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Final regulations make minor changes to expired temporary regulations implementing ODL and OFL rules

On June 21, 2012, Treasury and the IRS issued regulations finalizing temporary and proposed regulations under section 904(f) and (g) (the final regulations). These final regulations implement the overall domestic loss (ODL) regime enacted in the American Jobs Creation Act of 2004. They also provide updates that reflect statutory amendments to the overall foreign loss (OFL) rules enacted since 1986. On June 22, 2012, Treasury and the IRS issued proposed regulations that clarify the calculation of the high tax income provision of section 904. They also address the coordination of the OFL recapture provisions when those provisions require recognition of gain that would otherwise not be recognized on a property disposition.

The final regulations make only minor changes to the temporary regulations which were issued in 2007, and expired in late 2010. In general, those rules have:

1. created symmetry between the treatment of ODLs and OFLs;
2. clarified the application of the rules for OFLs and separate limitation losses (SLLs); and
3. provided ordering rules for coordination between allocation and recapture of losses among OFLs, ODLs, and SLLs.

The final regulations are generally effective for tax years beginning on or after January 1, 2012. However, taxpayers may choose to apply the updated OFL rules retroactively to tax years beginning after December 21, 2007, and the new ODL rules retroactively to tax years beginning after December 21, 2006. Rules that have not changed from the temporary regulations are still effective for tax years beginning after December 21, 2007.

The discussion below briefly reviews the rules in the ODL and OFL regulations, highlighting the two principal changes in the final regulations. The final regulations also include some minor revisions merely intended to improve the provisions' readability.

Observation: Taxpayers will generally welcome these final regulations. The temporary regulations expired in 2010, leaving taxpayers uncertain as to what rules might apply in computing OFLs, SLLs, and ODLs. Because the new regulations did not change the rules significantly, companies that have continued to apply the temporary regulations should not need to make many changes to their computational approach. In addition, taxpayers may apply retroactively the few changes in the final regulations. Accordingly, taxpayers anxious about the delayed final regulations should feel reassured that the delay has not disadvantaged them.

ODL accounts and recapture

Under section 904(g), an ODL occurs when a domestic loss offsets foreign-source taxable income in the same tax year (or an earlier tax year by reason of a carryback). For this purpose, a domestic loss is the amount by which deductions properly allocated and apportioned to US-source gross income exceed the amount of that income.

The final regulations in Treas. Reg. §§1.904(g)-1 and -2 address the establishment, maintenance, and recapture of ODL accounts. Taxpayers must establish separate ODL accounts for each section 904(d) basket of foreign-source income offset by a US-source loss. An ODL occurs generally in the later of (1) the tax year in which the domestic loss is incurred or (2) the tax year in which the foreign-source income offset by the domestic loss is earned.

Where US-source income has been offset by foreign-source losses, taxpayers recapture ODLs by treating a portion of their US-source taxable income as foreign-source income. The amount of US-source income subject to recapture is the lesser of the aggregate balance in the ODL account or 50 percent of the taxpayer's US-source taxable income. Taxpayers with ODL accounts attributable to more than one section 904(d) basket must allocate recharacterized income among those baskets on a pro rata basis. Unlike OFL recapture, taxpayers may not elect to recharacterize more than 50 percent of their US-source taxable income.

The only substantive change to the ODL rules in the final regulations regards adjustments for certain capital gains and losses. The 2007 temporary regulations provided rules coordinating the application of the ODL rules and the section 904(b) rules governing the effect of capital gains and losses on the foreign tax credit (FTC) limitation. The temporary regulations followed the approach of the ordering rule in Treas. Reg. §1.904(b)-1(h). Using that rule, adjustments under section 904(b) generally are taken into account before applying the ODL and OFL provisions. The final regulations retain that approach but make revisions and additions to implement the mechanics of the ordering rule, as follows:

1. The final regulations revise Treas. Reg. §1.904(g)-1(c)(2) and (d)(3) with respect to an ODL calculation. These revisions reflect the fact that the section 904(b) rules do not provide specific adjustments to determine US-source loss on a stand-alone basis. Instead, the section 904(b) rules define the amount of US-source loss that offsets foreign-source taxable income under section 904(f)(5)(D) as (i) adjusted foreign taxable income, less (ii) adjusted worldwide taxable income. Thus, the final regulations coordinate the ODL calculations with the calculation of the section 904(f)(5)(D) amount (as determined under Treas. Reg. §1.904(b)-1(h)(1)(iii)).

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2. The final regulations revise Treas. Reg. §1.904(g)-2(b) to clarify that taxpayers must make section 904(b) adjustments (for capital gains and losses and qualified dividend income) before determining how much US-source taxable income is available to recapture an ODL. Similar to the change above, Treas. Reg. §1.904(g)-2(b) provides that US-source taxable income available to recapture an ODL account is determined following the principles of Treas. Reg. §1.904(b)-1(h)(1)(i).
 3. The final regulations add a new step - step two - to the ordering rules in Treas. Reg. §1.904(g)-3. This requires any section 904(b) adjustments to be made after determining the amount of net operating loss (NOL) carryover (step one), but before allocating losses or recapturing loss accounts in steps three through seven.
 4. The final regulations clarify that coordination with the section 904(b) provisions requires adjustments not only to capital gains and losses, but also to qualified dividend income.

Observation: Taxpayers are likely to appreciate having final regulations governing ODLs, particularly since those rules have not changed significantly from the temporary regulations. The changes to coordinate with section 904(b) appear reasonable, although it is not clear whether application of section 904(b) principles may result in unintended consequences.

Updating OFL rules

The final regulations do not change significantly the 2007 temporary regulations. Those temporary regulations implemented statutory changes made in the Tax Reform Act of 1986 and subsequent legislation. The 2007 temporary regulations also made a few additional clarifications, including coordination with Notice 89-3 and updated rules under section 904(b).

The only substantive change in the final regulations regards dispositions of property under section 904(f)(3). That provision governs the FTC treatment of gain from dispositions of certain property used or held for use predominantly outside the United States in a trade or business. Under section 904(f)(3), regardless of whether gain on those dispositions would otherwise be recognized, any gain is treated as foreign-source income to the extent of any OFL account in the section 904(d) basket of income generated by the property. Thus, Treas. Reg. §1.904(f)-2(d) provides separate rules for (i) dispositions in which gain is recognized irrespective of section 904(f)(3) and (ii) dispositions in which the gain would not otherwise be recognized.

The preamble to the final regulations notes that a question was raised about this treatment when the gain upon disposition would otherwise be considered US source. The preamble states that, where gain is recognized irrespective of section 904(f)(3), section 904(f)(3)(A) provides clearly for the recharacterization of such gain as foreign-source income only to the extent of the applicable OFL recapture amount. Thus, the final regulations clarify that this limit on recharacterization applies. The amount of gain recharacterized as foreign-source would be the lesser of (i) the total recognized gain or (ii) the balance in the OFL account remaining after making any other required OFL recapture.

Note that Treasury and the IRS reserved on Treas. Reg. §1.904(g)-3(i), promising to issue guidance addressing adjustments required under section 904(f)(3) with respect to property dispositions. The proposed regulations provide that guidance, discussed below.

Observation: The final regulations still require independent recapture of OFL and ODL accounts. Thus, taxpayers would not take into account income recharacterized under one recapture provision in determining the amount of income subject to recharacterization under the other recapture provision. Although the preamble to the temporary regulations suggested that the IRS might issue rules netting OFL and ODL accounts, the final regulations do not include any such rules.

Updating SLL rules

The final regulations made no substantive changes to the 2007 temporary regulations with respect to the SLL provisions. The temporary regulations provide for the establishment, maintenance, and recapture of SLL accounts.

Under Treas. Reg. §1.904(f)-7, taxpayers must establish an SLL account for each section 904(d) basket to the extent that a foreign-source loss in that basket offsets foreign-source income in another basket. Treas. Reg. §1.904(f)-8 provides that SLL accounts are recaptured by recharacterizing a portion of the foreign-source income in a basket with an SLL account as income in the basket in which foreign-source income of a prior year was offset to create the SLL account.

The amount of foreign-source income subject to SLL recharacterization is the lesser of (i) the balance in an SLL account or (ii) the amount of foreign-source income for the taxable year in that same basket. There is no fifty-percent limitation for SLL account recapture.

Coordination of OFLs, SLLs, and ODLs

As previously mentioned, the final regulations add a new step - step two - to the 2007 temporary regulations with respect to ordering rules for coordinating OFLs, SLLs, and ODLs. This new step requires taxpayers to make any required adjustments to capital gains and losses, and qualified dividend income under section 904(b)(2). Thus, section 904(b) adjustments are made after determining the amount of net operating loss and capital loss carryovers, but before allocating losses or recapturing loss accounts. Treas. Reg. §1.904(g)-3 provides these rules, specifically regarding (i) the allocation of NOLs, net capital losses, US-source losses, and SLLs, and (ii) the recapture of SLLs, OFLs, and ODLs. The final regulations continue to follow generally the ordering rules in Notice 89-3, with some changes to take into account the ODL provisions.

Consolidated ODL accounts

The 2007 temporary regulations revised the consolidated return regulations to apply the ODL rules to consolidated groups and their members. The final regulations preserve these changes, which provide symmetrical treatment in Treas. Reg. §1.1502-9 for application of ODL and OFL rules to consolidated groups.

Proposed regulations

Coordination of high-taxed income and capital gains adjustments

Under the FTC rules, income that would otherwise be considered in a taxpayer's passive income category is treated as general category income if the foreign taxes paid or accrued with respect to such income exceed the US tax that would be imposed on such income using the highest US tax rate specified for the taxpayer. Further, under section 904(b), when the US tax rate that would be imposed upon foreign income is reduced, such as for capital gains and qualified dividend income, taxpayers must adjust the amount of foreign income taken into account in determining the taxpayer's FTC limitation. The proposed regulations address the timing of the calculation that determines whether an amount of income is high-taxed under section 904. The regulations provide that the high-taxed income calculation is made before taking into account any adjustments under section 904(b) or any allocation of losses or recapture under the OFL or ODL provisions.

Coordination of OFL recapture provisions where gain not otherwise recognized

As discussed above, the final regulations specifically address questions about the treatment of gain under the OFL provisions that is otherwise US-source income. The proposed regulations address other questions regarding the coordination of the OFL recapture provisions arising from the disposition of property and the remainder of the OFL and ODL provisions. The existing regulations address OFL recapture upon the disposition of property, but those provisions are not coordinated with the new final regulations. The proposed regulations would make slight revisions to step five of the seven-step procedure set forth in the final regulations (discussed above) to require gain that would be recognized irrespective of section 904(f) to be considered with other foreign-source income or gain for that year. Furthermore, the proposed regulations would add an eighth step to the coordination rules to address the circumstance where gain on the disposition of property would not otherwise be required to be recognized but for the special OFL provisions. The new eighth step would require taxpayers to determine the amount of the gain required to be recognized and recaptured after all other steps have been taken. To the extent that the additional gain results in an additional NOL that can be used for the year, that additional NOL is then allocated under the regulations, but only after the OFL account has been recaptured.

Conclusion

In general, taxpayers should find little change in their application of the ODL and OFL rules under these final regulations. In addition, these final regulations should relieve any uncertainty over the proper application of these rules. The option to apply the final regulations retroactively gives taxpayers flexibility that may prove useful. In any case, companies that have continued to apply the temporary regulations since they expired in 2010 should not need to make many changes to their computational approach.

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