

Instructions for Schedule J (Form 1118) (Rev. January 2009)



Department of the Treasury
Internal Revenue Service

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Purpose of Schedule

- Use Part I to show adjustments to separate limitation income or (losses) in determining the numerator of the limitation fraction for each separate category.
- Use Part II to show the year-end balances of future separate limitation income that must be recharacterized as income in other separate categories (as the result of current year or prior year separate limitation losses that were allocated to reduce income in those other separate categories).
- Use Part III to show: (a) the balances in the corporation's overall foreign loss accounts at the beginning of the tax year, (b) any current year adjustments, and (c) the balances in the overall foreign loss accounts at the end of the tax year.
- Use Part IV to show: (a) the balances in the corporation's overall domestic loss accounts at the beginning of the tax year, (b) any current year adjustments, and (c) the balances in the overall domestic loss accounts at the end of the tax year.

Important. Complete Schedule J **only once**. Include adjustments for each applicable separate category.

Computer-Generated Schedule

A computer-generated Schedule J can be filed if it conforms to the IRS version of the schedule. Expand Schedule J to properly complete Parts I, II, III, and IV of the schedule if the corporation has more than one separate category of "other income." Income from **each** sanctioned country to which section 901(j) applies and **each** item of income resourced under a tax treaty are treated as a separate category of "other income."

Specific Instructions

Part I

Note. See Temporary Regulations section 1.904(g)-3T for detailed information on the ordering of adjustments in Part I.

Line 1. For columns (i), (ii), and (iii), enter in each applicable column, the income or (loss) from column 13 of the corresponding Schedule A for that separate category. In column (iv), enter an amount equal to the income or (loss)

from Schedule B, Part II, line 8c, minus the aggregate income or (loss) entered in the other columns of this line 1.

Line 2. This allocation grid must be completed to show the pro rata share of each separate limitation loss to allocate among other applicable separate categories.

To determine each pro rata share:

1. Add all of the separate limitation loss amounts entered across line 1. Then add all of the separate limitation income amounts entered across line 1.

2. If the combined separate limitation losses for the tax year **do not exceed** the combined separate limitation income for the tax year, the pro rata share of each separate limitation loss to allocate to each category with positive income is as follows:

$$\frac{\text{Separate limitation income} / \text{Combined separate limitation income from all categories with positive income}}{\text{Separate limitation loss being allocated}}$$

3. If the combined separate limitation losses for the tax year **exceed** the combined separate limitation income for the tax year, the pro rata share of each separate limitation loss to allocate to each category with positive income is as follows:

$$\frac{\text{Separate limitation loss being allocated} / \text{Combined separate limitation losses from all categories with losses}}{\text{Separate limitation income in a given category}}$$

If separate limitation losses can be allocated, enter the total amounts allocated in the bold-outlined boxes as positive numbers. Enter each separate amount allocated to a given category across the same line under the appropriate column heading to which it was allocated.

Note. The numbers entered across any given line should "zero out."

If a separate limitation loss in one category offsets income in a second category and the second category has a separate limitation loss account balance that has not been recaptured with respect to the first category, then the two offsetting separate limitation loss account balances are netted for purposes of determining the amount of income in the second category that is subject to recharacterization on line 9, Part I, if any, and for purposes of determining the year-end balances in both categories reported in Part II.

The combined separate limitation losses for the tax year that are more than

the combined separate limitation income for the tax year reduce the U.S. source income (if any) for the tax year. If the corporation has no U.S. source income for the tax year, **or** if the excess of its combined separate limitation losses for the tax year over combined separate limitation income for the tax year exceeds its U.S. source income for the tax year, the excess is treated as a net operating loss. This loss may be carried over or back to other tax years according to the rules of section 172.

Example 1. Corporation X has a separate limitation loss of \$2,000 in its general category (line 1, column (i)) and separate limitation income of \$4,000 in its passive category (line 1, column (ii)). In addition, the corporation has separate limitation income of \$1,000 in its resourced treaty income category (line 1, column (iii)).

Since the corporation's combined separate limitation losses for the tax year (\$2,000) **do not exceed** its combined separate limitation income for the tax year (\$5,000), the entire \$2,000 loss may be allocated to other separate categories. Therefore, Corporation X enters a positive \$2,000 in the bold-outlined box on line 2a, column (i).

To compute the portion of the \$2,000 separate limitation loss that is allocable to passive category income, Corporation X divides the \$4,000 of income by \$5,000 (the combined separate limitation income from all separate categories with positive income). The result of 80% is multiplied by the separate limitation loss of \$2,000. Corporation X enters the product of \$1,600 on line 2a, column (ii).

To compute the portion of the \$2,000 separate limitation loss that is allocable to resourced treaty income, Corporation X divides the \$1,000 of separate limitation income by \$5,000. The result of 20% is multiplied by the separate limitation loss of \$2,000. Corporation X enters the product of \$400 on line 2a, column (iii).

Corporation X enters \$0 (negative \$2,000 plus positive \$2,000) on line 3, column (i); \$2,400 (\$4,000 minus \$1,600) on line 3, column (ii); and \$600 (\$1,000 minus \$400) on line 3, column (iii).

Line 4. In columns (i) through (iii), enter the overall foreign losses for the tax year (from line 3) as positive numbers if they have reduced U.S. source income for the tax year. In column (iv), enter the total amount of overall foreign losses that have reduced U.S. source income for the tax year as a negative number.

Note. The numbers entered across this line should “zero out.”

Line 5. In columns (i) through (iii), enter U.S. source losses allocated to separate categories with income on line 3 for the current tax year. In column (iv), enter the total amount of U.S. losses allocated to the separate categories as a positive number. Use the following formula:

U.S. source loss x (Line 3 income in a given category / Combined line 3 income of all separate categories with income on line 3)

U.S. source losses in excess of the combined line 3 income for a tax year is treated as a net operating loss that may be carried back or forward to other tax years using the rules of section 172.

Note. The numbers entered across this line should “zero out.”

Line 7. Recapture overall foreign losses that reduced U.S. source income in prior tax years (section 904(f)(1)). To do this, treat a portion of the current year separate limitation income that is of the same category as the loss that resulted in the prior year overall foreign loss as U.S. source income. Recapture continues until the applicable overall foreign loss account balance (Part III) is reduced to zero. Enter the recapture amount for each category of separate limitation income in the appropriate column as a negative number. Enter the total amount of recapture for all categories of separate limitation income as a positive number in column (iv).

Note. The numbers entered across this line should “zero out.”

The total amount of current year separate limitation income subject to recapture is the smaller of the aggregate amount of maximum potential recapture in all overall foreign loss accounts, or 50% of all amounts entered on Part I, line 6, columns (i) through (iii). The maximum potential recapture amount for the overall foreign loss account in any given category is the smaller of the current year separate limitation income in that category (the applicable amount entered in Part I, line 6), or the balance in the applicable overall foreign loss account (the applicable line 1 amount in Part III). If the aggregate amount of maximum potential recapture in all overall foreign loss accounts exceeds 50% of all amounts entered on Part I, line 6, columns (i) through (iii), then the amount of current year separate limitation income in each separate category subject to recapture is computed using the following formula:

Total recapture amount x (Maximum potential recapture amount for the overall foreign loss account in the separate category / Aggregate amount of maximum potential recapture in all overall foreign loss accounts)

The corporation can make an annual, revocable election to recapture a greater portion of the balance in an overall foreign

loss account by attaching a statement to Form 1118 indicating:

1. The percentage and dollar amount of the separate limitation income that is treated as U.S. source income and

2. The percentage and dollar amount of the balance (both before and after recapture) in the overall foreign loss account that is recaptured.

If the corporation disposes of property that was used predominantly in a foreign trade or business and that generated foreign source income in the same separate category as the applicable overall foreign loss account, the corporation generally must recognize gain on the disposition to the extent of the balance in the account (after amounts are recaptured under section 904(f)(1)), whether or not gain would otherwise be recognized on the disposition. See section 904(f)(3) and Regulations section 1.904(f)-2(d). Such gain is treated as foreign source taxable income in the same separate category as the applicable overall foreign loss account and is subject to recapture to the extent of the corporation's foreign source taxable income in that separate category or, if less, 100% of the corporation's foreign source taxable income.

Note. For dispositions after October 22, 2004, the previous paragraph applies to certain dispositions of stock in a CFC. See section 904(f)(3)(D) for details.

Example 2. Corporation Y has \$1,400 of current year separate limitation income, \$1,000 in its general category (Part I, line 6, column (i)) and \$400 in its passive category (Part I, line 6, column (ii)). The corporation has overall foreign loss accounts of \$600 in its general category and \$800 in its passive category (Part III, line 1, columns (i) and (ii)). The maximum potential recapture for the overall foreign loss account in the general category is \$600 (the smaller of current year income of \$1,000 in that category or the overall foreign loss account balance of \$600). The maximum potential recapture for the overall foreign loss account in the passive category is \$400 (the smaller of current year income of \$400 in that category or the overall foreign loss account balance of \$800). The aggregate amount of maximum potential recapture in all overall foreign loss accounts is therefore \$1,000 (\$600 + \$400).

The total amount of current year income subject to recharacterization is \$700 (the smaller of the aggregate amount of maximum potential recapture, \$1,000, or 50% of total current year separate limitation income entered on line 6, Part I (50% x \$1,400, or \$700)). To compute the amount of current year separate limitation income in the general category that is treated as U.S. source income, Corporation Y multiplies the total recapture amount of \$700 by the maximum recapture amount for the general category of \$600, divided by the

aggregate amount of maximum potential recapture of \$1,000. Corporation Y enters the result of \$420 on line 7, column (i). To compute the amount of current year separate limitation income in the passive category that is treated as U.S. source income, Corporation Y multiplies the total recapture amount of \$700 by the maximum recapture amount for the passive category of \$400, divided by the aggregate amount of maximum potential recapture of \$1,000. Corporation Y enters the result of \$280 on line 7, column (ii). Corporation Y enters the total recapture amount of \$700 as a positive number on line 7, column (iv). Note that the total amounts entered across line 7 equal zero.

Line 9. If a separate limitation loss was allocated in a prior tax year and the corporation has income during the current tax year in the separate category from which the loss was allocated, that current year income (if it was not previously recharacterized) must be recharacterized as income of the separate category(ies) to which the loss was allocated in the prior year(s) (section 904(f)(5)).

Note. The amount of current year income in a category subject to recharacterization is limited to the year-end balance in Part II for that category as reported on the prior tax year Schedule J, reduced by any netting of offsetting separate limitation loss accounts as provided for in the instructions for Part I, line 2.

If a prior year separate limitation loss was allocated to more than one separate category **and** there is not enough current year income in the separate category from which the loss was allocated to recharacterize all remaining balances, then the current year income must be recharacterized as income of the other separate categories on a pro rata basis in the following manner:

Current year income in separate category from which losses were previously allocated x (Amount remaining to be recharacterized as income of a given separate category / Amounts remaining to be recharacterized as income of all separate categories)

Any amount that is not recharacterized during the tax year (i.e., the excess of separate limitation losses previously allocated over current year income in that same separate category) must be entered into the grid at Part II.

Note. Recharacterization of separate limitation income does not result in recharacterizing any tax. The rules of Regulations section 1.904-6 apply on an annual basis for allocating taxes to separate categories before any income is recharacterized.

If prior year separate limitation losses can be recaptured, the total amounts recharacterized should be entered into the bold-outlined boxes as negative numbers. Each prior-year separate limitation loss recaptured should be entered as a positive number on the

same line under the appropriate column heading to which income was recharacterized.

Note. The numbers entered across any given line should “zero out.”

Example 3. Assume the same facts as in Example 1 on page 1. Also assume that, in a subsequent tax year, Corporation X has \$1,500 of income in its general category (on line 8, column (i), of its Schedule J).

Since there is not enough general category income to recapture the entire \$2,000 prior-year balance remaining to be recaptured, Corporation X will prorate the \$1,500 of general category income in that subsequent year as follows.

- To compute the portion to be recharacterized as passive category income, Corporation X should:

1. Divide the \$1,600 remaining to be recharacterized from general category income to passive category income by the \$2,000 remaining to be recharacterized from general category income to all separate categories.

2. Multiply the result (80%) by the \$1,500 of general category income.

3. Enter \$1,200 as a positive number on line 9a, column (ii).

- To compute the portion to be recharacterized as resourced treaty income, Corporation X should:

1. Divide the \$400 remaining to be recharacterized from general category income to resourced treaty income by \$2,000.

2. Multiply the result (20%) by the \$1,500 of general category income.

3. Enter \$300 as a positive number on line 9a, column (iii).

Corporation X enters the \$1,500 of general category income that was recharacterized in the bold-outlined box at line 9a, column (i). Note that the total amounts entered across line 9a equal zero.

Finally, Corporation X completes the Part II recharacterization balances grid by entering \$400 (\$1,600 minus \$1,200) on line a, column (ii), and \$100 (\$400 minus \$300) on line a, column (iii).

Line 10. Recapture overall domestic losses that reduced separate limitation income in prior tax years (section 904(g)(1)). To do this, treat a portion of the current year U.S. source income as separate limitation income in the same category(ies) as the separate limitation income that was reduced by the prior year overall domestic loss. Recapture

continues until the applicable overall domestic loss account balance (Part IV) is reduced to zero. Enter the total overall domestic loss recapture amount as a negative number in column (iv). Enter the amount recharacterized as separate limitation income in each category, as appropriate, as positive numbers in columns (i) through (iii).

Note. The numbers entered across this line should “zero out.”

The total amount of any current year U.S. income subject to recapture is the smaller of the total balance in the applicable overall domestic loss accounts (the applicable column(s) in Part IV, line 1) or 50% of the amount entered on Part I, line 6.

If a prior year overall domestic loss or losses were allocated to more than one separate category **and** there is not enough income in the current year subject to recharacterization to recapture all remaining overall domestic loss account balances, then the current year U.S. source income subject to recharacterization must be recharacterized as income of the separate categories on a pro rata basis in the following manner:

Current year U.S. source income subject to recharacterization x (Amount remaining to be recharacterized as income of a given separate category / Amounts remaining to be recharacterized as income of all separate categories)

Part II

If a separate limitation loss was allocated in a prior tax year and the corporation has income during the current tax year in the separate category from which the loss was allocated, that current year income (if it was not previously recharacterized) must be recharacterized as income of the category to which the loss was allocated in the prior year(s) (section 904(f)(5)).

To determine the amounts to enter into the grid:

1. Add the current year separate limitation loss allocations (adjusted as required by Regulations section 1.904(b)-1(h)(1) relating to capital gains) to last year's year-end balances.

2. Net any offsetting separate limitation loss accounts as described in the instructions for Part I, line 2.

3. Subtract the amounts recharacterized during the current tax year.

4. Enter the result on the line (line a, b, or c) for the separate category from which losses were previously allocated, under the appropriate column (column (i), (ii), or (iii)) to which the losses were previously allocated.

Example 4. Assume the same facts as in Example 1 on page 1. Also assume that Corporation X does not have any remaining balances from any prior allocations of losses from its general category to its passive category or its resourced treaty income category. The corporation should enter \$1,600 on line a, column (ii), and \$400 on line a, column (iii).

Part III

Line 1. Enter the ending balances from last year's schedule.

Lines 2, 3, and 4. Show any adjustments made to the overall foreign loss accounts for each separate category during the tax year. See Regulations section 1.904(f)-1(d) for a list of possible additions to the accounts. See Regulations section 1.904(f)-1(e) for a list of possible reductions (including recapture).

Line 6. Enter the year-end balances of the overall foreign loss accounts for each separate category.

Part IV

Line 1. Enter the ending balances from last year's schedule.

Lines 2, 3, and 5. Show any adjustments made to the overall domestic loss account with respect to each separate category during the tax year. See Temporary Regulations section 1.904(g)-1T(d) for a list of possible additions to the accounts. See Temporary Regulations section 1.904(g)-1T(e) for a list of possible reductions (including recapture).

Note. A U.S. source loss that is carried back as part of a net operating loss to offset foreign income in a prior qualified tax year will result in an increase to the overall domestic loss account in the year in which the loss arose, not the earlier year to which the loss was carried back to offset the foreign income.

Line 6. Enter the year-end balances of the overall domestic loss account with respect to each separate category.