



**Single Limitation and Overall  
Foreign Losses Under U.S.  
Repatriation Rules**

**by Martin B. Tittle**

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# Single Limitation and Overall Foreign Losses Under U.S. Repatriation Rules

by *Martin B. Tittle*

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## Background

The treatment of single limitation losses (SLLs) and overall foreign losses (OFLs) is detailed in U.S. Internal Revenue Code section 904(f), Treas. reg. section 1.904(f)-1 through -12, and Notice 89-3. Setting aside for simplicity's sake the provisions in section 904(f)(3) on particular dispositions of property and controlled foreign corporation stock, the basic ordering rules are:

- 1) Take net operating losses into account.
- 2) Offset SLLs against single limitation income (SLI) in other baskets and create recharacterization accounts in the SLL baskets. If those baskets have income in a later year, that income may need to be recharacterized as income of the current-year SLI baskets.
- 3) If SLLs are greater than aggregate SLI, they offset U.S.-source income "to the extent thereof" and create (or add to) OFL accounts in the SLL baskets.
- 4) If SLLs are less than aggregate SLI, and if there are prior-year OFL accounts in the baskets with SLI, those OFL accounts are recaptured to the extent of 50 percent of the income in each basket.
- 5) If there is still SLI after the OFL recapture(s), and if there are SLL recharacterization accounts in the baskets with SLI, that SLI is recharacterized.
- 6) If there is still SLI, and if there is a U.S.-source loss, that loss is offset against the remaining SLI. At this time, there is no recapture of U.S.-source loss applied to foreign-source income. However, for tax

years beginning after December 31, 2006, there may be recapture.<sup>1</sup>

Those six rules are illustrated in two examples that appear in Table 1 below. Example 1 begins in year 1 with an SLL of 40 in the general limitation basket, income of 100 in the passive basket, and a U.S.-source loss of 20. Under rule 2 above, the general limitation SLL of 40 is offset against the 100 of passive income, creating a passive recharacterization account in the general limitation basket. Under rule 6, the U.S. loss is offset against the remaining 60 of passive income, leaving total income for the year of 40.

In year 2 of example 1, the general limitation basket has income of 20, the passive basket has income of 100, and there is U.S.-source income of 100. Under rule 5, the 20 of income in the general limitation basket is recharacterized as passive basket income, and the passive recharacterization account in the general limitation basket is reduced from 40 to 20. The year ends with no general limitation income, 120 of passive income, and 100 of U.S.-source income.

In example 2, year 1 shows the general limitation basket with an SLL of 170, the passive basket with 100 of income, and U.S.-source income of 100. Under rule 2, 100 of the 170 general limitation SLL is offset against the 100 of passive income, creating a passive recharacterization account of 100 in the general limitation basket. Under rule 3, the remaining 70 of general limitation SLL is offset against the 100 of U.S. income, creating an OFL account of 70. The year ends with 30 of U.S.-source income and no foreign income.

In year 2 of example 2, the general limitation basket has income of 130, the passive basket has income of 10, and there is a U.S.-source loss of 70. Under rule 4, 50 percent of the income in the general limitation basket, or 65, is recaptured as U.S.-source income, reducing the U.S.-source loss from 70 to 5. That reduces the general limitation basket's OFL account from 70 to 5. Next, under rule 5, the

<sup>1</sup>See section 402 of the American Jobs Creation Act of 2004, P.L. 108-357 (creating new section 904(g)).

**Table 1.**  
**Application of the SLL and OFL Rules**

| Year 1                  |   |  | Year 2  |  |  |
|-------------------------|---|--|---|--|--|
|                         | Ex. 1                                   | Ex. 2  | Ex. 1   | Ex. 2  | Ex. 2  |
| Gen'l Limitation Basket | New passive recharacterization acct: 40 | New passive recharacterization acct: 100<br>New gen'l lim OFL acct: 70 | Prior year passive recharacterization acct: 40<br>-20<br>20 | Prior year passive recharacterization acct: 100<br>-65<br>35 | Prior year gen'l lim OFL acct: 70<br>-65†<br>5 |
| Passive Basket          | (40)<br>-0-<br>100<br>60<br>40          | (170)<br>(70)<br>-0-<br>100<br>-0-                                     | 20<br>-0-<br>100<br>120                                     | 130**<br>65<br>-0-<br>10<br>75<br>70<br>(70)                 | 130**<br>65<br>-0-<br>10<br>75<br>70<br>(70)   |
| U.S. Income             | (20)<br>-0-                             | 100<br>30  | 100   | (5)<br>-0-   | (5)<br>-0-                                     |
| Total                   | 40                                      | 30   | 220   | 70   | 70   |

① ② ③ = sequence of events

\*Ordering (after SLL reallocation) per Section 904(f)(5)(D) and Notice 89-3; no recapture for U.S. loss offset until tax years beginning after Dec. 31, 2006.

\*\*No Section 904(f)(3) disposition proceeds, so 50% ceiling applies.

† OFL recapture capped at 50% of current year basket income unless TP elects otherwise. Note: A different rule applies if foreign taxes are deducted rather than credited.

**Table 2.**  
**Notice 2005-64, Section 8.05 — Treatment of SLL and OFL in Section 965 context**

|                         | Ex. 1  | Ex. 2  | Ex. 3  | Ex. 4  | Ex. 5                                      | Ex. 6                   | Ex. 7                            |
|-------------------------|--|--|--|--|--|-------------------------|----------------------------------|
|                         | No taxable income limitation; allocation of SLL* | Taxable income limitation; allocation of SLL | Taxable income limitation; allocation of U.S. loss | Taxable income limitation; allocation of SLL & U.S. loss | OFL† recapture from other (non-NDD) income | OFL recapture from NDDs | SLL recharacterization from NDDs |
| Gen'l Limitation Basket | 100 NDD**<br>-0-                                 | 100 NDD                                      | 750, of which 500 is NDD<br>500, all NDD           | 100, all NDD   | 150 NDD                                    | 150 NDD<br>75 NDD       | 150 NDD<br>40 NDD                |
| Passive Basket          | (100)<br>-0-                                     | (100)<br>(60) NOL<br>(40)                    | (250)<br>-0-                                       | (100)<br>-0-<br>100<br>-0-                               | 150<br>+190<br>340<br>x50%<br>170          | 150<br>x50%<br>75       | 110<br>96<br>-8<br>99<br>200     |
| U.S. Income             | 200  | 40<br>-0-                                    | (750)<br>(500) NOL                                 | (100)<br>(100) NOL                                       | 170  | 75                      | -0-                              |
| Total                   | 200  | 100  | 500  | 100  | 340  | 150                     | 240                              |

\*SLL = single limitation loss

\*\*NDD = non-deductible CFC dividend

† OFL = overall foreign loss

① ② = sequence of events

remaining 65 of general limitation income is recharacterized as passive-source income. That raises passive basket income from 10 to 75 and reduces the general limitation basket's passive recharacterization account from 100 to 35. Finally, under rule 6, the remaining U.S. loss of 5 is offset against the 75 of passive-source income, leaving 70 of income in the passive basket.

### Section 965 and Notice 2005-64

Section 8 of Notice 2005-64 provides seven examples detailing the proper treatment of SLLs and OFLs in the context of IRC section 965, the repatriation provision in the American Jobs Creation Act of 2004. (For Notice 2005-64, see *2005 WTD 161-9* or *Doc 2005-17558*.) As may be seen from example 1 in Table 2, the regular rules apply as long as U.S.-source income is greater than the nondeductible portion of any section 965 dividends (NDDs).<sup>2</sup>

If U.S.-source income is less than the NDDs, however, SLLs offset only non-NDD income. As example 2 illustrates, non-NDD income can include U.S.-source income. To the extent that SLLs are

greater than non-NDD income, they become NOLs. Example 3 shows that offset of U.S.-source loss against SLI is subject to a similar limitation.

Example 4 combines the rules in examples 2 and 3, showing that the prohibition against SLLs offsetting NDDs extends to a loss in the same basket as an NDD and that a U.S.-source loss becomes an NOL if the only SLI against which it could be offset is an NDD.

Examples 5 through 7 illustrate the limitations that section 965 places on the OFL recapture and SLL recharacterization rules. OFL is recaptured first from non-NDD income (example 5), but if necessary, also from NDDs (example 6). A similar limitation applies to SLL recharacterization; non-NDD income is recharacterized first, and NDD income second (example 7).

One possible synthesis of those changes is that, in a section 965(e)(2)(A) context,<sup>3</sup> recapture and recharacterization work as usual for the most part, with a preference for non-NDD income. Offsets against SLI, however, are forbidden if they would affect NDD income. They are applied elsewhere, to the extent possible, and if any loss remains, it becomes an NOL. ♦

<sup>2</sup>Eighty-five percent of qualifying dividends under section 965 is excluded from taxable income, but taxable income cannot be less than the remaining 15 percent. See section 965(a)(1), (e)(2)(A).

<sup>3</sup>See *supra* note 2.