(b)(2) of this section $100

The amount of pre-1983 FORI 907(b) overall foreign loss recaptured from section general limitation income exclusive of foreign oil related income is the lesser of $500 (the remaining balance in that loss account) or 50 percent of $1,000 (the general limitation income exclusive of foreign oil related income), but only to the extent that the amount recaptured from such income under paragraph (b)(1) of this section is less than 50 percent of such income, or $100 (50 percent of $1,000)—$400 recaptured due to section 904(d)(1)(A–C) overall foreign loss account, and only up to the amount permitted by paragraph (b)(2)(ii) of this section, which is (12½ percent of $1,000 x 1)—$0, or $125.

Total amount recaptured in 1983 .... $1,000

At the end of 1983, Z has reduced its pre-1983 section 904(d)(1)(A–C) overall foreign loss account to zero, and has a balance in its pre-1983 FORI overall foreign loss account of $400.

[T.D. 8153, 52 FR 32003, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987]

§§ 1.904(f)–7—1.904(f)–11 [Reserved]

§ 1.904(f)–12 Transition rules.

(a) *Recapture in years beginning after December 31, 1986, of overall foreign losses incurred in taxable years beginning before January 1, 1987*—(1) *In general.* If a taxpayer has a balance in an overall foreign loss account at the end of its last taxable year beginning before January 1, 1987 (pre-effective date years), the amount of that balance shall be recaptured in subsequent years by recharacterizing income received in the income category described in section 904(d) as in effect for taxable years beginning after December 31, 1986 (post-effective date years), that is analogous to the income category for which the overall foreign loss account was established, as follows:

(i) Interest income as defined in section 904(d)(1)(A) as in effect for pre-effective date taxable years is analogous to passive income as defined in section 904(d)(1)(A) as in effect for post-effective date years;

(ii) Dividends from a DISC or former DISC as defined in section 904(d)(1)(B) as in effect for pre-effective date taxable years is analogous to dividends from a DISC or former DISC as defined in section 904(d)(1)(F) as in effect for post-effective date taxable years;

(iii) Taxable income attributable to foreign trade income as defined in section 904(d)(1)(C) as in effect for pre-effective date taxable years is analogous to taxable income attributable to foreign trade income as defined in section 904(d)(1)(G) as in effect for post-effective date years;

(iv) Distributions from a FSC (or former FSC) as defined in section 904(d)(1)(D) as in effect for pre-effective date taxable years is analogous to distributions from a FSC (or former FSC) as defined in section 904(d)(1)(H) as in effect for post-effective date taxable years;

(v) For general limitation income as described in section 904(d)(1)(E) as in effect for pre-effective date taxable years, see the special rule in paragraph (a)(2) of this section.

(2) *Rule for general limitation losses*—(i) *In general.* Overall foreign losses incurred in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, that are recaptured in post-effective date taxable years shall be recaptured from the taxpayer's general limitation income, financial services income, shipping income, and dividends from each noncontrolled section 902 corporation. If the sum of the taxpayer's general limitation income, financial services income, shipping income and dividends from each noncontrolled section 902 corporation for a taxable year subject to recapture exceeds the overall foreign loss to be recaptured, then the amount of each type of separate limitation income that will be treated as U.S. source income shall be determined as follows:

$$\text{Overall foreign loss subject to recapture} \times \frac{\text{Amount of income in each separate category from which the loss may be recaptured}}{\text{Sum of income in all separate categories from which the loss may be recaptured.}}$$

This recapture shall be made after the allocation of separate limitation losses pursuant to section 904(f)(5)(B) and before the recharacterization of post-effective date separate limitation income pursuant to section 904(f)(5)(C).

(ii) *Exception.* If a taxpayer can demonstrate to the satisfaction of the district director that an overall foreign loss in the general limitation category of section 904(d)(1)(E), as in effect for pre-effective date taxable years, is attributable, in sums certain, to losses in one or more separate categories of section 904(d)(1) (including for this purpose the passive income category and the high withholding tax interest category), as in effect for post-effective date taxable years, then the taxpayer may recapture the loss (in the amounts demonstrated) from those separate categories only.

(3) *Priority of recapture of overall foreign losses incurred in pre-effective date taxable years.* An overall foreign loss incurred by a taxpayer in pre-effective date taxable years shall be recaptured to the extent thereof before the taxpayer recaptures an overall foreign loss incurred in a post-effective date taxable year.

(4) *Examples.* The following examples illustrate the application of this paragraph (a).

Example 1. X corporation is a domestic corporation which operates a branch in Country Y. For its taxable year ending December 31, 1988, X has $800 of financial services income, $100 of general limitation income and $100 of shipping income. X has a balance of $100 in its general limitation overall foreign loss account which resulted from an overall foreign loss incurred during its 1986 taxable year. X is unable to demonstrate to which of the income categories set forth in section 904(d)(1) as in effect for post-effective date taxable years the loss is attributable. In addition, X has a balance of $100 in its shipping overall foreign loss account attributable to a shipping loss incurred during its 1987 taxable year. X has no other overall foreign loss accounts. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's foreign source taxable income for its 1988 taxable year, or $500. X's overall foreign loss incurred during its 1986 taxable year is recaptured before the overall foreign loss incurred during its 1987 taxable year, as follows: $80 ($100×800/1000) of X's financial services income, $10 ($100×100/1000) of X's general limitation income, and $10 (100×100/1000) of X's shipping income will be treated as U.S. source income. The remaining $90 of X corporation's 1988 shipping income will be treated as U.S. source income for the purpose of recapturing X's 100 overall foreign loss attributable to the shipping loss incurred in 1987. $10 remains in X's shipping overall foreign loss account for recapture in subsequent taxable years.

Example 2. The facts are the same as in *Example* 1 except that X has $800 of financial services income, $100 of general limitation income, a $100 dividend from a noncontrolled section 902 corporation and a ($100) shipping loss for its taxable year ending December 31, 1988. Separate limitation losses are allocated pursuant to the rules of section 904(f)(5) before the recapture of overall foreign losses. Therefore, the ($100) shipping loss incurred by X will be allocated to its separate limitation income as follows: $80 ($100×800/1000) will be allocated to X's financial services income, $10 ($100×100/1000) will be allocated to its general limitation income and $10 ($100×100/1000) will be allocated to X's dividend from the noncontrolled section 902 corporation. Accordingly, after allocation of the 1988 shipping loss, X has $720 of financial services income, $90 of general limitation income, and a $90 dividend from the noncontrolled section 902 corporation. Pursuant to section 904(f)(1), the full amount in each of X corporation's overall foreign loss accounts is subject to recapture since $200 (the sum of those amounts) is less than 50% of X's net foreign source taxable income for its 1988 taxable year, or $450. X's overall foreign loss incurred during its 1986 taxable year is recaptured as follows: $80 ($100×720/900) of X's financial services income, $10 ($100×90/900) of its general limitation income and $10 ($100×90/900) of its dividend from the noncontrolled section 902 corporation will be treated as U.S. source income. Accordingly, after application of section 904(f), X has $100 of U.S. source income, $640 of financial services income, $80 of general limitation income and a $80 dividend from the noncontrolled section 902 corporation for its 1988 taxable year. X must establish a separate limitation loss account for each portion of the 1988 shipping loss that was allocated to its financial services income, general limitation income and dividends from the noncontrolled section 902 corporation. X's overall foreign loss account for the 1986 general limitation loss is reduced to zero. X still has a $100 balance in its overall foreign loss account that resulted from the 1987 shipping loss.

Example 3. Y is a domestic corporation which has a branch operation in Country Z. For its 1988 taxable year, Y has $5 of shipping income, $15 of general limitation income and $100 of financial services income. Y has a balance of $100 in its general limitation overall foreign loss account attributable to its 1986 taxable year. Y has no other overall foreign loss accounts. Pursuant to section 904(f)(1), $60 of the overall foreign loss is subject to recapture since 50% of Y's foreign source income for 1988 is less than the balance in its overall foreign loss account. Y can demonstrate that the entire $100 overall foreign loss was attributable to a shipping limitation loss incurred in 1986. Accordingly, only Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income, Because Y can demonstrate that the 1986 loss was entirely attributable to a shipping loss, none of Y's general limitation income or financial services income received in 1988 will be treated as U.S. source income.

Example 4. The facts are the same as in *Example* 3 except that Y can only demonstrate that $50 of the 1986 overall foreign loss account was attributable to a shipping loss incurred in 1986. Accordingly, Y's $5 of shipping limitation income received in 1988 will be treated as U.S. source income. The remaining $50 of the 1986 overall foreign loss that Y cannot trace to a particular separate limitation will be recaptured and treated as U.S. source income as follows: $43 ($50×100/115) of Y's financial services income will be treated as U.S. source income and $7 ($50×15/115) of Y's general limitation income will be treated as U.S. source income. Y has $45 remaining in its overall foreign loss account to be recaptured from shipping income in a future year.

(b) *Treatment of overall foreign losses that are part of net operating losses incurred in pre-effective date taxable years which are carried forward to post-effective date taxable years*—(1) *Rule.* An overall foreign loss that is part of a net operating loss incurred in a pre-effective date taxable year which is carried forward, pursuant to section 172, to a post-effective date taxable year will be carried forward under the rules of section 904(f)(5) and the regulations under that section. *See also* Notice 89–3, 1989–1 C.B. 623. For this purpose the loss must be allocated to income in the category analogous to the income category set forth in section 904(d) as in effect for pre-effective date taxable years in which the loss occurred. The analogous category shall be determined under the rules of paragraph (a) of this section.

(2) *Example.* The following example illustrates the rule of paragraph (b)(1) of this section.

Example. Z is a domestic corporation which has a branch operation in Country D. For its taxable year ending December 31, 1988, Z has $100 of passive income and $200 of general limitation income. Z also has a $60 net operating loss which was carried forward pursuant to section 172 from its 1986 taxable year. The net operating loss resulted from an overall foreign loss attributable to the general limitation income category. Z can demonstrate that the loss is a shipping loss. Therefore, the net operating loss will be treated as a shipping loss for Z's 1988 taxable year. Pursuant to section 904(f)(5), the shipping loss will be allocated as follows: $20 ($60×100/300) will be allocated to Z's passive income and $40 ($60×200/300) will be allocated to Z's general limitation income. Accordingly, after application of section 904(f), Z has $80 of passive income and $160 of general limitation income for its 1988 taxable year. Although no addition to Z's overall foreign loss account for shipping income will result from the NOL carry forward, shipping income earned by Z in subsequent taxable years, will be subject to recharacterization as a passive income and general limitation income pursuant to the rules set forth in section 904(f)(5).

(c) *Treatment of overall foreign losses that are part of net operating losses incurred in post-effective date taxable years which are carried back to pre-effective date taxable years*—(1) *Allocation to analogous income category.* An overall foreign loss that is part of a net operating loss incurred by the taxpayer in a post-effective date taxable year which is carried back, pursuant to section 172, to a pre-effective date taxable year shall be allocated first to income in the pre-effective date income category analogous to the income category set forth in section 904(d) as in effect for post-effective date taxable years in which the loss occurred. Except for the general limitation income category, the pre-effective date income category that is analogous to a post-effective date income category shall be determined under paragraphs (a)(1) (i) through (iv) of this section. The general limitation income category for pre-effective date years shall be treated as the income category that is analogous to the post-effective date categories for general limitation income, financial services income, shipping income, dividends from each noncontrolled section 902 corporation and high withholding tax interest income. If the net operating loss resulted from separate limitation losses in more than one post-effective date income category and more than one loss is carried back to pre-effective date general limitation income, then the losses shall be allocated to the pre-effective date general limitation income based on the following formula:

$$\text{Pre-effective date general limitation income} \times \frac{\text{Loss in each post-effective date separate limitation category that is analogous to pre-effective date general limitation income}}{\text{Losses in all post-effective categories that are analogous to pre-effective date general limitation income}}$$

(2) *Allocation to U.S. source income.* If an overall foreign loss is carried back to a pre-effective date taxable year and the loss exceeds the foreign source income in the analogous category for the carry back year, the remaining loss shall be allocated against U.S. source income as set forth in §1.904(f)–3. The amount of the loss that offsets U.S. source income must be added to the taxpayer's overall foreign loss account. An addition to an overall foreign loss account resulting from the carry back of a net operating loss incurred by a taxpayer in a post-effective date taxable year shall be treated as having been incurred by the taxpayer in the year in which the loss arose and shall be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(3) *Allocation to other separate limitation categories.* To the extent that an overall foreign loss that is carried back as part of a net operating loss exceeds the separate limitation income to which it is allocated and the U.S. source income of the taxpayer for the taxable year to which the loss is carried, the loss shall be allocated pro rata to other separate limitation income of the taxpayer for the taxable year. However, there shall be no recharacterization of separate limitation income pursuant to section 904(f)(5) as a result of the alloction of such a net operating loss to other separate limitation income of the taxpayer.

(4) *Examples.* The following examples illustrate the rules of paragraph (c) of this section.

Example 1. X is a domestic corporation which has a branch operation in Country A. For its taxable year ending December 31, 1987, X has a $60 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1985. The net operating loss resulted from a shipping loss; X had no U.S. source income in 1987. X had $20 of general limitation income, $40 of DISC limitation income and $10 of U.S. source income for its 1985 taxable year. The $60 NOL is allocated first to X's 1985 general limitation income to the extent thereof ($20) since the general limitation income category of section 904(d) as in effect for pre-effective date taxable years is the income category that is analogous to shipping income for post-effective date taxable years. Therefore, X has no general limitation income for its 1985 taxable year. Next, pursuant to section 904(f) as in effect for pre-effective date taxable years, the remaining $40 of the NOL is allocated first to X's $10 of U.S. source income and then to $30 of X's DISC limitation income for its 1985 taxable year. Accordingly, X has no U.S. source income and $10 of DISC limitation income for its 1985 taxable year after allocation of the NOL. X has a $10 balance in its shipping overall foreign loss account which is subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years. X will not be required to recharacterize, pursuant to section 904(f)(5), subsequent shipping income as DISC limitation income.

Example 2. Y is a domestic corporation which has a branch operation in Country B. For its taxable year ending December 31, 1987, X has a $200 net operating loss which is carried back pursuant to section 172 to its taxable year ending December 31, 1986. The net operating loss resulted from a ($100) general limitation loss and a ($100) shipping loss. Y had $100 of general limitation income and $200 of U.S. source income for its taxable year ending December 31, 1986. The separate limitation losses for 1987 are allocated pro rata to Y's 1986 general limitation income as follows: $50 of the ($100) general limitation loss ($100 x 100/200) and $50 of the ($100) shipping loss ($100 x 100/200) is allocated to Y's $100 of 1986 general limitation income. The remaining $50 of Y's general limitation loss and the remaining $50 of Y's shipping loss are allocated to Y's 1986 U.S. source income. Accordingly, Y has no foreign source income and $100 of U.S. source income for its 1986 taxable year. Y has a $50 balance in its general limitation overall foreign loss account and a $50 balance in its shipping overall foreign loss account, both of which will be subject to recapture pursuant to section 904(f) as in effect for post-effective date taxable years.

(d) *Recapture of FORI and general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983.* For taxable years beginning after December 31, 1986, and before January 1, 1991, the rules set forth in §1.904 (f)–6 shall apply for purposes of recapturing general limitation and foreign oil related income (FORI) overall foreign losses incurred in taxable years beginning before January 1, 1983 (pre-1983). For taxable years beginning after December 31, 1990, the rules set forth in this section shall apply for purposes of recapturing pre-1983 general limitation and FORI overall foreign losses.

(e) *Recapture of pre-1983 overall foreign losses determined on a combined basis.* The rules set forth in paragraph (a)(2) of this section shall apply for purposes of recapturing overall foreign losses incurred in taxable years beginning before January 1, 1983, that were computed on a combined basis in accordance with §1.904 (f)–1(c) (1).

(f) *Transition rules for taxable years beginning before December 31, 1990.* For transition rules for taxable years beginning before January 1, 1990, see 26 CFR 1.904 (f)–13T as it appeared in the Code of Federal Regulations revised as of April 1, 1990.

[T.D. 8306, 55 FR 31381, Aug. 2, 1990]

§ 1.904(i)–1 Limitation on use of deconsolidation to avoid foreign tax credit limitations.

(a) *General rule.* If two or more includible corporations are affiliates, within the meaning of paragraph (b)(1) of this section, at any time during their taxable years, then, solely for purposes of applying the foreign tax credit provisions of section 59(a), sections 901 through 908, and section 960, the rules of this section will apply.

(1) *Determination of taxable income*—(i) Each affiliate must compute its net taxable income or loss in each separate category (as defined in §1.904–5(a)(1), and treating U.S. source income or loss as a separate category) without regard to sections 904(f) and 907(c)(4). Only affiliates that are members of the same consolidated group use the consolidated return regulations (other than those under sections 904(f) and 907(c)(4)) in computing such net taxable income or loss. To the extent otherwise applicable, other provisions of the Code and regulations must be used in the determination of an affiliate's net taxable income or loss in a separate category.

(ii) The net taxable income amounts in each separate category determined under paragraph (a)(1)(i) of this section are combined for all affiliates to determine one amount for the group of affiliates in each separate category. However, a net loss of an affiliate (first affiliate) in a separate category determined under paragraph (a)(1)(i) of this section will be combined under this paragraph (a) with net income or loss amounts of other affiliates in the same category only if, and to the extent that, the net loss offsets taxable income, whether U.S. or foreign source, of the first affiliate. The consolidated return regulations that apply the principles of sections 904(f) and 907(c)(4) to consolidated groups will then be applied to the combined amounts in each separate category as if all affiliates were members of a single consolidated group.

(2) *Allocation.* Any net taxable income in a separate category calculated under paragraph (a)(1)(ii) of this section for purposes of the foreign tax credit provisions must then be allocated among the affiliates under any consistently applied reasonable method, taking into account all of the facts and circumstances. A method is consistently applied if used by all affiliates from year to year. Once chosen, an allocation method may be changed only with the consent of the Commissioner. This allocation will only affect the source and foreign tax credit separate limitation character of the income for purposes of the foreign tax credit separate limitation of each affiliate, and will not otherwise affect an affiliate's total net income or loss. This section applies