

§ 1.904(f)-3

26 CFR Ch. I (4-1-02 Edition)

property generated foreign oil related income. The excess of the fair market value of the property transferred in the first disposition over Z's adjusted basis in such property is \$575. The excess of the fair market value of the property transferred in the second disposition over Z's adjusted basis in such property is \$1,000. Under paragraph (c) of this section, Z is required to recapture \$800 (the lesser of 50 percent of its foreign oil related income of \$1,600 or the balance (\$1,500) in its FORI overall foreign loss account) of its foreign oil related loss. In accordance with paragraphs (d)(4) (i) and (iv) of this section, Z is required to recognize foreign oil related income in the amount of \$575 on the first disposition and, since the foreign oil related loss account is now reduced by \$1,375 (the \$800 and \$575 amounts previously recaptured), Z is required to recognize foreign oil related income in the amount of \$125 on the second disposition. In accordance with paragraph (d)(4)(iii) of this section, the entire amount recognized is treated as United States source income and the balance in the FORI overall foreign loss account is reduced to zero under § 1.904 (f)-1 (e)(2). Z's foreign tax credit limitation for FORI is \$400 ($\$800/\$2,300 \times \$1,150$) instead of \$800 ($\$1,600/\$1,600 \times \800).

Example 5. The facts are the same as in example 4, except that the gain from the two dispositions of property is treated as net capital gain and the United States corporate tax rate is assumed to be 46 percent. As in example 4, Z is required to recapture \$800 of its foreign oil related loss from its 1981 ordinary foreign oil related income. In accordance with paragraph (d)(4) (i) and (iv) of this section, Z is first required to recognize foreign oil related income (which is net capital gain) on the first disposition in the amount of \$575. Under paragraphs (b) and (d) (2) of this section, this net capital gain is adjusted by subtracting the rate differential portion of such gain from the total amount of such gain to determine the amount by which the foreign oil related loss account is reduced, which is \$350 ($\$575 - (\$575 \times 18/46)$). The balance remaining in Z's foreign oil related loss account after this step is \$350. Therefore, this process will be repeated, in accordance with paragraph (d)(4)(iv) of this section, to recapture that remaining balance out of the gain deemed recognized on the second disposition, resulting in reduction of the foreign oil related loss account to zero and net capital gain required to be recognized from the second disposition in the amount of \$575, which must also be adjusted by subtracting the rate differential portion to determine the amount by which the foreign oil related loss account is reduced (which is \$350). The \$575 of net capital gain from each disposition is recharacterized as United States source net capital gain. Z's section 907 (b) foreign tax

credit limitation is the same as in example 4, and Z has \$1,150 ($\$575 + \575) of United States source net capital gain.

[T.D. 8153, 52 FR 31997, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987]

§ 1.904(f)-3 Allocation of net operating losses and net capital losses.

(a) *Allocation of net operating loss carrybacks and carryovers that include overall foreign losses.* If a taxpayer sustains an overall foreign loss that is part of a net operating loss for the year, then, in carrying such net operating loss back to an earlier year or forward to a later year in accordance with section 172 (or § 1.1502-21(b) (or §§ 1.1502-21A(b) and 1.1502-79A(a), as appropriate)), the portion, if any, of the net operating loss attributable to a United States source loss shall be allocated first to United States source income and the portion of the net operating loss attributable to an overall foreign loss shall be allocated first to foreign source taxable income subject to the same separate limitation in the carryback or carryover year. To the extent that the overall foreign loss component of the net operating loss exceeds foreign source taxable income subject to the same separate limitation in the year to which it is carried, it shall be allocated next to the taxpayer's United States source income for such year and then to foreign source taxable income subject to another separate limitation. See paragraph § 1.904 (f)-1(d) of this section for additions to the applicable overall foreign loss account to the extent that the United States source taxable income is reduced in the taxable year to which the loss is carried.

(b) *Allocation of net capital loss carrybacks and carryovers that include overall foreign losses.* If a taxpayer sustains an overall foreign loss that is part of a net capital loss for the year, then in carrying the net capital loss back to an earlier year or forward to a later year in accordance with section 1212 (or §§ 1.1502-22(b) (or §§ 1.1502-22A and 1.1502-79A(b), as appropriate)), the portion of the net capital loss that is attributable to a foreign source capital loss shall be allocated first to foreign source capital gain net income subject to the same separate limitation in the

carryback or carryover year. To the extent that such foreign source capital loss exceeds foreign source capital gain net income subject to the same separate limitation in the year to which it is carried, it shall be allocated first to United States source capital gain net income in such year and then to foreign source capital gain net income subject to another separate limitation. An overall foreign source net capital loss carried over to a later year in accordance with this paragraph (b) shall be taken into consideration in determining the taxpayer's overall foreign loss in the year to which it is carried and shall be added to the applicable overall foreign loss account for such year in accordance with paragraph (c) of this section. An overall foreign source net capital loss carried back to an earlier year in accordance with this paragraph (b) shall be added to the applicable overall foreign loss account in the year in which the loss occurred.

(c) *Transitional rule.* When a taxpayer incurs a net operating loss in a post-1982 taxable year that is carried back to a pre-1983 taxable year and creates an overall foreign loss in the pre-1983 year, for purposes of this section, § 1.904(f)-1(c)(1), and § 1.904(f)-2(b), that loss will be treated as if it arose in the post-1982 year; thus the loss will first offset United States source income before it offsets foreign source income subject to another limitation. When a taxpayer incurs a net operating loss in a pre-1983 taxable year that is carried forward to a post-1982 taxable year and creates an overall foreign loss in the carryover year, for purposes of this section, § 1.904(f)-1(c)(1), and § 1.904(f)-2(b), that loss is treated as if it arose in the post-1982 taxable year; thus the loss will first offset United States source income before it offsets foreign source income subject to another limitation.

(d) *Illustrations.* The following examples illustrate the application of this section.

Example 1. X Corporation is a domestic corporation with foreign branch operations in Country C. For its taxable year 1985, X has a net operating loss of (\$1250), determined as follows:

| | |
|--|---------|
| U.S. source taxable income (loss)..... | (\$250) |
| Foreign source taxable income (loss) | |
| subject to the general limitation | |

| | |
|-------|-----------|
| | (\$1,000) |
|-------|-----------|

The only prior year to which the net operating loss can be carried under section 172 is 1983. For its taxable year 1983, X had the following taxable income:

| | |
|---------------------------------------|---------|
| U.S. source taxable income | \$1,900 |
| Foreign source taxable income subject | |
| to the general limitation | \$400 |

X has a general limitation overall foreign loss for 1985 of \$1,000. X's overall foreign loss is part of a net operating loss of \$1,250 for 1985. In accordance with § 1.904(f)-3(a), the foreign loss carried back to 1983 is first allocated to X's foreign source taxable income subject to the limitation under which the loss arose, the general limitation. This amount is not added to X's overall foreign loss account under paragraph (c)(1)(i). The remaining \$600 of 1985 foreign source loss is allocated to and thus reduces 1983 United States source income, and this amount is added to X's general limitation overall foreign loss account in 1985.

Example 2. The facts are the same as in example 1, except that in 1983, X's United States source taxable income was zero. No amount is added to X's overall foreign loss account at the end of 1985. X's income and deductions for 1986 are as follows:

| | |
|---------------------------------------|---------|
| U.S. source taxable income | \$1,250 |
| Foreign source taxable income subject | |
| to the general limitation | \$300 |

X has a net operating loss carryover to 1986 of \$850 (\$1,250-\$400). The \$850 net operating loss carryover is comprised of \$600 of foreign losses (\$1,000 of 1985 loss, minus \$400 offset by foreign source income in the carryback year) and \$250 of United States source loss. The \$600 foreign source component of the net operating loss is first allocated to X's foreign source taxable income subject to the general limitation in 1986, in accordance with § 1.904(f)-3(a), prior to reducing United States source income. The \$250 United States source component of the net operating loss component is also allocated first to United States income in the carryover year before reducing any foreign source income. Thus, \$300 of the remaining \$600 of foreign source net operating loss carryover is first applied to eliminate foreign source income in the carryover year, leaving \$300 of foreign source net operating loss. The \$250 United States source component of the net operating loss reduces United States source taxable income to \$1,000 in 1986. This \$1,000 of United States source income is then further reduced by the remaining \$300 of foreign source net operating loss. Therefore, in 1986, X has \$700 of United States source income and \$300 is added to X's general limitation overall foreign loss account in accordance with § 1.904(f)-1(d)(4) of this section.

Example 3. Z is a domestic corporation that does business in the United States and

abroad. For taxable years prior to 1983, Z computed its overall foreign losses on a separate limitation basis. In 1980, Z had \$100 of United States source income and (\$100) of foreign source loss subject to the general limitation. On December 31, 1980, the balance in Z's general limitation overall foreign loss account was \$100. In 1981, Z had \$50 of United States source income and \$100 of general limitation foreign source income. In 1982, Z also had \$50 United States source income and \$100 foreign source general limitation income. Therefore, in both 1981 and 1982, Z recaptured \$50 and at the end of 1982, Z's general limitation overall foreign loss account was reduced to zero. In 1983, Z had no income. In 1984, Z had a (\$150) United States source loss and a (\$150) general limitation foreign source loss. The 1984 net operating loss is carried back first to 1981 and then to 1982. Because of the overall foreign loss recapture that occurred in those years, Z is considered to have \$100 of United States source income and \$50 of foreign source income in each year. Thus, in 1981, (\$50) of the (\$150) foreign source component of the carryback eliminated the \$50 foreign source income in that year and (\$100) of the (\$150) domestic source component of the carryback eliminated the United States source income in that year. In 1982, (\$50) of the remaining domestic source component of the net operating loss reduced the United States source income to \$50. The remaining (\$100) of the foreign source component of the loss first reduced the foreign source income to zero and then reduced the remaining United States source income to zero, thus creating a \$50 overall foreign loss. Therefore, at the end of 1984, Z has \$50 in its general limitation overall foreign loss account.

Example 4. In 1985, V Corporation has a general limitation loss of <\$1,000> and no other income or loss in that year. The 1985 loss is carried back to 1982. For taxable years prior to 1983, V computed its overall foreign losses on a combined basis for income subject to the passive interest limitation, the DISC dividend limitation, and the general limitation. In 1982, V had \$400 of passive interest limitation income and \$200 of general limitation income and \$1,000 of United States source taxable income. Under paragraph (d) of this section, the \$1,000 NOL attributable to the 1985 loss is first offset by the general limitation income in 1982 and then the United States source passive interest limitation income in that year. V therefore adds \$800 to its general limitation overall foreign loss account in 1985.

Example 5. In 1982, W Corporation has a general limitation loss of <\$500> and \$200 of passive interest limitation income. For taxable years prior to 1983, W computed its overall foreign losses on a combined basis. W has no other taxable income or loss. W cannot carry back the \$300 NOL and so it carries it forward to 1983, a year in which it has \$600

passive interest limitation income and \$500 of United States source income and no general limitation income. Under paragraph (d) of this section, the NOL is not offset by the foreign source income in 1984 but first is applied against United States source income. Thus, \$300 is added to W's general limitation overall foreign loss account in 1984.

[T.D. 8153, 52 FR 32001, Aug. 25, 1987; 52 FR 43434, Nov. 12, 1987, as amended by T.D. 8677, 61 FR 33323, June 27, 1996; T.D. 8823, 64 FR 36099, July 2, 1999]

§ 1.904(f)-4 Recapture of foreign losses out of accumulation distributions from a foreign trust.

(a) *In general.* If a taxpayer receives a distribution of foreign source taxable income subject to a separate limitation in which the taxpayer had a balance in an overall foreign loss account and that income is treated under section 666 as having been distributed by a foreign trust in a preceding taxable year, a portion of the balance in the taxpayer's applicable overall foreign loss account shall be subject to recapture under this section. The amount subject to recapture shall be the lesser of the balance in the taxpayer's overall foreign loss account (after applying §§ 1.904(f)-1, 1.904(f)-2, 1.904(f)-3, and 1.904(f)-6 to the taxpayer's other income or loss in the current taxable year) or the entire amount of foreign source taxable income deemed distributed in a preceding year or years under section 666.

(b) *Effect of recapture on foreign tax credit limitation under section 667(d).* If paragraph (a) of this section is applicable, then in applying the separate limitation (in accordance with section 667(d)(1) (A) and (C)) to determine the amount of foreign taxes deemed distributed under section 666 (b) and (c) that can be credited against the increase in tax in a computation year, a portion of the foreign source taxable income deemed distributed in such computation year shall be treated as United States source income. Such portion shall be determined by multiplying the amount of foreign source taxable income deemed distributed in the computation year by a fraction. The numerator of this fraction is the balance in the taxpayer's overall foreign loss account (after application of §§ 1.904(f)-1, 1.904(f)-2, 1.904(f)-3, and