Internal Revenue Service
DEPARTMENT OF THE TREASURY

# LB&I Virtual Library
# Concept Unit

| Library Level | Number | Title |
|---|---|---|
| **Shelf** | – | Business Outbound |
| **Book** | 3 | FTC Management |
| **Chapter** | 3.3 | Accessing Foreign Source Income |
| **Section** | 3.3.5 | Overall foreign loss & overall domestic loss calculation & recapture |
| **Subsection** | N/A | N/A |

| | | |
|---|---|---|
| **Unit Name** | Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit | |
| **Primary UIL Code** | 9413.03-05 | Overall Foreign Loss & Overall Domestic Loss Calculation & Recapture |

| | |
|---|---|
| **Document Control Number (DCN)** | FTM/C/03_03_05-01 |
| **Date of Last Update** | 02/13/17 |

# Table of Contents

***(View this PowerPoint in "Presentation View" to click on the links below)***

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

- In General

The United States taxes U.S. persons on their worldwide income, including their Foreign Taxable Income (FTI). The Foreign Tax Credit (FTC) generally prevents U.S. taxpayers from being taxed twice on their FTI - once by the foreign country where the income is earned, and again by the United States. The FTC generally allows U.S. taxpayers to reduce (on a dollar-for-dollar basis) the U.S. tax on their FTI by the foreign income taxes they pay on that FTI.

Note that in the context of this practice unit, references to foreign income and loss amounts generally are made with respect to such foreign amounts reported on the U.S. income tax return. For example, this would include the dividends received from a CFC and the results of a directly-owned foreign disregarded entity's business operations that are included on Form 1120 or Form 1040. Such references to foreign income and loss do not refer to excluded amounts subject to deferral, like the undistributed earnings and profits of a CFC reported on information return Form 5471, Schedule J.

- FTC Limitation

A premise of the FTC is that it should not reduce a taxpayer's U.S. tax on its U.S. Taxable Income (USTI), only a taxpayer's U.S. tax on its FTI. As such, the tax laws impose a limitation on the amount of FTCs that can be claimed in a year. The FTC limitation prevents taxpayers from using FTCs to offset U.S. tax on USTI. This limitation generally is calculated as:

$$\frac{\text{Foreign taxable income}}{\text{Worldwide taxable income}} \quad \text{x} \quad \text{Pre-credit U.S. tax}$$

The FTC limitation is calculated separately for various categories of FTI (separate categories). For example, passive category income and general category income are separate income categories, with distinct FTC limitations, which are calculated and reported on discrete Forms 1118. Applying separate limitations by category prevents any excess foreign taxes imposed on a separate category of income from reducing a taxpayer's U.S. tax on other separate FTI categories.

Back to Table of Contents

# General Overview (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

- Losses

A business has expenses and losses in the ordinary course of its operations. In order to determine the USTI and FTI in each separate category, the Code and Treasury Regulations contain rules that allocate and apportion such expenses, losses, and other deductions to U.S. Source Income (USI) and to the separate categories of Foreign Source Income (FSI). Note that people sometimes use the terms FSI and FTI interchangeably to refer to FTI. Also, the terms USTI and USI are sometimes used interchangeably to refer to USTI.

To the extent the allocation and apportionment of expenses, losses, and other deductions results in either a domestic loss or a foreign loss in one or more separate categories, such separately computed net losses will be allocated against other net income, if any. When a net loss offsets net income of a different source or a different category of FTI, the loss recapture rules that are the subject of this unit are triggered.

A net loss in a separate category of FTI is known as a Separate Limitation Loss, or SLL.

An SLL must offset net income in other FTI categories ("Separate Limitation Income" or SLI) on a pro rata basis prior to offsetting USTI. When an SLL in one separate category offsets SLI in another separate category, an SLL account is created or increased.

An SLL account is recaptured when future FTI is produced in the same separate category as the SLL. Recapture occurs when this FTI gets recharacterized as FTI in the other separate category/categories in which SLI was previously offset by the SLL. For example, if a passive category SLL offsets general category SLI, then future passive category income will be recharacterized as general category income in subsequent years until the prior loss is fully recaptured. The SLL rules help to regulate the use of FTCs among and within separate categories and generally ensure that FTCs are not utilized disproportionately.

Examples of SLL account creation and recharacterization/recapture are provided in this practice unit

# General Overview (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

- Losses (cont'd)

To the extent aggregate SLLs exceed aggregate SLI, the excess ("Overall Foreign Loss" or OFL) may reduce the taxpayer's USTI.

When an OFL offsets USTI, an OFL account is created or increased. An OFL account is recaptured by recharacterizing future FTI, produced in the same separate category/categories that originally generated the OFL, as USTI. The OFL rules eliminate a double benefit over time, namely, the reduction of U.S. tax in the Taxable Year (TY) in which the OFL offsets USTI and the full allowance of an FTC with respect to FTI in a later TY.

A net U.S. source loss is known as an Overall Domestic Loss (ODL).

When an ODL is allocated to reduce FTI, an ODL account is created or increased. An ODL account is recaptured by recharacterizing future USTI as FTI in the same separate category as the FTI that was originally offset by the domestic loss. The ODL rules eliminate the double taxation of FTI over time. When USTI is recharacterized as FTI in a later TY, it may generate FTC limitation that can absorb the excess FTCs that may have resulted from the reduction of FTC limitation in the earlier TY in which the domestic loss offset FTI. The enactment of the ODL rules also created a level of parity with the OFL rules that were enacted on an earlier date.

Generally speaking, the loss recapture process overall resembles what can be thought of as the borrowing and repayment of income among the different categories and sources of income/loss. In a sense, losses are 'spread around' to income (according to the rules explained in this practice unit) and later the income that was previously reduced is restored. This returns balance to the equation. This practice unit provides an overview of the OFL, SLL, and ODL rules, as well as examples of the concept.

# Relevant Key Factors

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Key Factors**

- The following factors are relevant in determining the applicability of the OFL, SLL, and ODL rules:

- Foreign Loss
  - OFL:  Net loss in a separate category of FTI offsets/reduces USTI.  This establishes (or increases) an OFL account with respect to that separate category.
  - OFL Recapture:  When there is an OFL account with respect to a separate category, FTI generated in a future year in that separate category is recharacterized as USTI.
  - SLL:  Net loss in one separate category of FTI offsets/reduces FTI in another separate category.  This establishes (or increases) an SLL account.
  - SLL Recapture:  When there is an SLL account, SLI generated in a future year within the prior year SLL category is recharacterized to the other separate category (or categories) previously reduced/offset.

- Domestic Loss
  - ODL:  A domestic loss offsets/reduces FTI in a separate category.  This establishes (or increases) an ODL account with respect to that separate category.
  - ODL Recapture:  When there is an ODL account with respect to a separate category, USTI generated in a future year is recharacterized as FTI in that separate category.

# Detailed Explanation of the Concept

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Loss Allocation, Recharacterization, and Recapture – Overall Foreign Loss (OFL) |

| Analysis | Resources |
|---|---|
| An OFL is the amount by which FSI for the TY is exceeded by the sum of deductions properly allocated and apportioned to such income. If the sum total of all categories of FTI is negative, then this OFL amount offsets USTI and creates an OFL account.<br><br>In determining an OFL, a taxpayer first determines the net income or loss in each separate category after allocating and apportioning expenses, losses, and other deductions (not including any Net Operating Loss (NOL) deduction or any expropriation loss or casualty loss) to the appropriate separate category in accordance with the applicable statutory and regulatory rules.<br><br>A Separate Limitation Loss (SLL) is, with respect to any separate category, the amount by which FSI in that category is exceeded by the deductions apportioned or allocated to that income for the TY. Separate Limitation Income (SLI) is the amount by which FSI exceeds the deductions apportioned and allocated to such income with respect to any separate category. An SLL for any TY is first allocated to SLI in other separate categories, giving rise to an SLL account, which is discussed in more detail later in this unit. Any remaining SLL is an OFL that may be allocated against USTI.<br><br>If more than one separate income category has an OFL, and the OFLs exceed USTI in the aggregate, the OFLs will be allocated proportionately against USTI. OFLs are determined by taking into account any adjustments for capital gains and losses and qualified income. | ▪ IRC 904(f)(2)<br>▪ Treas. Reg. 1.904(f)-1<br>▪ Treas. Reg. 1.904(f)-2<br>▪ Treas. Reg. 1.904(f)-7<br>▪ IRC 862(b)<br>▪ Treas. Reg. 1.861-8<br>▪ Treas. Reg. 1.861-8T<br>▪ Treas. Reg. 1.904(g)-3<br>▪ IRC 904(b)(2)<br>▪ Treas. Reg. 1.904(b)-1<br>▪ IRC 1(h)(11) |

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Loss Allocation, Recharacterization, and Recapture – Overall Foreign Loss (OFL) (cont'd) |

| Analysis | Resources |
|---|---|
| A taxpayer that sustains an OFL that is allocated to reduce USTI in the current TY or in a carryback year must establish, or increase the balance of, an OFL account in the separate category that produced the OFL. An OFL account is also increased by the amount of any NOL carryover to the extent any OFL included in the NOL carryover reduces USTI in the current TY. An OFL account is established or increased at the end of the TY.<br><br>An OFL account in a separate category is reduced in future years when FTI generated in the separate category with the OFL account is recharacterized as USTI under the OFL recapture rules described in the following slides.<br><br>OFL accounts may be increased or decreased in any TY regardless of whether the taxpayer elects to credit or deduct foreign taxes for that TY. | ▪ Treas. Reg. 1.904(f)-1<br>▪ Treas. Reg. 1.904(g)-3<br>▪ IRC 904(f)<br>▪ IRC 164(a)<br>▪ IRC 275(a)(4)(A)<br>▪ Treas. Reg. 1.904(f)-2(c)(1)<br>▪ Treas. Reg. 1.904-2(d) |

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
| --- |
| Loss Allocation, Recharacterization, and Recapture – Overall Foreign Loss (OFL) (cont'd) |

| Analysis | Resources |
| --- | --- |
| A taxpayer with an OFL account recaptures that account by recharacterizing a portion of taxpayer's FTI for each year that follows as USTI in the amount of the OFL recapture amount (as defined on the next slide).<br><br>As a result of the OFL recapture, if the taxpayer elects to credit its foreign taxes, the taxpayer's FTI is decreased by the recaptured amount for purposes of the computation of the FTC limitation with respect to that separate category, thereby reducing the allowable foreign tax credit for the year.<br><br>Recapture continues until such time as the total amount of FTI recharacterized as USTI equals the amount in the OFL account. | ▪ IRC 904(f)(1)<br>▪ Treas. Reg. 1.904(f)-2 |

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Loss Allocation, Recharacterization, and Recapture – Overall Foreign Loss (OFL) (cont'd) |

| Analysis | Resources |
|---|---|
| The OFL recapture amount equals the lesser of the aggregate amount of maximum potential recapture in all OFL accounts or fifty percent of the taxpayer's total FTI.<br><br>The maximum potential recapture of a separate category OFL account is equal to the lesser of the balance in the OFL account itself or the FTI for the year in the same separate category.<br><br>If the aggregate amount of maximum potential recapture in all OFL accounts exceeds 50 percent* of the total FTI, then FTI in each separate category with an OFL account is proportionately recharacterized as USTI.<br><br>The recharacterization amount in each category is determined by multiplying the aggregate OFL recapture amount by the maximum potential recapture in the OFL account with respect to that category, divided by the aggregate amount of maximum potential recapture in all OFL accounts.<br><br>Examples of this can be found on the following slides.<br><br>* A taxpayer may make an annual revocable election to recapture a greater amount than the required 50 percent minimum.  The taxpayer makes this election by attaching a statement to its Form 1116 or 1118. | ▪ Treas. Reg. 1.904(f)-2 |

# Examples of the Concept

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

OFL Example 1 - Creation of OFL Account

| Taxable Year 1 | General | Passive | USI |
|---|---|---|---|
| Initial Income (Loss) | ($600) | ($700) | $1,500 |
| OFL Allocation | $600 | $700 | ($700)<br>($600) |
| Final Income (Loss) | $0 | $0 | $200 |
| Ending OFL Account | $600 | $700 | |

In this example, USP, a U.S. corporation, allocates the full amount of the general category and passive category SLLs to its USTI for the TY, and increases its OFL accounts by those amounts (that is, $600 with respect to the general category and $700 with respect to the passive category).

# Examples of the Concept (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

OFL Example 2 - Computing OFL Recapture (considering maximum potential recapture vs. 50 percent of FTI)

| Taxable Year 2 | General | Passive | USI |
|---|---|---|---|
| Beginning OFL Account | $600 | $700 | |
| Initial Income (Loss) | $450 | $800 | $500 |

In this example, assume that USP has not made an election to recapture more than the required amount of OFLs. As of January 1, TY2, USP has a $600 general category OFL account and a $700 passive category OFL account. For TY2, USP has $450 of general category income, $800 of passive category income, and $500 of USTI.

As stated previously, the OFL recapture amount is the lesser of:

- The aggregate amount of maximum potential recapture in all OFL accounts, or
- 50 percent of taxpayer's FTI.

The maximum potential recapture in an OFL account in a separate category is the lesser of:

- The OFL account with respect to a separate category, or
- FTI in that separate category.

…cont'd on next page…

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

OFL Example 2 - Computing OFL Recapture (considering maximum potential recapture vs. 50 percent of FTI) (cont'd)

| Taxable Year 2 | General | Passive | USI |
|---|---|---|---|
| Beginning OFL Account | $600 | $700 | |
| Initial Income (Loss) | $450 | $800 | $500 |

The maximum potential recapture in the OFL account with respect to the general category is $450, the lesser of :

- $600, or
- $450.

The maximum potential recapture in the OFL account with respect to the passive category is $700, the lesser of:

- $700, or
- $800.

The aggregate amount of maximum potential recapture in all OFL accounts is $1,150 ($450 + $700).

FTI is the sum of general category income ($450) and passive category income ($800), or $1,250. 50 percent of FTI is $625.

Therefore, the OFL recapture amount is $625 (that is, the lesser of $1,150 or $625).

…cont'd on next page…

# Examples of the Concept (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

OFL Example 2 - Computing OFL Recapture (considering maximum potential recapture vs. 50 percent of FTI) (cont'd)

Where the aggregate amount of maximum potential recapture in all OFL accounts (in this case, $1,150) exceeds 50 percent of total FTI (in this case, $625), FTI in each separate category with an OFL account is recharacterized in an amount equal to:

| | | | | | |
|---|---|---|---|---|---|
| | OFL recapture amount | x | Maximum potential recapture in the OFL account / Aggregate amount of potential recapture in all OFL accounts | | |
| General Category | $625 | x | $450 / $1,150 | = | $245 |
| Passive Category | $625 | x | $700 / $1,150 | = | $380 |

General category income and passive category income will be recharacterized as USTI in amounts (rounded) equal to $245 and $380, respectively.

The OFL account in the general category is reduced by the OFL recapture amount apportioned to the general category (that is, $245) from $600 to $355.

The OFL account in the passive category is reduced by the OFL recapture amount apportioned to the passive category (that is, $380) from $700 to $320.

# Examples of the Concept (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

OFL Example 3 – OFL Recapture

| Taxable Year 2 | General | Passive | USI |
|---|---|---|---|
| Beginning OFL Account | $600 | $700 | |
| Initial Income (Loss) | $450 | $800 | $500 |
| OFL Recapture | ($245) | ($380) | $380<br>$245 |
| Final Income (Loss) | $205 | $420 | $1,125 |
| Ending OFL Account | $355 | $320 | |

In this example, a total of $625 of FTI is recharacterized as USTI (in the manner described by the computations detailed in the prior slides). The OFL account in the general category is reduced by the general category recapture amount (that is, $245) from $600 to $355. The OFL account in the passive category is reduced by the passive category recapture amount (that is, $380) from $700 to $320.

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Loss Allocation, Recharacterization, and Recapture – Overall Foreign Loss (OFL) (cont'd) |

| Analysis | Resources |
|---|---|
| If in any TY,  a taxpayer deducts rather than credits its foreign taxes, recapture is applied to the extent of the lesser of:<br>▪ The balance in the OFL account in each separate category; or<br>▪ FTI (net of foreign taxes) in each separate category.<br><br>The taxpayer must report the balances in its OFL account annually on Form 1116 or Form 1118 (Schedule J).  The balance in each account does not have to be attributed to the year or years in which the loss was incurred.<br><br>For purposes of determining the amount of an OFL subject to recapture, the taxpayer's FTI in each category is determined by taking into account adjustments for capital gains and losses and qualified dividend income.<br><br>This unit does not cover the following special rules:<br>▪ OFLs of other taxpayers<br>▪ Capital gains and losses and qualified dividend income<br>▪ Recapture of OFLs from dispositions<br>▪ Recapture of foreign source losses out of accumulation distributions from a foreign trust<br>▪ Special rules for recapture of OFL of a domestic trust<br>▪ Consolidated OFLs<br>▪ Interplay of the Dual Consolidated Loss (DCL) and branch loss recapture rules | ▪ IRC 164(a)<br>▪ IRC 275(a)(4)(A)<br>▪ Treas. Reg. 1.904(f)-1<br>▪ Treas. Reg. 1.904(f)-2<br>▪ Treas. Reg. 1.904(f)-4<br>▪ Treas. Reg. 1.904(f)-5<br>▪ IRC 904(f)(3)<br>▪ Treas. Reg. 1.1502-9<br>▪ IRC 1503(d)<br>▪ Treas. Reg. 1.367(a)-6T |

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
| --- |
| Loss Allocation, Recharacterization, and Recapture – Separate Limitation Loss (SLL) |

| Analysis | Resources |
| --- | --- |
| As previously described, an SLL is, with respect to any separate category of FTI, the amount by which the FSI in that category is exceeded by the sum of expenses, losses, and other deductions (not including any NOL deduction or any expropriation loss or casualty loss) properly allocated and apportioned to that separate category for the TY.<br><br>If instead FSI exceeds the expenses, losses, and other deductions allocated and apportioned to a separate category, then a taxpayer has SLI with respect that category for the TY.<br><br>SLL and SLI are determined by taking into account any adjustments for capital gains and losses and qualified dividend income.<br><br>An SLL for any TY is allocated first to SLI in other separate categories and then any remaining SLL amount is allocated to USTI (giving rise to, or increasing, an OFL account as discussed earlier).<br><br>If more than one separate category has an SLL and in the aggregate the SLLs exceed the SLI in another separate category, the SLLs will be allocated proportionately against SLI. Similarly if more than one separate category has SLI and in the aggregate the SLIs exceed the SLL in another separate category, the SLL will be allocated proportionately against the SLIs. | ▪ IRC 172(a)<br>▪ IRC 904(b)(2)<br>▪ Treas. Reg. 1.904(b)-1<br>▪ IRC 1(h)(11)<br>▪ IRC 904(f)(5)<br>▪ Treas. Reg. 1.904(f)-7<br>▪ IRC 904(d)<br>▪ Treas. Reg. 1.904-4 |

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Loss Allocation, Recharacterization, and Recapture – Separate Limitation Loss (SLL) (cont'd) |

| Analysis | Resources |
|---|---|
| Any taxpayer that sustains an SLL that is allocated to reduce SLI in one or more other separate categories must establish, or increase the balance of, an SLL account in the separate category of the SLL with respect to each separate category with SLI to which the SLL is allocated.  An SLL account is also increased by the amount of any NOL carryover to the extent any SLL included in the NOL carryover reduces SLI in another separate category. SLLs are established or added to the applicable SLL accounts at the end of the TY.<br><br>An SLL account is reduced in future years when FTI generated in the separate category with the SLL account is recharacterized as income in another separate category under the SLL recapture rules described below.  An SLL account is also reduced to take into account any netting of SLL accounts that is required when offsetting SLL accounts are created.  An illustration of netting is provided later in this practice unit (see *SLL Example 3 - SLL Netting*).<br><br>A taxpayer with an SLL account in a separate category recaptures that account by recharacterizing a portion of the FTI in that category as income in the separate category to which that SLL account relates, in the amount of the lesser of:<br>▪ The SLL account (not yet recaptured in prior years), or<br>▪ The FTI for that year in the separate category with the SLL account.<br><br>Examples relating to SLLs can be found on the following slides. | ▪ IRC 904(f)(5)<br>▪ Treas. Reg. 1.904(f)-7<br>▪ Treas. Reg. 1.904(f)-8<br>▪ Treas. Reg. 1.904(g)-3 |

# Examples of the Concept (cont'd)

| **Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit** | | | |
|---|---|---|---|
| **Examples** | | | |
| SLL Example 1 - Creation of SLL Account | | | |
| Taxable Year 1 | General | Passive | USI |
| Initial Income (Loss) | $400 | ($300) | $200 |
| SLL Allocation | ($300) | $300 | |
| Final Income (Loss) | $100 | $0 | $200 |
| Ending SLL Account | | $300 General | |

In this example, USP, a U.S. corporation, allocates the full amount of passive category loss to general category income for the TY, and increases its passive category SLL account with respect to the general category by that amount (that is, $300).

# Examples of the Concept (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

SLL Example 2 - SLL Recapture

| Taxable Year 2 | General | Passive | USI |
|---|---|---|---|
| Beginning SLL Account | | $300 General | |
| Initial Income (Loss) | $200 | $200 | $500 |
| SLL Recapture | $200 | ($200) | |
| Final Income (Loss) | $400 | $0 | $500 |
| Ending SLL Account | | $100 General | |

In this example, $200 of USP's passive category SLL account with respect to the general category is recaptured when $200 of passive category income is recharacterized as general category income. After recapture, there is $100 remaining in the passive category SLL account with respect to the general category.

# Examples of the Concept (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

SLL Example 3 - SLL Netting

| Taxable Year 3 | General | Passive | USI |
|---|---|---|---|
| Beginning SLL Account | | $100 General | |
| Initial Income (Loss) | ($300) | $400 | $300 |
| SLL Allocation | $300 | ($300) | |
| Interim Income (Loss) | $0 | $100 | $300 |
| Interim SLL Account | $300 Passive | $100 General | |

In this example, USP's $300 of general category loss partially offsets the $400 of passive category income, creating a general category SLL account of $300 with respect to the passive category. At this point, USP will partly offset its interim SLL accounts, as shown on the next slide.

…cont'd on next page…

# Examples of the Concept (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

SLL Example 3 - SLL Netting (cont'd)

| Taxable Year 3 | General | Passive | USI |
|---|---|---|---|
| Interim Income (Loss) | $0 | $100 | $300 |
| Interim SLL Account | $300 Passive | $100 General | |
| SLL Account Netting | ~~($100) Passive~~ | ~~($100) General~~ | |
| Final Income (Loss) | $0 | $100 | $300 |
| Ending SLL Account | $200 Passive | | |

In the current year, a $300 general category SLL account with respect to the passive category was created. Also, there is a passive category SLL account of $100 with respect to the general category remaining from Year 2. As such, $100 of each of the two SLL accounts are netted against each other. All that remains is a $200 general category SLL account with respect to the passive category.

Therefore, the remaining $100 of passive category income is not recaptured and recharacterized as general category income.

| **Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit** |
|---|
| Loss Allocation, Recharacterization, and Recapture – Separate Limitation Loss (SLL) (cont'd) |

| Analysis | Resources |
|---|---|
| For purposes of determining the amount of an SLL account subject to recapture, the taxpayer's FTI in each category is determined by taking into account adjustments for capital gains and losses and qualified dividend income.<br><br>Recharacterization of income under the SLL rules does not result in the recharacterization of any tax. The rules of Treas. Reg. 1.904-6 that allocate taxes to separate categories on an annual basis are applied before the recapture of any SLL accounts of the taxpayer under the rules described in this concept unit. Once foreign taxes are allocated to a separate category under those rules, they remain associated with that separate category even if the income in the category is recharacterized under the SLL recapture rules.<br><br>This unit does not discuss:<br><br>▪ Pre-recapture reduction for amounts allocated to other taxpayers<br>▪ SLLs of another taxpayer<br>▪ Consolidated SLL rules | ▪ IRC 904(f)(5)<br>▪ Treas. Reg. 1.904-6<br>▪ Treas. Reg. 1.904(f)-7<br>▪ Treas. Reg. 1.904(f)-8<br>▪ Treas. Reg. 1.1502-9 |

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Loss Allocation, Recharacterization, and Recapture – Overall Domestic Loss (ODL) |

| Analysis | Resources |
|---|---|
| Congress enacted the ODL statute in 2005. It is effective with respect to losses for TYs beginning after December 31, 2006.<br><br>An ODL is a domestic loss that offsets/reduces FTI in a qualified TY, including when a domestic loss offsets FTI in any preceding qualified TY by reason of a carryback. The term "qualified taxable year" means any TY for which the taxpayer chose to credit its foreign taxes. Therefore, unlike under the OFL rules, an ODL is not established or increased in a year in which the taxpayer deducts foreign taxes.<br><br>A domestic loss is the amount by which USI is exceeded by the sum of the deductions properly allocated and apportioned to that gross income, taking into account any NOL carried forward from a prior year, but not any loss carried back. Domestic loss is determined by taking into account any adjustments for capital gains and losses and qualified income.<br><br>The ODL rules create parity with the OFL rules, treating domestic loss offsets of FTI similar to OFL offsets of USTI.<br><br>In any given TY, the domestic loss (that does not exceed the SLI amounts) gets allocated among (and operates to reduce) the SLI amounts on a proportionate basis. This rule is applied after the allocation of SLLs to SLI amounts. | ▪ IRC 904(g)<br>▪ Treas. Reg. 1.904(g)-1<br>▪ Treas. Reg. 1.904(g)-3<br>▪ IRC 861(b)<br>▪ IRC 865 |

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Loss Allocation, Recharacterization, and Recapture – Overall Domestic Loss (ODL) (cont'd) |

| Analysis | Resources |
|---|---|
| Any taxpayer that sustains a domestic loss must establish, or increase the balance of, an ODL account with respect to each separate category in which FTI is offset by the domestic loss.<br><br>When a domestic loss is carried back or carried over as part of an NOL, and offsets FTI in a carryover year, the resulting ODL is treated as sustained in the later of the year in which the domestic loss was incurred or the year to which the loss was carried.<br><br>For example, if a taxpayer incurs a domestic loss in the 2016 TY that is carried back to the 2015 qualified TY and offsets FTI in 2015, the resulting ODL is treated as sustained in the 2016 TY. If a taxpayer incurs a domestic loss in the 2015 TY that is carried forward to the 2016 TY and offsets FTI in the 2016 TY, the resulting ODL is also treated as sustained in the 2016 TY. An ODL account is established, or increased, at the end of the TY in which the ODL is treated as sustained.<br><br>An ODL account with respect to a separate category of FTI is reduced in future years when USTI is recharacterized as FTI in that separate income category under the ODL recapture rules described in the following slides. | ▪ IRC 904(g)<br>▪ Treas. Reg. 1.904(g)-1 |

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Loss Allocation, Recharacterization, and Recapture – Overall Domestic Loss (ODL) (cont'd) |

| Analysis | Resources |
|---|---|
| A taxpayer with an ODL account recaptures that account by recharacterizing a portion of the taxpayer's USTI for each following year as FTI in the amount of the lesser of:<br>▪ the aggregate balance of the taxpayer's ODL accounts (to the extent not recaptured in prior years), or<br>▪ 50 percent of the taxpayer's USTI for such future year.<br><br>As a result of the ODL recapture, if the taxpayer elects to credit its foreign taxes, the taxpayer's FTI is increased by the recaptured amount for purposes of the computation of the FTC limitation, thereby increasing the allowable amount of FTC for the year.<br><br>Any USTI that is treated as FTI is allocated among, and increases, the separate FTI categories in proportion to the ODL account balances, which were established with respect to each separate FTI category that was offset by domestic loss.<br><br>Recapture continues until such time as the total amount of USTI recharacterized as FTI equals the amount in the ODL account(s).<br><br>Examples relating to ODLs can be found on the following slides. | ▪ IRC 904(g)<br>▪ Treas. Reg. 1.904(g)-1<br>▪ Treas. Reg. 1.904(g)-2 |

# Examples of the Concept (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

ODL Example 1 - Creation of ODL Account

| Taxable Year 1 | General | Passive | USI |
|---|---|---|---|
| Initial Income (Loss) | $600 | $400 | ($200) |
| ODL Allocation | ($120) | ($80) | $200 |
| Final Income (Loss) | $480 | $320 | $0 |
| Ending ODL Accounts | | | $120 General<br>$80 Passive |

In this example, USP, a U.S. corporation, proportionately allocates the full amount of its U.S. source net loss (that is, ODL) to FTI for the TY, and increases its ODL accounts by those amounts (that is, $120 with respect to the general category and $80 with respect to the passive category).

# Examples of the Concept (cont'd)

## Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit

**Examples**

ODL Example 2 - ODL Recapture

| Taxable Year 2 | General | Passive | USI |
|---|---|---|---|
| Beginning ODL Accounts | | | $120 General<br>$80 Passive |
| Initial Income (Loss) | $500 | $500 | $100 |
| ODL Recapture | $30 | $20 | ($50) |
| Final Income (Loss) | $530 | $520 | $50 |
| Ending ODL Accounts | | | $90 General<br>$60 Passive |

In this example, USP recaptures $50 of USTI as FTI (that is, the lesser of 50 percent of USTI ($50), or the aggregate balance of the ODL accounts ($200)). Thus, $50 of USTI is recharacterized proportionately 60 percent, or $30, to general category income and 40 percent, or $20, to passive category income.

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Loss Allocation, Recharacterization, and Recapture – Overall Domestic Loss (ODL) (cont'd) |

| Analysis | Resources |
|---|---|
| For purposes of determining the amount of an ODL subject to recapture, the taxpayer's USTI is determined by taking into account adjustments for capital gains and losses and qualified dividend income in a similar manner to the adjustments made to FTI.<br><br>This unit does not cover:<br><br>▪ ODL of another taxpayer<br>▪ Adjustments for capital gains and losses<br>▪ Pre-recapture reduction for amounts allocated to other taxpayers<br>▪ Consolidated ODL rules | ▪ IRC 904(b)(2)<br>▪ IRC 904(g)<br>▪ Treas. Reg. 1.904(b)-1<br>▪ Treas. Reg. 1.904(g)-1<br>▪ Treas. Reg. 1.904(g)-2<br>▪ Treas. Reg. 1.1502-9 |

# Detailed Explanation of the Concept (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Recap of Initial Steps in Applying the Loss Rules |

| Analysis | Resources |
|---|---|
| Before referencing the loss ordering rules (next slide), taxpayers will have taken the following steps:<br><br>1. Sum Up Gross Income<br>– On Forms 1116 and 1118, taxpayers identify the amount of gross income reported on Forms 1040 and 1120, respectively, that is FSI. FSI is split into separate categories based on income character (for example, general vs. passive category income).<br><br>2. Compute Net Income<br>– On Forms 1116 and 1118, deductions claimed on Forms 1040 and 1120, respectively, are allocated to and apportioned among the various sources and categories of income (based on factual relationships) to derive net income for each income classification. | ▪ Treas. Reg. 1.904(g)-3<br>▪ IRC 861<br>▪ IRC 862<br>▪ IRC 863<br>▪ IRC 864<br>▪ IRC 865<br>▪ Treas. Reg. 1.861-8<br>▪ Treas. Reg. 1.861-8T |

| **Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit** |
| --- |
| Summary of the Ordering Rules for Losses |

| Analysis | Resources |
| --- | --- |
| Below are the ordering rules for the allocation of NOLs, net capital losses, domestic losses, and SLLs, and for the recapture of SLL, OFL, and ODL accounts. (Note that some of these steps might not be applicable, based on a taxpayer's facts and circumstances.) See Schedule J, Form 1118.<br><br>▪ Step One – Allocation of NOL and Net Capital Loss Carryovers<br>▪ Step Two – Application of Capital Gain/Loss and Qualified Dividend Adjustments<br>▪ Step Three – Allocation of SLLs<br>▪ Step Four – Allocation of U.S. Source Losses<br>▪ Step Five – Recapture of OFL Accounts<br>▪ Step Six – Recapture of SLL Accounts<br>▪ Step Seven – Recapture of ODL Accounts<br><br>These steps will be discussed in depth in a process unit on foreign and domestic losses and the FTC. | ▪ IRC 904(b)<br>▪ IRC 904(f)<br>▪ IRC 904(g)<br>▪ Treas. Reg. 1.904(g)-3 |

# Index of Referenced Resources

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| IRC 1(h)(11) |
| IRC 1503(d) |
| IRC 164(a) |
| IRC 172(a) |
| IRC 275(a)(4)(A) |
| IRC 861 |
| IRC 861(b) |
| IRC 862 |
| IRC 862(b) |
| IRC 863 |
| IRC 864 |
| IRC 865 |
| IRC 904(b) |
| IRC 904(b)(2) |
| IRC 904(d) |
| IRC 904(f) |
| IRC 904(f)(1) |

Back to Table of Contents

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| IRC 904(f)(2) |
| IRC 904(f)(3) |
| IRC 904(f)(5) |
| IRC 904(g) |
| Treas. Reg. 1.1502-9 |
| Treas. Reg. 1.367(a)-6T |
| Treas. Reg. 1.861-8 |
| Treas. Reg. 1.861-8T |
| Treas. Reg. 1.904(b)-1 |
| Treas. Reg. 1.904(f)-1 |
| Treas. Reg. 1.904(f)-2 |
| Treas. Reg. 1.904(f)-2(c)(1) |
| Treas. Reg. 1.904(f)-4 |
| Treas. Reg. 1.904(f)-5 |
| Treas. Reg. 1.904(f)-7 |
| Treas. Reg. 1.904(f)-8 |
| Treas. Reg. 1.904(g)-1 |

# Index of Referenced Resources (cont'd)

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit |
|---|
| Treas. Reg. 1.904(g)-2 |
| Treas. Reg. 1.904(g)-3 |
| Treas. Reg. 1.904-2(d) |
| Treas. Reg. 1.904-4 |
| Treas. Reg. 1.904-6 |

# Training and Additional Resources

| Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit | |
| --- | --- |
| **Type of Resource** | **Description(s)** |
| White Papers / Guidance | ▪ Fed. Tax'n Income, Est.& Gifts, Bittker & Lokken 72.8<br>▪ Fed. Tax Coordinator O-4700 (2d.)<br>▪ Mertens Law of Fed. Income Tax'n § 45D, IV, F & G.<br>▪ U.S. Tax Rep. P 9044.01<br>▪ Other guidance is accessible through the IRS' various research subscription services (sample materials provided) |

# Glossary of Terms and Acronyms

| Term/Acronym | Definition |
|---|---|
| DCL | Dual Consolidated Loss |
| FSI | Foreign Source Income |
| FTC | Foreign Tax Credit |
| FTI | Foreign Taxable Income |
| NOL | Net Operating Loss |
| ODL | Overall Domestic Loss |
| OFL | Overall Foreign Loss |
| SLI | Separate Limitation Income |
| SLL | Separate Limitation Loss |
| TY | Taxable Year |
| USI | U.S. Source Income |
| USTI | U.S. Taxable Income |

Back to Table of Contents

# Index of Related Practice Units

| Associated UIL(s) | Related Practice Unit | DCN |
|---|---|---|
| 9413 | FTC Management Narrative Overview (Internal SharePoint Site) | |
| 9413.03 | Accessing FSI Narrative Overview (Internal SharePoint Site) | |
| 9413.03-02 | Overview of Interest Expense Allocation & Apportionment in Calculation of the FTC Limitation - IPS Units (Internal SharePoint Site) | FTM/C/03_03_02-01 (formerly FTC/9413.03-02_06(2014)) |
| 9413.03-03 | How to Allocate and Apportion Research and Experimental Expenses - IPS Units (Internal SharePoint Site) | FTM/P/03_03_03-01 (formerly FTM/9413.03_04(2014)) |