign branches.

Aggregate **all** section 863(b) gross income and deductions and report the totals on a single line.

Column 1. Enter the two-letter codes (from the list beginning on page 11) of all foreign countries and U.S. possessions within which income is sourced and/or to which taxes were paid, accrued, or deemed paid.

For section 863(b) income, enter "863(b)" instead of a two-letter code.

Column 2(a). If the corporation is a U.S. shareholder in a CFC, report all income deemed received under section 951(a)(1)(A) (before gross-up). See section 904(d)(3) and *Look-Through Rules* on page 3 for more information. If the corporation is a U.S. shareholder in a passive foreign investment company (PFIC) and receives distributions from stock in that PFIC, report all income deemed received (before gross-up) under section 1291.

Column 3(a). Report all other dividends (before gross-up) not included in column 2(a) from sources outside the United States for the applicable separate category. Other dividends include amounts included in gross income under section 951(a)(1)(B).

Note. All dividends from a domestic corporation are of U.S. source, including dividends from a domestic corporation which has 80% or more of its gross income from sources outside the United States.

Columns 2(b) and 3(b). Include taxes deemed paid by a domestic corporation under section 902 or section 960 on distributions by a foreign corporation in income as dividend gross-up. See Regulations section 1.960-3(b) for exceptions.

Column 4. Enter all interest received from foreign sources. See section 861(c) for the treatment of interest from a domestic corporation that meets the foreign business requirement.

Column 6. Include gross income, including compensation, commissions, fees, etc., for technical, managerial, engineering, construction, scientific, or similar services outside the United States. Be sure to include gross income from services performed through a foreign branch.

Column 7. Include all other gross income from sources outside the United States for the applicable separate category, including all other gross income of foreign branches and pass-through entities and any exchange gain or loss recognized under sections 986(c) or 987(3) on a distribution or remittance of previously taxed amounts. Attach a schedule identifying the gross income by type and by the foreign country or U.S. possession from which it was sourced.

Column 9(d). Include all other deductions definitely allocable to income from sources outside the United States (dividends, interest, etc.) for the applicable separate category. Include deductions allocable to income of foreign branches.

Include any reduction of foreign source capital gain net income. If foreign source capital gain net income from all separate categories is more than the capital gain net income reported on the corporation's tax return, enter a pro rata portion of the excess as a negative number in each separate category. See *Capital Gains* on page 3.

Column 10. Enter only the apportioned share from Schedule H, Part II, column (d) that relates to gross income reported in columns 2 through 7.

Note. If the corporation qualified as a financial services entity because it treated certain amounts as active financing income that are not listed in Regulations sections 1.904-4(e)(2)(i)(A) through (X), but that are described as similar items in Regulations section 1.904-4(e)(2)(i)(Y), attach a statement to Form 1118 showing the types and amounts of the similar items.

Schedule B

Part I—Foreign Taxes Paid, Accrued, and Deemed Paid

Report only foreign taxes paid, accrued, or deemed paid for the separate category for which this Form 1118 is being completed. Report all amounts in U.S. dollars. If the corporation must convert from foreign currency, attach a schedule showing the amounts in foreign currency and the exchange rate used.

For corporations claiming the credit on the accrual basis, the exchange rate for translating foreign taxes into U.S. dollars will generally be an average exchange rate for the tax year to which the taxes relate. However, the exchange rate on the date of payment must be used if the foreign taxes (a) are paid more than 2 years after the close of the tax year to which they relate or (b) are paid in a tax year prior to which they relate. In addition, for tax years beginning after December 31, 2004, taxpayers may elect to use the exchange rate on the date of payment. Taxpayers may elect to use the payment date exchange rates for all creditable foreign income taxes or only those taxes that are attributable to qualified business units with U.S. dollar functional currencies. The election is made by attaching a statement to a timely-filed (including extensions) Form 1118 that indicates the corporation is making the election under section 986(a)(1)(D). Once made, the election applies for all subsequent tax years and is revocable only with the consent of the IRS. See section 986(a).

Column 1. Claim the foreign tax credit for the tax year in which the taxes were paid or accrued, depending on the method of accounting used. If a credit for taxes accrued is claimed, show both the date accrued and the date paid (if paid).

If the cash method of accounting is used, an election under section 905(a) may be made to claim the credit based on accrued taxes. If this election is made, figure the foreign tax credit for all subsequent tax years on the same basis. Also, the credits are subject to the redetermination provisions of section 905(c). See page 4 for details.

Column 2(d). Include foreign taxes paid or accrued on foreign branch taxable income to which the rules of section 863(b) apply.

Note. Do not include these overlapping amounts in column 2(e).

Part II—Separate Foreign Tax Credit

Line 4. Enter the total amount of foreign taxes carried forward or back to the current year (see page 4 for general rules). Include all taxes carried forward, whether or not such taxes are used. Attach a schedule reconciling the prior year's carryover with this year's carryover, identifying carrybacks and any other adjustments.

Line 6. If the corporation has, in any of its separate categories, a current year separate limitation loss, an overall domestic loss, an overall foreign loss, recapture of an overall foreign loss, or current year separate limitation income in a category in which it has a beginning balance of income that must be recharacterized, adjustments must be made. See the instructions for *Schedule J* to determine if that schedule must be filed.

Line 7b. Enter taxable income that should not be taken into account in computing the foreign tax credit limitation. For example, enter the income taken into account in computing the possessions corporation tax credit under section 936 (without regard to sections 936(a)(4) and 936(i)) or section 30A.

Line 8. Divide line 6 by line 7c to determine the limitation fraction. Enter the fraction on line 8 as a decimal with the same number of places as the number of digits to the left of the decimal in adjusted taxable income on line 7c. For example, if adjusted taxable income on line 7c is $100,000, compute the limitation fraction to 6 decimal places.

Line 10. The limitation may be increased under section 960(b) for any tax year that the corporation receives a distribution of previously taxed E&P. See section 960(b).

Part III—Summary of Separate Credits

Complete Part III only once. Enter on lines 1 through 8 the separate foreign tax credits from Part II, line 11, for each applicable separate category.

Line 10. If the corporation participates in or cooperates with an international boycott, the foreign tax credit may be reduced. Complete Form 5713, International Boycott Report. If the corporation chooses to apply the international boycott factor to calculate the reduction in the credit, enter the amount from line 2a(3) of Schedule C (Form 5713) on line 10.

Schedules C, D, and E

If the corporation is a partner in a partnership, for taxes of foreign corporations for tax years beginning after October 22, 2004, stock owned directly or indirectly, by or for a partnership shall be considered as being owned proportionately by its partners. See section 902(c)(7).

Schedule C

Part I—Dividends and Deemed Inclusions From Post-1986 Undistributed Earnings

Column 1. Enter the name of the foreign corporation (or DISC or former DISC) whose earnings were distributed to, or included in income by, the domestic corporation filing the return.

Column 2. Enter the year and month in which the foreign corporation's U.S. tax year ended.

Example. When figuring foreign taxes deemed paid in 2005 by a calendar year domestic corporation with respect to dividends and inclusions out of post-1986 undistributed earnings for the foreign corporation's tax year that ended June 30, 2005, enter "0506."

Column 4. Enter the distributing corporation's post-1986 undistributed earnings pool for the separate category for which the schedule is being completed. Generally, this amount is the corporation's E&P (computed in the corporation's functional currency according to sections 964(a) and 986) accumulated in tax years beginning after 1986, determined as of the close of the corporation's tax year without reduction for any earnings distributed or otherwise included in income (e.g., under section 304, 367(b), 951(a), 1248, or 1293) during the current tax year.

Post-1986 undistributed earnings are reduced to account for distributions or deemed distributions that reduced E&P and inclusions that resulted in previously taxed amounts described in section 959(c)(1) and (2) or section 1293(c) in prior tax years beginning after 1986. See Regulations section 1.902-1(a)(9). Also, see section 902(c)(3) and Regulations section 1.902-1(a)(13) for special rules treating earnings accumulated in post-1986 years as pre-1987 accumulated profits when no U.S. shareholder was eligible to claim a section 902 credit with respect to taxes paid by the foreign corporation.

Column 5. Enter the opening balance in the distributing corporation's post-1986 foreign income taxes pool for the tax year indicated. This amount is the foreign income taxes paid, accrued, or deemed paid (in U.S. dollars) by the foreign corporation for prior tax years beginning after 1986, reduced by foreign taxes attributable to distributions or deemed inclusions of earnings in prior tax years. See Regulations section 1.902-1(a)(8)(i).

Column 6(a). Enter the foreign income taxes paid or accrued by the foreign corporation for the tax year indicated, translated into U.S. dollars using the exchange rate specified in section 986(a).

Column 6(b). Enter the foreign income taxes deemed paid (under section 902(b)) by the corporation for the tax year indicated (from Schedule D, Part I, Section A, column 10, and Section B, column 8(b)).

Column 8(a). Report the sum (in the foreign corporation's functional currency) of all dividends paid and deemed inclusions out of post-1986 undistributed earnings for the tax year indicated.

Column 8(b). Report the column 8(a) amounts, translated into U.S. dollars at the appropriate exchange rates (as defined in section 989(b)). If the foreign corporation's functional currency is the U.S. dollar, **do not** complete column 8(b).

Part II—Dividends Paid Out of Pre-1987 Accumulated Profits

Use a separate line for each dividend paid. If a dividend is paid out of the accumulated profits of more than one pre-1987 tax year, figure and show the tax deemed paid on a separate line for each tax year. In applying section 902, the IRS may determine from which tax year's accumulated profits the dividends were paid. See Regulations section 1.902-3(g)(4).

Important: The formula for calculating foreign taxes deemed paid under section 902 with respect to dividends paid in a post-1986 year out of pre-1987 accumulated profits requires that all components (dividends, accumulated profits, and taxes) be maintained in the foreign corporation's functional currency and translated into U.S. dollars at the exchange rate in effect on the date of the dividend distribution. See Regulations section 1.902-1(a)(10)(ii) and (iii).

Column 1. Enter the name of the first-tier foreign corporation (or DISC or former DISC) that paid a dividend out of pre-1987 profits to the domestic corporation filing the return.

Column 2. Enter the year and month in which the foreign corporation's pre-1987 tax year ended.

Column 4. For each line, enter the pre-1987 accumulated profits for the tax year indicated in column 2, computed in functional currency under section 902. See Regulations section 1.902-1(a)(10)(i) and (ii).

Column 5. Enter the foreign taxes paid and deemed paid (in functional currency) with respect to the pre-1987 accumulated profits entered in column 4 for the tax year indicated in column 2. See the instructions for Schedule G on page 8 for information on reduction of foreign taxes for failure to furnish information required under section 6038.

Column 6(a). Enter the amount of each dividend paid by the first-tier foreign corporation (or DISC or former DISC) to the domestic corporation (in functional currency) out of the accumulated profits of the pre-1987 tax year indicated in column 2.

Column 6(b). Enter the amount from column 6(a) translated into U.S. dollars using the spot exchange rate in effect on the date of distribution. See Regulations sections 1.902-1(a)(10)(ii) and 1.902-3(g)(1).

Column 8(a). Multiply column 5 by column 7. Enter this amount in column 8(a) in functional currency.

Column 8(b). Enter the amount from column 8(a) translated into U.S. dollars at the spot exchange rate in effect on the date of distribution. See Regulations section 1.902-1(a)(10)(iii).

Part III—Deemed Inclusions From Pre-1987 Earnings and Profits

Important: The formula for calculating foreign taxes deemed paid under section 960 with respect to deemed inclusions (e.g., under section 956 or 1248) in a post-1986 year out of pre-1987 E&P requires that earnings and profits and foreign taxes be calculated in U.S. dollars under the rules of Regulations section 1.964-1(a) through (e), and then translated into the foreign corporation's functional currency at the exchange rate in effect on the first day of the foreign corporation's first post-1986 tax year. See Notice 88-70, 1988-2 C.B. 369. The deemed inclusion is then translated into U.S. dollars at the appropriate exchange rate specified in section 989(b). Foreign income taxes paid in pre-1987 tax years are translated into U.S. dollars for purposes of section 960 at the exchange rate in effect when the foreign taxes were paid. See Regulations section 1.964-1(d) and Temporary Regulations section 1.905-5T(b)(1).

Column 1. Enter the name of the first- or lower-tier foreign corporation whose earnings were deemed included in the income of the domestic corporation filing the return.

Column 2. Enter the year and month in which the corporation's pre-1987 tax year ended. If the deemed inclusion is from the accumulated E&P of more than 1 tax year, figure and show the tax deemed paid on a separate line for each year.

Column 4. For each line, enter the E&P calculated in U.S. dollars under Regulations sections 1.964-1(a) through (e), translated into functional currency under Notice 88-70 for the tax year indicated in column 2.

Column 5. Enter foreign taxes paid and deemed paid (in U.S. dollars) with respect to the E&P entered in column 4. See the instructions for Schedule G on page 8 for information on reduction of foreign taxes for failure to furnish information required under section 6038.

Column 6(b). Enter the amount from column 6(a) translated into U.S. dollars at the appropriate exchange rate specified in section 989(b).

Schedule D

Part I—Tax Deemed Paid by First-Tier Foreign Corporations

Section A—Dividends Paid Out of Post-1986 Undistributed Earnings

Column 1. Enter the name of the second-tier foreign corporation and the name of the first-tier foreign corporation to which it paid a dividend out of post-1986 undistributed earnings.

Example. The U.S. corporation filing the return owns all of the stock of CFC1 and CFC2. CFC1 and CFC2 each own 50% of the stock of CFC3. In 2005, CFC3 pays a dividend to CFC1 and CFC2. Use one line to report dividends from CFC3 to CFC1 and another line to report dividends from CFC3 to CFC2.

Column 2. Enter the year and month in which the distributing second-tier foreign corporation's tax year ended.

Example. If a first-tier foreign corporation that uses the calendar year 2005 as its tax year receives dividends out of post-1986 undistributed earnings of a second-tier foreign corporation for a tax year that ended June 30, 2005, enter "0506."

Column 3. Enter the second-tier foreign corporation's applicable two-digit foreign country or U.S. possession code from the list beginning on page 11.

Column 4. Enter the second-tier foreign corporation's post-1986 undistributed earnings pool (in functional currency) for the separate category for which the schedule is being completed. See the instructions for Schedule C, Part I, column 4.

Column 5. Enter the opening balance in the second-tier foreign corporation's post-1986 foreign income taxes pool for the tax year indicated. See the instructions for Schedule C, Part I, column 5.

Column 6(a). Enter the foreign income taxes paid or accrued by the second-tier foreign corporation for the tax year indicated, translated from foreign currency into U.S. dollars using the exchange rate specified in section 986(a).

Column 6(b). Enter the foreign income taxes deemed paid (under section 902(b)) by the second-tier foreign corporation for the tax year indicated (from Schedule D, Part II, Section A, column 10, and Part II, Section B, column 8(b).

Column 8(a). Report the sum (in the second-tier foreign corporation's functional currency) of all dividends paid out of its post-1986 undistributed earnings for the tax year indicated.

Column 8(b). Report the sum of the column 8(a) amounts translated into the functional currency of the first-tier foreign corporation at the spot rate in effect on the date of each distribution.

Section B—Dividends Paid Out of Pre-1987 Accumulated Profits

Use a separate line for each dividend paid. If a dividend is paid out of the accumulated profits of more than one pre-1987 tax year, figure and show the tax deemed paid on a separate line for each tax year. In applying section 902, the IRS may determine from which tax year's accumulated profits the dividends were paid. See Regulations section 1.902-3(g)(4).

Important: The formula for calculating foreign taxes deemed paid by a first-tier foreign corporation under section 902(b) with respect to dividends paid by a second-tier foreign corporation in a post-1986 year out of pre-1987 accumulated profits requires that all components (dividends, accumulated profits, and taxes) be maintained in the second-tier foreign corporation's functional currency. Dividends are translated into the first-tier foreign corporation's functional currency and added to its post-1986 undistributed earnings at the exchange rate in effect on the date of the dividend distribution. See Regulations section 1.902-1(a)(9)(ii). Foreign taxes are translated into U.S. dollars, and added to the first-tier foreign corporation's post-1986 foreign income taxes, at the exchange rate in effect on the date of the dividend distribution. See Regulations section 1.902-1(a)(8)(ii).

Column 1. Enter the name of the second-tier foreign corporation and the name of the first-tier foreign corporation to which it paid a dividend out of pre-1987 accumulated profits.

Column 2. For each pre-1987 tax year, enter the year and month in which the second-tier foreign corporation's tax year ended.

Column 4. For each line, enter the pre-1987 accumulated profits for the tax year indicated in column 2, computed in the second-tier corporation's functional currency under section 902. See Regulations sections 1.902-1(a)(10)(i) and (ii).

Column 5. Enter the foreign taxes paid and deemed paid under section 902(b) (in functional currency) with respect to the accumulated profits entered in column 4 for the pre-1987 tax year indicated in column 2. See the instructions for Schedule G below for information on reduction of foreign taxes for failure to furnish information required under section 6038.

Column 6(a). Enter each dividend paid by the second-tier foreign corporation (in functional currency) to the first-tier foreign corporation out of the accumulated profits of the pre-1987 tax year indicated in column 2.

Column 6(b). Enter the amount from column 6(a), translated into the first-tier foreign corporation's functional currency using the spot exchange rate in effect on the date of distribution. See Regulations sections 1.902-1(a)(10)(ii) and 1.902-3(g)(1).

Column 8(a). Multiply column 5 by column 7. Enter this amount in column 8(a).

Column 8(b). Enter the amount from column 8(a), translated in U.S. dollars at the spot exchange rate in effect on the date of distribution. See Regulations section 1.902-1(a)(10)(iii).

Part II—Tax Deemed Paid by Second-Tier Foreign Corporations

Follow the instructions for the corresponding columns of Schedule D, Part I, substituting "second-tier foreign corporation" for references to the "first-tier foreign corporation" and "third-tier foreign corporation" for references to the "second-tier foreign corporation."

Note. In completing Section A, column 5, note that section 902(b) as in effect prior to the Taxpayer Relief Act of 1997 did not treat any foreign taxes as deemed paid by a third- or lower-tier foreign corporation with respect to dividends received from lower-tier foreign corporations.

Schedule E

Use Schedule E to report foreign taxes deemed paid with respect to dividends from certain fourth-, fifth-, and sixth-tier controlled foreign corporations out of earnings accumulated in tax years beginning after August 5, 1997. Follow the instructions for the corresponding columns of Schedule D, Part I, Section A, substituting references to the next lower-tier foreign corporation as appropriate.

The post-1986 undistributed earnings and taxes pools for the eligible CFCs begin on the first day of the CFC's first tax year beginning after August 5, 1997. Earnings accumulated in tax years beginning before August 6, 1997, will be treated as pre-1987 accumulated profits for section 902 purposes. See section 902(c)(6) and Regulations section 1.902-1(a)(10)(i). Foreign income taxes attributable to these pre-pooling profits must be reduced when the associated earnings are distributed. However, such taxes are not eligible for the deemed paid credit. See Regulations section 1.902-1(a)(10)(iii) and section 1113(c)(2) of the Taxpayer Relief Act of 1997.

Note. In completing Part III, column 5, note that, under section 902(b) as amended by the Taxpayer Relief Act of 1997, no taxes are deemed paid by a sixth- or lower-tier foreign corporation with respect to dividends received from lower-tier foreign corporations.

Schedule F

Enter the gross income and definitely allocable deductions for each foreign branch (including a disregarded entity) as indicated. For each such foreign branch for which Form 8858, Information Return of U.S. Persons With Respect To Foreign Disregarded Entities, is not filed, attach an income statement, balance sheet, and schedule of remittances.

Schedule G

Line A. If the corporation claims a deduction for percentage depletion under section 613 with respect to any part of its foreign mineral income (as defined in section 901(e)(2)) for the tax year, any foreign taxes on that income must be reduced by the smaller of:

1. The foreign taxes minus the tax on that income or
2. The tax on that income determined without regard to the deduction for percentage depletion minus the tax on that income.

The reduction must be made on a country-by-country basis (Regulations section 1.901-3(a)(1)). Attach a separate schedule showing the reduction.

Line C. If the corporation chooses to calculate the reduction in the foreign tax by identifying taxes specifically attributable to participation in or cooperation with an international boycott, enter the amount from Form 5713, Schedule C, line 2b. See Form 5713 and its separate Schedule C and instructions.

Line D. If the corporation controls a foreign corporation or partnership and fails to furnish any return or any information in any return required under section 6038(a) by the due date, reduce the foreign taxes available for credit under sections 901, 902, and 960 by 10%. If the failure continues for 90 days or more after the date of written notice by the IRS, reduce the tax by an additional 5% for each 3-month period or fraction thereof during which the failure continues after the 90-day period has expired. See section 6038(c) for limitations and special rules.

In addition, a $10,000 penalty is imposed under section 6038(b) for failure to supply the information required under section 6038(a) for each entity within the time prescribed. If the required information is not submitted within 90 days after the IRS has mailed notice to the U.S. person, additional penalties apply.

Note. The reduction in foreign taxes available for credit is reduced by any dollar penalty imposed under section 6038(b).

Line E. Include the reduction for foreign taxes on foreign oil related income under section 907(b) and taxes attributable to the deductible portion of any cash dividend described in section 965(a).

Schedule H

Computer-Generated Schedule H

A computer-generated Schedule H may be filed if it conforms to the IRS version. In some cases, Schedule H can be expanded to properly apportion deductions. This applies in cases such as when the corporation:

- Has more than two product lines (under the sales method of apportioning R&D deductions),
- Has section 901(j) income from more than one sanctioned country, or
- Has income re-sourced by treaty for more than one country.

Part I—Research and Development Deductions

Use Part I to apportion the research and development (R&D) deductions that cannot be definitely allocated to some item or class of gross income. Use **either** the sales method **or** one of the gross income methods described in Regulations section 1.861-17.

Note. The line 4 totals will generally be less than the totals on lines 1 and 2 because the line 4 totals do not include the gross income and deductions that are implicitly apportioned to the residual grouping.

Column (a) Sales Method

Complete these columns only if the corporation elects the sales method of apportioning R&D deductions described in Regulations section 1.861-17(c). Enter in the spaces provided the SIC Code numbers (based upon the Standard Industrial Classification System) of the product lines to which the R&D deductions relate. See Regulations section 1.861-17(a)(2)(ii) and (iii) for details on choosing SIC codes and changing a product category.

Note. If the corporation has more than two product lines, see *Computer-Generated Schedule H* above.

Columns (a)(i) and (a)(iii)

Line 1. Enter the worldwide gross sales for the product lines.

Lines 3a through 3h. Enter the gross sales that resulted in gross income for each statutory grouping.

Columns (a)(ii) and (a)(iv)

Line 1. Enter the total R&D deductions connected with the product lines.

Line 2. Reduce the line 1 totals by legally mandated R&D (Regulations section 1.861-17(a)(4), and a 50% exclusive apportionment amount (Regulations section 1.861-17(b)(1)(i)).

The legally mandated R&D rules apply to R&D undertaken solely to meet legal requirements imposed by a particular political entity for improvement or marketing of specific products or processes **if** the corporation does not reasonably expect the results of that research to generate gross income (beyond de minimis amounts) outside a single geographic source.

Under the exclusive apportionment rules, 50% of the R&D deductions are apportioned exclusively to the statutory grouping of gross income, or the residual grouping of gross income, as the case may be, from the geographic source where the R&D activities which account for more than 50% of the amount of such deduction were performed. If the 50% test is **not** met, then no part of the deduction is apportioned under these rules.

Lines 3a through 3h. To figure the amount of R&D deductions to apportion to each statutory grouping, divide the gross sales apportioned to the statutory grouping by the worldwide gross sales for the product line. Multiply the result by the R&D deductions to be apportioned.

Note. If the corporation had section 901(j) income from more than one sanctioned country or had income re-sourced by treaty for more than one country, see *Computer-Generated Schedule H* above.

Example 1. To determine the amount to enter on line 3a, column (a)(ii):

1. Divide the amount on line 3a, column (a)(i) by the amount on line 1, column (a)(i).
2. Multiply the result by the amount on line 2, column (a)(ii).

Example 2. To determine the amount to enter on line 3b, column (a)(iv):

1. Divide the amount on line 3b, column (a)(iii) by the amount on line 1, column (a)(iii).
2. Multiply the result by the amount on line 2, column (a)(iv).

Column (b) Gross Income Methods

Complete these columns only if the corporation elects one of the gross income methods of apportioning R&D deductions described in Regulations section 1.861-17(d)(2) and (3). Check the box for the option used. Use Option 1 only if certain conditions are met. See Regulations section 1.861-17(d)(2).

Column (b)(vi)

Line 1. Enter the total gross income (excluding exempt income according to Temporary Regulations section 1.861-8T(d)(2)).

Lines 3a through 3h. Enter the gross income within each statutory grouping.

Column (b)(vii)

Line 1. Enter the total R&D deductions.

Line 2. Reduce the line 1 totals by legally mandated R&D (Regulations section 1.861-17(a)(4)), and a 25% exclusive apportionment amount (Regulations section 1.861-17(b)(1)(ii)).

Lines 3a through 3h. If Option 1 is checked, divide the gross income apportioned to the statutory grouping by the total gross income and multiply the result by the R&D deductions to be apportioned. If Option 2 is checked, enter the appropriate amount as described in Regulations section 1.861-17(d)(3).

Part II—Interest Deductions, All Other Deductions, and Total Deductions

Note. The line 4 totals will generally be less than the totals on lines 1 and 2 because the line 4 totals do not include the gross income and deductions that are implicitly apportioned to the residual grouping.

Columns (a)(i) through (b)(iv)

Use these columns to apportion interest deductions. See Temporary Regulations sections 1.861-8T through 1.861-13T for rules on the apportionment of interest deductions based on the fair market value, tax book value, or adjusted tax book value of assets.

If the corporation elected to use the fair market value method to apportion interest expense, see Temporary Regulations section 1.861-9T(h). Also see Rev. Proc. 2003-37, 2003-1 C.B. 950, for procedures for supplying certain documentation and information.

For tax years beginning on or after March 26, 2004, a corporation may elect to use the alternative tax book value method. See Regulations section 1.861-9(i).

Columns (a) and (b) are subdivided into “Nonfinancial Corporations” and “Financial Corporations.” In allocating interest deductions, members of an affiliated group that are financial corporations must be treated as a separate affiliated group. Complete columns (a)(ii) and (b)(iv) for members of the corporation’s affiliated group that are financial corporations and columns (a)(i) and (b)(iii) for members that are nonfinancial corporations.

See Regulations section 1.861-11 for the definition of an affiliated group and special rules for section 936 corporations.

Columns (a)(i) and (a)(ii)

Line 1a. Enter the average of the total assets of the affiliated group. See Temporary Regulations section 1.861-9T(g)(2) for the definition of average for these purposes.

Line 1b. Enter the assets included on line 1a that are characterized as excess related party indebtedness. See Temporary Regulations section 1.861-10T(e) for an exception to the general rule of fungibility for excess related party indebtedness.

Line 1c. Enter all other assets that attract specifically allocable interest deductions. See Temporary Regulations section 1.861-10T for other exceptions to the general rule of fungibility (such as qualified nonrecourse indebtedness and integrated financial transactions).

Line 1d. Enter the total of the exempt assets and assets without directly identifiable yield that are to be excluded from the interest apportionment formula (Temporary Regulations sections 1.861-8T(d)(2) and 1.861-9T(g)(3)).

Lines 3a through 3j. The assets on line 2 are characterized as assets in one of the statutory groupings or as belonging to the residual grouping. Enter the value of the assets in each of the statutory groupings on line 3a through 3j. See Temporary Regulations sections 1.861-9T(g)(3), 1.861-12T(g)(2), and 1.861-12T(h)(2) for the rules for characterizing the assets.

Columns (b)(iii) and (b)(iv)

Line 1a. Enter the total interest deductions for the members of the corporation's affiliated group. These include any expense that is currently deductible under section 163 (including original issue discount), and interest equivalents. See Temporary Regulations section 1.861-9T for the definition of interest equivalents and a list of the sections that disallow or suspend interest deductions or require the capitalization of interest deductions.

Line 1b. Enter the interest deductions associated with the assets on line 1b of columns (a)(i) and (a)(ii), respectively, that attract specifically allocable interest deductions under Temporary Regulations section 1.861-10T(e).

Note. These interest deductions will be divided among the statutory groupings and will appear as a definitely allocable deduction in Schedule A, column 9(d).

Line 1c. Enter the interest deductions associated with the assets on line 1c of columns (a)(i) and (a)(ii), respectively, that attract specifically allocable interest deductions.

Lines 3a through 3j. To figure the amount of interest deductions to apportion to each statutory grouping, divide the assets apportioned to the grouping by the total assets apportioned and multiply the result by the interest deductions to be apportioned.

Example 1. To figure the amount to enter on line 3a, column (b)(iii): (a) divide the amount entered on line 3a, column (a)(i), by the amount on line 2, column (a)(i); and (b) multiply the result by the amount on line 2, column (b)(iii).

Example 2. To figure the amount to enter on line 3b, column (b)(iv): (a) divide the amount on line 3b, column (a)(ii) by the amount on line 2, column (a)(ii); and (b) multiply the result by the amount on line 2, column (b)(iv).

Column (c)

Complete this column to apportion all other deductions not definitely allocable (other than interest deductions and R&D deductions). See Regulations sections 1.861-8 and 1.861-14 and Temporary Regulations sections 1.861-8T and 1.861-14T.

Line 1a. Enter the total other deductions. Examples include: stewardship expenses; legal and accounting expenses; and other expenses related to certain supportive functions such as overhead, general and administrative, advertising, and marketing. Deductions for charitable contributions made on or after July 28, 2004, generally are definitely related and allocable to all gross income and apportioned solely to domestic source income.

Lines 3a through 3j. Enter the amounts apportioned to each statutory grouping.

Schedules I and J

See the separate instructions for Schedule I and Schedule J to see if the corporation must file these schedules.

Foreign Country and U.S. Possession Codes

Enter the following codes in the appropriate columns as requested in Schedule A, Schedule C, Schedule D, and Schedule E.

Country	Code
Abu Dhabi	TC
Afghanistan	AF
Albania	AL
Algeria	AG
American Samoa	AQ
Andorra	AN
Angola	AO
Anguilla	AV
Antarctica	AY
Antigua and Barbuda	AC
Argentina	AR
Armenia	AM
Aruba	AA
Ashmore and Cartier Islands	AT
Australia	AS
Austria	AU
Azerbaijan	AJ
Azores	PO
Bahamas, The	BF
Bahrain	BA
Baker Island	FQ
Balearic Islands *(Mallorca, etc.)*	SP
Bangladesh	BG
Barbados	BB
Bassas da India	BS
Belarus	BO
Belgium	BE
Belize	BH
Benin *(Dahomey)*	BN
Bermuda	BD
Bhutan	BT
Bolivia	BL
Bonaire	NT
Bosnia-Herzegovina	BK
Botswana	BC
Bouvet Island	BV
Brazil	BR
British Indian Ocean Territory	IO
Brunei	BX
Bulgaria	BU
Burkina Faso *(Upper Volta)*	UV
Burma	BM
Burundi	BY
Cambodia *(Kampuchea)*	CB
Cameroon	CM
Canada	CA
Canary Islands	SP
Cape Verde	CV
Cayman Islands	CJ
Central African Republic	CT
Chad	CD
Chile	CI
China, People's Republic of *(including Inner Mongolia, Tibet, and Manchuria)*	CH
Christmas Island *(Indian Ocean)*	KT
Clipperton Island	IP
Cocos *(Keeling)* Islands	CK
Colombia	CO
Comoros	CN
Congo *(Brazzaville)*	CF
Congo, Democratic Republic of *(Zaire)*	CG
Cook Islands	CW
Coral Sea Islands Territory	CR
Corsica	VP
Costa Rica	CS
Cote D'Ivoire *(Ivory Coast)*	IV
Croatia	HR
Cuba	CU
Curacao	NT
Cyprus	CY
Czech Republic	EZ
Denmark	DA
Djibouti	DJ
Dominica	DO
Dominican Republic	DR
Dubai	TC
East Timor	TT
Ecuador	EC
Egypt	EG
Eleuthera Island	BF
El Salvador	ES
Equatorial Guinea	EK
Eritrea	ER
Estonia	EN
Ethiopia	ET
Europa Island	EU
Falkland Islands *(Islas Malvinas)*	FK
Faroe Islands	FO
Fiji	FJ
Finland	FI
France	FR
French Guiana	FG
French Polynesia *(Tahiti)*	FP
French Southern and Antarctic Lands	FS
Gabon	GB
Gambia	GA
Gaza Strip	GZ
Georgia	GG
Germany	GM
Ghana	GH
Gibraltar	GI
Glorioso Islands	GO
Great Britain *(United Kingdom)*	UK
Greece	GR
Greenland	GL
Grenada *(Southern Grenadines)*	GJ
Guadeloupe	GP
Guam	GQ
Guatemala	GT
Guernsey	GK
Guinea	GV
Guinea-Bissau	PU
Guyana	GY
Haiti	HA
Heard Island and McDonald Islands	HM
Honduras	HO
Hong Kong	HK
Howland Island	HQ
Hungary	HU
Iceland	IC
India	IN
Indonesia *(including Bali, Belitung, Flores, Java, Moluccas, Sumatra, Timor, etc.)*	ID
Iran	IR
Iraq	IZ
Ireland, Republic of *(Eire)*	EI
Isle of Man	IM
Israel	IS
Italy	IT
Jamaica	JM
Jan Mayen	JN
Japan	JA
Jarvis Island	DQ
Jersey	JE
Johnston Atoll	JQ
Jordan	JO
Juan de Nova Island	JU
Kazakhstan	KZ
Kenya	KE
Kingman Reef	KQ
Kiribati *(Gilbert Islands)*	KR
Korea, Democratic People's Republic of *(North)*	KN
Korea, Republic of *(South)*	KS
Kosovo	YO
Kurile Islands	RS
Kuwait	KU
Kyrgyzstan	KG
Laos	LA
Latvia	LG
Lebanon	LE
Lesotho	LT
Liberia	LI
Libya	LY
Liechtenstein	LS
Lithuania	LH
Luxembourg	LU
Macau	MC
Macedonia	MK
Madagascar *(Malagasy Republic)*	MA
Malawi	MI
Malaysia	MY
Maldives	MV
Mali	ML
Malta	MT
Marshall Islands	RM
Martinique	MB
Mauritania	MR
Mauritius	MP
Mayotte	MF
Mexico	MX
Micronesia, Federated States of	FM
Midway Islands	MQ
Moldova	MD
Monaco	MN
Mongolia	MG
Montenegro	YO
Montserrat	MH
Morocco	MO
Mozambique	MZ
Namibia	WA
Nauru	NR
Navassa Island	BQ
Nepal	NP
Netherlands	NL
Netherlands Antilles	NT
New Caledonia	NC
New Zealand	NZ
Nicaragua	NU
Niger	NG
Nigeria	NI
Niue	NE
Norfolk Island	NF
Northern Ireland	UK
Northern Mariana Islands	CQ
Norway	NO

Oman	MU
Pakistan	PK
Palau	PS
Palmyra Atoll	LQ
Panama	PM
Papua New Guinea	PP
Paracel Islands	PF
Paraguay	PA
Peru	PE
Philippines	RP
Pitcairn Island	PC
Poland	PL
Portugal	PO
Puerto Rico	RQ
Qatar	QA
Redonda	VI
Reunion	RE
Romania	RO
Russia	RS
Rwanda	RW
Ryukyu Islands	JA
St. Helena *(Ascension Island and Tristan de Cunha Island Group)*	SH
St. Kitts *(St. Christopher and Nevis)*	SC
St. Lucia	ST
St. Pierre and Miquelon	SB
St. Vincent and the Grenadines *(Northern Grenadines)*	VC
San Marino	SM
Sao Tome and Principe	TP
Sarawak	MY
Saudi Arabia	SA
Senegal	SG
Serbia	YO
Seychelles	SE
Sierra Leone	SL
Singapore	SN
Slovak Republic *(Slovakia)*	LO
Slovenia	SI
Solomon Islands	BP
Somalia	SO
South Africa	SF
South Georgia and the South Sandwich Islands	SX
Spain	SP
Spratly Islands	PG
Sri Lanka	CE
Sudan	SU
Suriname	NS
Svalbard *(Spitsbergen)*	SV
Swaziland	WZ
Sweden	SW
Switzerland	SZ
Syria	SY
Taiwan	TW
Tajikistan	TI
Tanzania	TZ
Thailand	TH
Togo	TO
Tokelau	TL
Tonga	TN
Tortola	VI
Trinidad and Tobago	TD
Tromelin Island	TE
Tunisia	TS
Turkey	TU
Turkmenistan	TX
Turks and Caicos Islands	TK
Tuvalu	TV
Uganda	UG
Ukraine	UP
United Arab Emirates	TC
United Kingdom *(England, Wales, Scotland, No. Ireland)*	UK
Uruguay	UY
Uzbekistan	UZ
Vanuatu	NH
Vatican City	VT
Venezuela	VE
Vietnam	VM
Virgin Islands *(British)*	VI
Virgin Islands *(U.S.)*	VQ
Wake Island	WQ
Wallis and Futuna	WF
West Bank	WE
Western Sahara	WI
Western Samoa	WS
Windward Islands	VC
Yemen *(Aden)*	YM
Yugoslavia *(Kosovo, Montenegro, Serbia)*	YO
Zaire *(Democratic Republic of Congo)*	CG
Zambia	ZA
Zimbabwe	ZI
Other Country	OC
Unknown Country	UC

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form and related schedules will vary depending on individual circumstances. The estimated average times are:

Form	Recordkeeping	Learning about the law or the form	Preparing and sending the form to the IRS
1118	93 hr., 16 min.	18 hr., 32 min.	22 hr., 4 min.
Sch. I (Form 1118)	9 hr., 19 min.	1 hr.	1 hr., 11 min.
Sch. J (Form 1118)	89 hr., 26 min.	1 hr., 17 min.	2 hr., 48 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form and related schedules simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.