Profit Playbook: Avoiding the Foreign Tax Man

By S. Kay Bell

An internationally diversified portfolio makes perfect sense. Choosing a few foreign investments here and there helps spread your risk and take advantage of global income and growth opportunities.

But worldwide investing can complicate the tax lives of U.S. shareholders. Most countries withhold taxes from investments there, while our tax law covers *all* income, regardless of where it's earned. That means two tax collectors are taking a cut of the international earnings pie.

But don't rush to call your broker with a sale order just yet. The IRS is more forgiving — in this situation, at least — than you might think. You can claim a tax credit or an itemized deduction on your federal tax return to avoid the double taxation you face for your global holdings.

Claim Your Credits or Deductions

It's better to take a credit than a deduction if you have the choice. You subtract a tax credit directly from the amount of tax you owe, reducing your tax bill dollar for dollar. The impediment here is that claiming the foreign tax credit can get complicated. Form 1040's foreign tax credit line asks you to include Form 1116 — a dense two-page form (its instructions are pretty dense, too) that calls for details such as foreign source gross income, currency conversion, and foreign tax credit redetermination.

Got those handy? If not, or if you don't use a tax preparer or software, the process can be quite daunting. Fortunately, if your foreign taxes are $300 or less ($600 for married couples filing jointly), you can ignore Form 1116 altogether and simply enter the foreign tax amount on your return.

If you choose to claim the foreign taxes you paid as an itemized deduction on Form 1040 Schedule A, that will increase your deduction total — and in most cases, that'll help lower your tax bill, too.

But fair warning: It takes a sizeable deduction to get a worthwhile decrease, and if your total itemized deductions exceed the limits for higher-income taxpayers, you'll benefit even less. That's why it's often worth the trouble to claim a credit for those foreign taxes.

Follow the Rules

Regardless of which method you use to offset your foreign tax payments, some general rules apply. For starters, the foreign tax must be similar to U.S. taxes, and you have to exercise all available options to reduce those foreign taxes in order to claim a credit for any excess.

Let's assume that Country X imposes a 25% dividend withholding tax and therefore withholds $250 in taxes from your $1,000 in dividend income. If the dividend income had been from a U.S. source, your tax liability would have been only 15%, or $150. As a result, you can claim a foreign tax credit for only $150, even though you're out-of-pocket $250. But don't get too upset — the IRS allows you to carry back any unused foreign tax credit to the previous tax year or forward to one of the next 10 tax years.

If you've paid taxes to a country the U.S. government has designated as supporting terrorist activities, you're out of luck — you can't file for a credit. (Got any good North Korean stock tips?) Curiously, there's no specific restriction on claiming those taxes as a deduction.

The United States has negotiated income tax treaties with many countries, and in some cases, that could affect your personal foreign tax break. For example, the tax treaty with Norway reduces the dividend withholding tax from the standard 25% to 15%, and the treaty with the United Kingdom eliminates dividend withholding tax altogether!

Be Careful: Foreign Stocks and IRAs

Finally, the foreign credit or deduction is of no use if your international holdings are in an individual retirement account. Gains in an IRA don't show up on your tax return, and consequently there's no tax to claim a credit against. The tax credit is lost.

This is especially a problem for traditional IRAs, because their account values are eventually taxed when you start to take distributions. The means you get taxed twice: on the front end by the foreign country on the total dividend amount, and then on the back end by the United States on the dividend amount that was not withheld. Holding foreign dividend stocks in a traditional IRA is therefore not generally the best tax strategy.

A Roth IRA is less troublesome because contributions are after-tax and distributions are free of U.S. taxes. Ultimately, foreign dividend stocks are better if you invest them in a taxable account, because you can take advantage of the tax credit and avoid double-taxation. A Roth IRA also avoids double taxation, while a traditional IRA can end up costing you double.

You should certainly include international stocks in your portfolio — just be sure to include some time for tax planning.

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