



**BDO Seidman, LLP**  
Accountants and Consultants

## **Subject:**

**Draft Form 1118  
Issued by Internal  
Revenue Service**

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# International Tax Alert

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The Internal Revenue Service (IRS) has made changes to Form 1118 to reflect recent amendments to Code Sec. 904 under the American Jobs Creation Act of 2004.

### **Date/Timing**

Effective for tax years beginning after December 31, 2006.

### **Affecting**

Any U.S. corporation reporting the foreign tax credit for certain taxes paid or accrued to foreign countries or U.S. possessions.

### **Summary of Revisions**

#### **(a) Reduction to two of the number of separate foreign tax credit limitation categories**

The amendment to IRC Sec. 904 by the American Jobs Creation Act of 2004 reduced the number of categories under IRC Sec. 904(d) from eight to two, effective for tax years beginning after December 31, 2006. Consequently, Form 1118 is being revised to eliminate information reporting for the categories that were eliminated, leaving only the passive and the general category income baskets (other than any baskets created as a result of treaty re-sourcing or sanctions country income).

Passive category income is comprised of passive income and specified passive category income. Generally, the term "passive income" means any income received or accrued by any person which is of a kind which would be foreign personal holding company income (as per section 954(c)). The term "specified passive category" income includes: (a) dividends from a DISC or former DISC (as per section 992(a)) to the point such dividends are treated as income from non-US sources; (b) taxable income attributable to foreign trade income (within the meaning of section 923(b)); and (c) distributions from a FSC (per section 923(b) or interest/carrying charges (per section 927(d)(1)) derived from a transaction which results in foreign trade income.

Any taxable income other than passive category income should be treated as general category income. Taxes carried from any taxable year prior to January 1, 2007, with respect to any item of income, is treated in the same manner as income allocated between passive and general category income. Carrybacks for taxes paid or accrued for a taxable year beginning on or after January 1, 2007, should be allocated according to the separate limitation categories in effect for the tax years to which carried.

On June 27<sup>th</sup>, 2007 the IRS proposed revisions to Form 1118 (Foreign Tax Credit – Corporations) and accompanying Schedule J (Adjustments to Separate Limitations Income (Loss) Categories for Determining Numerators of Limitation Fractions, Year-End Recharacterization Balances, and Overall Foreign and Domestic Loss Account Balances). The proposed revised forms have been posted on the IRS website<sup>1</sup>.

#### **(b) The introduction of the overall domestic loss (ODL) account under Sec. 904(g)**

The new IRC §904(g) provision recently added to the American Jobs Creation Act of 2004 reflects the recharacterization of overall domestic loss (IRC Sec. 904(g)). It requires any taxpayer who incurs an “overall domestic loss”<sup>2</sup> for any taxable year beginning after December 31, 2006 to apportion its U.S. sourced income as foreign source income in every subsequent year limited to the portion of the taxpayer’s U.S. source taxable income equals the lesser of:

1. the amount of the unused overall domestic losses from the prior years, or
2. 50 percent of the taxpayer’s U.S. source taxable income for such succeeding taxable year.

A number of revisions have been made to Form 1118 and its schedules to reflect the overall domestic loss provisions of new section 904(g).

#### **(c) Interest expense allocation and apportionment options for FTC calculations**

IRC §864(e)(2) specifically requires that all allocations and apportionment of interest expense be made on the basis of assets, not gross income. Under Treas. Reg. §1.861-8T(c)(2), a taxpayer may elect to value its assets based on either their tax book value or fair market value. For tax years beginning after December 31, 2008, a taxpayer may elect to use their worldwide assets as the basis for allocation, rather than the value of the stock or the investment of affiliated foreign corporations (as per Sec. 864(f)(1)(A)); hence, it would allow a taxpayer to allocate interest on a worldwide basis (as if all members of the worldwide affiliated group were a single corporation).

Note that prior to January 1, 2009, taxpayers have three options available to allocate and apportion interest expense: the fair market value method, tax book value method and alternative tax book value method. Form 1118 has not been affected by this change at this time.

The legislative changes from 2004 provide planning opportunities for U.S. taxpayers with foreign source income and foreign tax credits.

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<sup>1</sup> In order to see the draft version of the proposed forms, go to [www.irs.gov](http://www.irs.gov); select ‘Tax Professionals’; ‘More Topics’ and ‘Draft Tax Forms.’ Draft forms and instructions can be sorted either by form or date of the revisions.

<sup>2</sup> An ODL means any domestic loss that offsets the foreign-sourced taxable income for the current taxable year or any preceding qualified taxable year by reason of a carryback. “Domestic loss” in this case means the amount by which the sum of deduction is in excess of the U.S.-sourced gross income for the current taxable year (determined without regard to any carryback from a subsequent taxable year). See IRC §904(g)(2)).

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