cases of "the downstream pipeline's partial requirements customer's responsibility for shouldering any of the downstream pipeline's minimum bill payments to the upstream pipeline." That was not our intent and, indeed, is contrary to our policy expressed in Order Nos. 380–A and 380–E that all customers should bear responsibility for such variable charges in accordance with the amount of gas that they buy from the downstream pipeline. As we emphasized earlier in this order and in Order Nos. 380–B and 380–E, the issue of cost responsibility can be raised in a PGA or section 4 proceeding.

For the reasons set forth above and in Order No. 380–E, the Commission finds that Midwestern and Indiana Gas have raised no new facts or principles of law that warrant a modification of Order No. 380–E. To the extent not specifically discussed herein, all other arguments are rejected.

The Commission orders:

Except to the extent clarified above, the requests for rehearing of Order No. 380–E are denied.

By the Commission.

Kenneth F. Plumb,

Secretary.

[FR Doc. 87–19421 Filed 8–24–87; 8:45 am]

BILLING CODE 6717–01–M

18 CFR Part 389

[Docket No. RM87–31–000 et al; Order No. 479]

Procedures for Determining High-Cost Natural Gas Produced From Tight Formations

August 20, 1987.

AGENCY: Federal Energy Regulatory Commission, DOE.

ACTION: Final rule; notice of OMB Control Number.

SUMMARY: On July 29, 1987, the Federal Energy Regulatory Commission issued a final rule (Order No. 479) in Docket No. RM87–31–000, 52 FR 29,003 (Aug. 5, 1987), changing the procedures for qualifying gas as high cost natural gas produced from tight formations eligible for incentive prices pursuant to section 107(c)(5) of the Natural Gas Policy Act of 1978. The information collection provisions in the rule were submitted to the Office of Management and Budget (OMB) for approval under the Paperwork Reduction Act. OMB has provided an OMB control number.

EFFECTIVE DATE: August 20, 1987.

FOR FURTHER INFORMATION CONTACT: Julia Lake White, Office of the General Counsel, Federal Energy Regulatory Commission, 825 North Capitol Street, NE., Washington, DC 20426, (202) 357–8530.

SUPPLEMENTARY INFORMATION: The Paperwork Reduction Act, 44 U.S.C. 3501–3520 (1982), and the Office of Management and Budget's (OMB) regulations, 5 CFR Part 1320 (1987) require that OMB approve information collection requirements imposed by agency rule. OMB has approved the information collection requirements of the tight formation designation procedures in Order No. 479. OMB issued Control Number 1902–0112 for § 271.703(c) of the Commission's regulations. The control number is effective August 20, 1987.

Accordingly, Part 389, Chapter I, Title 18, Code of Federal Regulations is amended as set forth below.

Kenneth F. Plumb,

Secretary.

List of Subjects in 18 CFR Part 389

Reporting and recordkeeping requirements.

PART 389—OMB CONTROL NUMBERS FOR COMMISSION INFORMATION COLLECTION REQUIRMENTS

1. The authority citation for Part 389 continues to read as follows:

Authority: Paperwork Reduction Act of 1980 (44 U.S.C. 3501–3520) (1982).

§ 389.101 [Amended]

2. The table of OMB control numbers in § 389.101(b) is amended by inserting "271.703(c)" in numerical order in the "section" column and "0112" in the corresponding position in the "OMB control number" column.

[FR Doc. 87–19420 Filed 8–24–87; 8:45 am]

BILLING CODE 6717–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Part 74

[Docket No. 86C–0192]

Confirmation of Effective Date for FD&C Yellow No. 6

AGENCY: Food and Drug Administration.

ACTION: Final rule; confirmation of effective date.

SUMMARY: The Food and Drug Administration (FDA) is confirming the effective date of July 9, 1987, for the final rule that amended the color additive regulations to modify the manufacturing process for FD&C yellow No. 6.

EFFECTIVE DATE: Effective date confirmed: July 9, 1987.

FOR FURTHER INFORMATION CONTACT: Blondell Anderson, Center for Food Safety and Applied Nutrition (HFF–334), Food and Drug Administration, 200 C St. SW., Washington, DC 20204, 202–472–5690.

SUPPLEMENTARY INFORMATION: In the **Federal Register** of June 8, 1987 (52 FR 21505), FDA amended § 74.706(a)(1) (21 CFR 74.706(a)(1)) to provide for the use of sulfuric acid in the diazotization step of the manufacturing process for FD&C Yellow No. 6.

FDA gave interested persons until July 8, 1987, to file objections or requests for a hearing on this amendment. The agency received no objections or requests for a hearing. Therefore, FDA concludes that the final rule published in the **Federal Register** of June 8, 1987, should be confirmed.

List of Subjects in 21 CFR Part 74

Color additives, Cosmetics, Drugs, Medical devices.

Therefore, under the Federal Food, Drug, and Cosmetic Act (secs. 701, 706, 52 Stat. 1055–1056 as amended, 74 Stat. 399–407 as amended (21 U.S.C. 371, 376)) and under authority delegated to the Commissioner of Food and Drug (21 CFR 5.10), notice is given that no objections or requests for a hearing were filed in response to the June 8, 1987, final rule. Accordingly, the amendment promulgated thereby become effective July 9, 1987.

Dated: August 19, 1987.

John M. Taylor,

Associate Commissioner for Regulatory Affairs.

[FR Doc. 87–19395 Filed 8–24–87; 8:45 am]

BILLING CODE 4160–01–M

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Office of the Assistant Secretary for Housing—Federal Housing Commissioner

24 CFR Parts 207 and 255

[Docket No. R–87–1300; FR–2224]

Section 223(f) Mortgage Insurance; Inspection Fees for Repairs

AGENCY: Office of the Assistant Secretary for Housing—Federal Housing Commissioner, HUD.

ACTION: Final rule.

SUMMARY: This rule revises current regulations governing the section 223(f) mortgage insurance programs to authorize the charging of an inspection fee where the application for mortgage insurance (or coinsurance) covering an existing multifamily project involves the carrying out of repairs and improvements.

EFFECTIVE DATE: October 12, 1987.

FOR FURTHER INFORMATION CONTACT: James Hamernick, Director, Office of Insured Multifamily Housing Development, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410. Telephone (202) 755–6500. (This is not a toll-free number.)

SUPPLEMENTARY INFORMATION: The current regulation for the full insurance of existing multifamily projects pursuant to section 223(f) expressly states that "No inspection fee will be required" in connection with the transaction (*see* 24 CFR 207.32a(a)(4)). Under similar Part 255 coinsurance, there is a provision in the current regulation authorizing the coinsuring lender to collect an inspection fee "if applicable" (*see* 24 CFR 255.206(a)). To date, HUD has limited the charging of inspection fees in coinsurance to cases where the project is also receiving assistance under the Rental Rehabilitation (24 CFR Part 511) or Housing Development Grant (24 CFR Part 850) program. This rule revises both § 207.32a(a)(4) and § 255.206(a) to permit, in cases where an application provides for the completion of repairs and improvements, an inspection fee to be charged by the FHA Commissioner (or, in the case of the coinsurance rule, by the lender). The fee for projects involving repairs may be up to one percent of the cost of repairs and improvements.

This revision is needed if the section 223(f) programs are to be effectively administered. Under both the full insurance and the coinsurance programs, allowable repairs are for up to $6500 per unit (adjusted by any high-cost factor for the area), and if the project is assisted under the Part 511 Rental Rehabilitation or the Part 850 Housing Development Grant program, allowable costs may go up to $25,000 per dwelling unit. Program experience has demonstrated that most section 223(f) projects involve repairs and improvements and that a uniform procedure for inspection of these repairs is essential.

On October 8, 1986, the Department published a proposed rule in the **Federal Register** (51 FR 36021) revising the section 223(f) mortgage insurance program regulations to authorize the charging of an inspection fee where the application for mortgage insurance (or coinsurance) involves repairs and improvements. The rule proposed a two-tier fee structure to cover inspection costs, with repair and improvement costs of $3000 serving as the dividing point.

Four public comments were received. Three comments were favorable, with one also providing specific recommendations for improving the rule. The fourth commenter objected to the inspection fee, contending that charging an inspection fee would have an adverse impact on the Federal budget. We disagree, since we believe that the charging of inspection fees will lessen budgetary impact. The Department must use staff to make necessary inspections and is justified in charging the mortgagor for this service. In the case of coinsured projects, the coinsuring lender must see to the performance of the inspection and should be compensated. Inspection fees have consistently been charged under HUD's other multifamily mortgage insurance programs.

Of the three favorable comments, one commenter specifically recommended that the fee apply only to repair not completed at the time of endorsement. We do not agree with this suggestion. It would not provide compensation for inspections before endorsement, and providing adequate compensation for inspections is a primary reason for this regulation change.

The same commenter suggested that a single one percent fee structure would be simpler than the proposed two-tier system, and would facilitate bookkeeping. The proposed rule's two-tier structure was based on the cost of repairs; *i.e.*, a fee of one percent of the repair cost for repairs over $3000 per unit, and a flat fee of $30 per unit in cases where the cost of repairs was under $3000 per unit. The flat rate ($30 per unit for repairs under $3000 per unit) was intended to ensure a minimal fee amount for cases where the cost of repairs was so minor that the one percent factor would not cover the actual costs of inspection. The higher one percent fee would apply where repairs are extensive, inspection visits more frequent, and more complex repair items are usually involved. While a single, one percent fee structure would be more simple to administer, we believe the two tier structure proposed is more equitable in that it reflects more accurately actual inspection costs. This final rule therefore, retains the two tier structure as it was originally set forth in the proposed rule.

In accordance with 5 U.S.C. 605(b) (the Regulatory Flexibility Act), the Undersigned hereby certifies that this rule does not have a significant economic impact on a substantial number of small entities. The inspection fee is reasonably related to the cost of inspection services and, for small projects, the fee is very modest. Similar fees, charged in other FHA multifamily programs, have not been a burden on small entities.

This rule was listed under the Office of Housing, item H–20–86 (sequence number 960) in the Department's Semiannual Agenda of Regulations published on April 27, 1987 (52 FR 14362, 14387) under Executive Order 12291 and the Regulatory Flexibility Act.

A Finding of No Significant Impact with respect to the environment has been made in accordance with HUD regulations in 24 CFR Part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969. The Finding of No Significant Impact is available for public inspection during regular business hours in the Office of the Rules Docket Clerk, Office of the General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410.

This rule does not constitute a "major rule" as that term is defined in section 1(b) of Executive Order 1229 on Federal Regulation issued by the President on February 17, 1981. Analysis of the proposed rule indicates that it does not: (1) Have an annual effect on the economy of $100 million or more; (2) cause a major increase in costs or prices for consumers, individual industries, Federal, State or local government agencies, or geographic regions; or (3) have a significant adverse effect on competition, employment, investment, productivity, innovation, or the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or export markets.

The catalog of Federal Domestic Assistance program numbers are 14.135 and 14.173.

List of Subjects

24 CFR Part 207

Mortgage insurance, Rental housing.

24 CFR Part 255

Mortgage insurance, Coinsurance of multifamily mortgages.

Accordingly, 24 CFR Parts 207 and 255 are amended as follows:

PART 207—MULTIFAMILY HOUSING MORTGAGE INSURANCE

1. The authority citation for Part 207 continues to read as follows:

Authority: Secs. 207, 211, National Housing Act, (12 U.S.C. 1713, 1715b); sec. 7(d), Department of Housing and Urban Development Act, (42 U.S.C. 3535(d)).

2. Section 207.32a(a)(4) is revised to read as follows:

§ 207.32a Eligibility of mortgages on existing projects.

* * * * *

(4) *Inspection fee.* Where an application provides for the completion of repairs and improvements, an inspection fee may be charged by the Commission. A fee of $30 per dwelling unit will be charged where the project involves repairs of $3000 or less per unit. The fee for projects involving repairs in excess of $3000 per dwelling unit may not exceed one percent of the cost of the repairs.

* * * * *

PART 255—COINSURANCE FOR THE PURCHASE OR REFINANCING OR FINANCING OF EXISTING MULTIFAMILY HOUSING PROJECTS

3. The authority citation for Part 255 continues to read as follows:

Authority: Secs. 211, 244, National Housing Act, 12 U.S.C. 1715b, 1715z(9); sec. 7(d), Department of Housing and Urban Development Act, (42 U.S.C. 3535(d)).

4. Paragraph (a) of § 255.206 is revised to read as follows:

§ 255.206 Lender's fees and premium.

(a) The lender may collect from the Mortgagor, and include in the Mortgage, an application fee, financing fee, permanent placement fee, and where an application provides for the completion of repair and improvements, an inspection fee. These fees may not exceed maximums approved by the Commissioner. In the case of inspection fees, a fee of up to $30 per dwelling unit may be charged where the project involves repairs of $3000 or less per unit. The fee for projects involving repairs in excess of $3000 per dwelling unit may not exceed one percent of the cost of repairs. The lender may collect other reasonable fees approved by the Commissioner that are paid from sources other than Mortgage proceeds and are disclosed at endorsement. In no event will the fees allowed under this paragraph be permitted to exceed comparable fees allowed in the full insurance program under § 207.32a of this chapter.

* * * * *

Date: August 20, 1987.

James E. Schoenberger,

General Deputy Assistant Secretary for Housing—Federal Housing Commissioner.

[FR Doc. 87-19480 Filed 8-24-87; 8:45 am]

BILLING CODE 4210-27-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8153]

Income Taxes; Recapture of Overall Foreign Losses

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the recapture of overall foreign losses. Changes to the applicable tax law were made by the Tax Reform Act of 1976. These regulations provide the public with the guidance needed to comply with that Act and may affect taxpayers receiving income from foreign sources. The regulations do not reflect changes made to section 904(f) by the Tax Reform Act of 1986 and therefore for taxable years beginning after December 31, 1986, some provisions of these regulations may not apply.

DATES: The amendments are effective for taxable years beginning after December 31, 1975 except for the amendments under § 1.1502-9, which are effective for taxable years for which the due date (without extensions) for filing returns is after September 24, 1987.

FOR FURTHER INFORMATION CONTACT: Carolyn DuPuy of the Office of the Associate Chief Counsel (International) within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, Attention: CC:LR:T (INTL-47-86), (202) 566-3289, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under section 904(f) of the Internal Revenue Code of 1954. These amendments are made to conform the regulations to section 1032 of the Tax Reform Act of 1976 (90 Stat. 1624) and are issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917, 26 U.S.C. 7805). The amendments under paragraph 3 are also issued under the authority contained in section 1502 of the Internal Revenue Code (68A Stat. 637, 26 U.S.C. 1502).

On January 24, 1986, the **Federal Register** published proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections (904 and 1502 of the Internal Revenue Code of 1954 (51 FR 3193). On April 2, 1986, the **Federal Register** published corrections to the proposed regulations (51 FR 11324). The amendments provide rules for determining a taxpayer's overall foreign losses in a taxable year and for determining how and when such losses will be recaptured. In addition, the amendments provide rules for determining overall foreign losses on a consolidated basis.

Numerous written comments were received with respect to the proposed regulations. A public hearing was held on June 5, 1986. The significant points raised by the comments and the changes made to the proposed amendments are discussed in the remainder of the preamble. After consideration of the comments regarding the proposed amendments, the amendments are adopted as modified by this Treasury decision.

Discussion of Major Comments and Revised Amendments

Section 1.904 (f)-1 Overall foreign loss and overall foreign loss accounts.

Paragraphs (a) and (c) of § 1.904 (f)-1 have been revised to provide that for taxable years beginning prior to January 1, 1983, a taxpayer will be allowed to net losses and income subject to the separate limitations in former section 904(d)(1)(A) (passive interest limitations), (B) (DISC dividend limitation), and (C) (general limitation) (prior to amendment by the Tax Reform Acts of 1984 and 1986) in determining whether the taxpayer incurred an overall foreign loss. This alternative is available to a taxpayer only if the taxpayer filed its pre-1983 return using this method of computing overall foreign losses.

The proposed amendments required all taxpayers to determine whether they had overall foreign losses on a separate limitation basis for all years beginning after December 31, 1975. Many commenters criticized this position in the proposed regulations. Nevertheless, for taxable years beginning after December 31, 1982 and before January 1, 1987, the final regulations retain the requirement that overall foreign losses must be determined on a separate limitation basis. The determination of overall foreign losses on a separate

limitation basis, while not clearly required by the statute, is consistent with Congressional intent as expressed in section 904(d) to prevent United States tax on separate limitation items from being reduced by foreign tax credits attributable to other types of income. If this intent is to be effectuated, the separate limitations approach should apply when there is a loss under a separate limitation as well as when there is income. However, because this requirement is not clear on the face of the statute and taxpayers could, in the absence of regulations, reasonably have computed their foreign losses on an overall basis, the requirement that overall foreign losses be determined on a separate limitation basis will only be applied to the extent all taxpayers would have had open years at the time the proposed regulations were issued.

Section 1.904 (f)–2 Recapture of overall foreign losses.

In response to comments, paragraph (b) has been modified to delete the requirement that section 904(a) apply before recapture under section 904(f). Therefore, under the final regulations, recapture will apply before the application of section 904(a).

Paragraph (c) has been revised to provide for recapture in years in which taxpayers deduct and do not credit foreign taxes. A number of taxpayers objected to the fact that, under the proposed regulations, recapture was limited to cases in which there was a reduction in a taxpayer's foreign tax credit limitation. This provision was changed because, to the extent a taxpayer deducts its foreign taxes and its foreign taxable income minus foreign taxes paid is subject to United States tax, the double benefit that section 904 (f) is intended to prevent is not present. In cases in which the amount of recapture (foreign taxable income minus foreign taxes paid) in a deduction year exceeds fifty percent of the foreign source taxable income subject to recapture, taxpayers will be deemed to have elected under section 904(f)(1)((B) to recapture such larger percentage that the recapture amount represents.

In addition, in response to comments, paragraph (c) has been clarified with respect to the treatment of the overall foreign losses of a section 936 corporation that was a member of a consolidated group. The final regulations provide that in the case of a section 936 corporation that was previously part of a consolidated group, the possession source income, including qualified possession source investment income, shall be used to recapture the portion of any overall foreign loss that was allocated to the section 936 corporation under § 1.1502–9.

Paragraph (c) has also been revised to provide a rule for recapturing from post-1982 income pre-1983 overall foreign losses incurred when taxpayers computed their pre-1983 overall foreign losses on a combined basis. That rule provides that overall foreign loss accounts created in taxable years beginning before January 1, 1983 and computed on a combined basis shall be recaptured solely out of foreign source income subject to the general limitation. A similar transition rule for overall foreign losses that are part of net operating losses is added in § 1.904 (f)–3 (c).

Paragraph (d)(4)(iv) provides an ordering rule for dispositions in which gain is deemed to be recognized. That paragraph was changed to add a rule that provides for recapture on a pro rata basis when there is a simultaneous transfer of more than one asset in a disposition subject to the rules in section (d)(4).

Paragraph (d)(5)(i) has been revised to provide two additional exceptions to the definition of dispositions for section 904(f)(3) purposes. Several commenters argued that the proposed regulation's definition of "disposition" was too broad and that, in light of the purpose of section 904(f)(3), the disposition rule should only apply to situations in which the disposition is of a type such that the taxpayer would escape application of the recapture rule. It was, therefore, suggested that the regulations be amended to include an exception to the disposition rule for any transaction in which after the transaction a taxpayer is as likely to recapture the balance of its overall foreign loss account as before the transaction. It was decided that such an exception to the disposition rule was inappropriate both because it is contrary to the statutory definition of a disposition in section 904(f)(3)(B)(i) and because an exception based on a subjective judgment as to whether or not the overall foreign loss is likely to be recaptured would not be administrable. However, paragraph (d)(5)(i) has been revised to except from the definition of disposition two specific situations: (1) Transactions in which gross income is not realized (such as farmouts); and (2) the entering into of certain unitization or pooling agreements in which gain from any subsequent disposition would be entirely foreign source. The exception for non-realization events is a clarifying change. The exception for pooling and unitization agreements was made because such arrangements are essentially financing transactions. The pooling exception is limited to cases in which the subsequent disposition would generate all foreign source income in order to eliminate the potential for avoidance of overall foreign loss recapture.

In response to one commenter's suggestion, paragraph (d)(5)(ii) has been revised to provide that, for purposes of section 904(f)(3), stock of a corporation will not be considered property used in a trade or business if a substantial investment motive exists for acquiring and holding the stock. This change was made to conform these rules to the standard developed in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), as applied by the Service in Rev. Rul. 78–94, 1978–1 CB 58.

Paragraph (d)(5)(ii) has also been revised to provide that a partnership interest will be property used in a trade or business if the underlying assets of the partnership would be property used in a trade or business. Without such a rule, recapture of overall foreign losses incurred by a partner could be avoided by structuring a disposition of partnership assets as the disposition of a partnership interest.

Section 1.904(f)–3 Net operating loss carrybacks and carryovers.

Paragraph (a) has been clarified to provide that an overall foreign loss that is part of a net operating loss first offsets foreign source taxable income in the carryback or carryover year that is subject to the same limitation as the loss, next offsets United States source taxable income in the carryback or carryover year and then offsets foreign source taxable income subject to other limitations.

Paragraph (c) has been added to provide a rule for the treatment of loss carryovers when a loss is incurred in a pre-1983 year and carried forward to a post-1982 year or when a loss is incurred in a post-1982 year and is carried back to a pre-1983 year. The rule provides that a post-1982 loss that is carried back to a pre-1983 year and creates an overall foreign loss in that year is treated as if the loss arose in the post-1982 year. The rule also provides that a pre-1983 loss that is carried forward and creates an overall foreign loss in a post-1982 year is treated as if it arose in a post-1982 year. This ensures, to the maximum extent possible, that an overall foreign loss will be recaptured on a separate limitation basis, regardless of the method used by the taxpayer to compute overall foreign losses for pre-1983 years.

Section 1.904 (f)–6 Transition rules.

Paragraph (a) provides transition rules for recapture of pre-1983 foreign oil related income (FORI) limitation and general limitation losses from post-1982 income subject to the general limitation. This paragraph has been revised to account for the revision to § 1.904 (f)–1 (a) and (c) which allows pre-1983 overall foreign losses to be computed on a combined basis, if the taxpayer computed overall foreign losses in that manner on returns previously filed.

Section 1.1502–9 Consolidated overall foreign loss accounts.

In response to suggestions by several commenters, paragraph (b)(1)(iii) has been revised to limit the recapture of an overall foreign loss from a separate return limitation year (SRLY) to 50% of the consolidated foreign source taxable income minus 50% of such income recomputed by excluding the items of income and deduction of the SRLY member.

A suggestion that paragraph (b) be revised to provide that an overall foreign loss that a part of a net operating loss carryover be classified as a SRLY loss only if the loss reduced United States income in a SRLY year was not adopted because it was considered to be inconsistent with the rules for allocating consolidated overall foreign losses to departing members of the group. It was decided that, in both cases, the appropriate focus was on the year in which the loss arose rather than the carryover year.

In response to one comment, paragraph (e) has been revised to provide that dispositions between members of an affiliated group will not automatically trigger 904(f)(3) recapture. However, gain will be recognized (and a loss recaptured) to the extent of the balance in the selling member's SRLY overall foreign loss account unless the selling member adds the balance in its SRLY overall foreign loss account to the applicable consolidated overall foreign loss account. The effect of this requirement is to recharacterize SRLY overall foreign losses as overall foreign losses arising in a consolidated year. This new rule, which permits a taxpayer to defer intercompany profit notwithstanding SRLY overall foreign losses, has been adopted because it more closely follows the consolidated group provisions on intercompany dispositions. Recharacterization is required so that the recapture rule cannot be circumvented. Without such recharacterization as a consolidated overall foreign loss, income derived from such transferred property could avoid recapture. The selling member might have no subsequent foreign source income and if the overall foreign loss remained a SRLY overall foreign loss, it could only be recaptured to the extent of the selling member's foreign source income.

Special Analyses

It has been determined that this regulation will not have a significant economic impact on a substantial number of small entities. The number of small entities affected is minimal. Accordingly, these final regulations are not subject to the requirements of the Regulatory Flexibility Act of 1980 (5 U.S.C. Chapter 6).

It has also been determined that this regulation is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis is therefore not required.

Paperwork Reduction Act

The collection of information requirements contained in this regulation have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved under OMB number 1545–0121.

Drafting Information

The principal author of these final regulations is Carolyn M. DuPuy of the Office of Associate Chief Counsel (International), Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

List of Subjects

26 CFR 1.861–1 through 1.997–1

Income taxes, Aliens, Exports, DISC, Foreign investments in U.S., Foreign tax credit, FSC, Sources of income, United States investment abroad.

26 CFR 1.1501–1 through 1.1564–1

Income taxes, Controlled group of corporations, Consolidated returns.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

PART 1—[AMENDED]

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * Sections 1.904(f)–(2) and 1.1502–9 are also issued under 26 U.S.C. 904 (f)(3)(b) and 26 U.S.C. 1502. * * *

Par. 2. The following new §§ 1.904(f)–1 through 1.904(f)–6 are added immediately following § 1.904(b)–4 to read as set forth below:

§ 1.904(f)–1 Overall foreign loss and the overall foreign loss account.

(a) *Overview of regulations.* In general, section 904(f) and these regulations apply to any taxpayer that sustains an overall foreign loss (as defined in paragraph (c)(1) of this section) in a taxable year beginning after December 31, 1975. For taxable years ending after December 31, 1984, and beginning before January 1, 1987, there can be five types of overall foreign losses: a loss under each of the five separate limitations contained in former section 904(d)(1)(A) (passive interest limitation), (d)(1)(B) (DISC dividend limitation), (d)(1)(C) (foreign trade income limitation), (d)(1)(D) (foreign sales corporation (FSC) distributions limitation), and (d)(1)(E) (general limitation). For taxable years beginning after December 31, 1982, and ending before January 1, 1985, there can be three types of overall foreign losses under former section 904(d)(1)(A) (passive interest limitation), former section 904(d)(1)(B) (DISC dividend limitation) and former section 904(d)(1)(C) (general limitation). For taxpayers subject to section 907, the post-1982 general limitation overall foreign loss account may be further subdivided, as provided in § 1.904(f)–6. For taxable years beginning after December 31, 1975, and before January 1, 1983, taxpayers should have computed overall foreign losses separately under the passive interest limitation, the DISC dividend limitation, the general limitation, and the section 907(b) (FORI) limitation. However, for taxable years beginning after December 31, 1975, and before January 1, 1983, taxpayers may have computed only two types of overall foreign losses: A foreign oil related loss under the FORI limitation and an overall foreign loss computed on a combined basis for the passive interest limitation, the DISC dividend limitation, and the general limitation. A taxpayer that computed overall foreign losses for these years on a combined basis will not be required to amend its return to recompute such losses on a separate

basis. If a taxpayer computed its overall foreign losses for these years separately under the passive interest limitation, the DISC dividend limitation, and the general limitation, on returns previously filed, a taxpayer may not amend those returns to compute such overall foreign losses on a combined basis. Section 1.904(f)–1 provides rules for determining a taxpayer's overall foreign losses, for establishing overall foreign loss accounts, and for making additions to and reductions of such accounts for purposes of section 904(f). Section 1.904(f)–2 provides rules for recapturing the balance in any overall foreign loss account under the general recapture rule of section 904(f)(1) and under the special recapture rule of section 904(f)(3) when the taxpayer disposes of property used predominantly outside the United States in a trade or business. Section 1.904(f)–3 provides rules for allocating overall foreign losses that are part of net operating losses or net capital losses to foreign source income in years to which such losses are carried. In addition, § 1.904(f)–3 provides transition rules for the treatment of net operating losses incurred in taxable years beginning after December 31, 1982, and carried back to taxable years beginning before January 1, 1983, and of net operating losses incurred in taxable years beginning before January 1, 1983, and carried forward to taxable years beginning after December 31, 1982. Section 1.904(f)–4 provides rules for recapture out of an accumulation distribution of a foreign trust. Section 1.904(f)–5 provides rules for recapture of overall foreign losses of domestic trusts. Section 1.904(f)–6 provides a transition rule for recapturing a taxpayer's pre-1983 overall foreign losses under the general limitation and the FORI limitation out of taxable income subject to the general limitation in taxable years beginning after December 31, 1982. Section § 1.1502–9 provides rules concerning the application of these regulations to corporations filing consolidated returns.

(b) *Overall foreign loss accounts.* Any taxpayer that sustains an overall foreign loss under paragraph (c) of this section must establish an account for such loss. Separate types of overall foreign losses must be kept in separate accounts. For taxable years beginning prior to January 1, 1983, taxpayers that computed losses on a combined basis in accordance with § 1.904(f)–1(c)(1) will keep one overall foreign loss account for such overall foreign loss. The balance in each overall foreign loss account represents the amount of such overall foreign loss subject to recapture by the taxpayer in a given year. From year to year, amounts may be added to or subtracted from the balances in such accounts as provided in paragraphs (d) and (e) of this section. The taxpayer must report the balances (if any) in its overall foreign loss accounts annually on a Form 1116 or 1118. Such forms must be filed for each taxable year ending after September 24, 1987. The balance in each account does not have to be attributed to the year or years in which the loss was incurred.

(c) *Determination of a taxpayer's overall foreign loss*—(1) *Overall foreign loss defined.* For taxable years beginning after December 31, 1982, and before January 1, 1987, a taxpayer sustains an overall foreign loss in any taxable year in which its gross income from sources without the United States subject to a separate limitation (as defined in paragraph (c)(2) of this section) is exceeded by the sum of the deductions properly allocated and apportioned thereto. Such losses are to be determined separately in accordance with the principles of the separate limitations. Accordingly, income and deductions subject to a separate limitation are not to be netted with income and deductions subject to another separate limitation for purposes of determining the amount of an overall foreign loss. A taxpayer may, for example, have an overall foreign loss under the general limitation in the same taxable year in which it has taxable income under the DISC dividend limitation. The same principles of calculating overall foreign losses on a separate limitation basis apply for taxable years beginning before January 1, 1983, except that a taxpayer shall determine its overall foreign losses on a combined basis, except for income subject to the FORI limitation, if the taxpayer filed its pre-1983 returns on such basis. Thus, for taxable years beginning prior to January 1, 1983, a taxpayer can net income and losses among the passive interest limitation, the DISC dividend limitation, and the general limitation if the taxpayer calculated its overall foreign losses that way at the time. Taxpayers that computed overall foreign losses separately under each of the separate limitations on their returns filed for taxable years beginning prior to January 1, 1983, may not amend such returns to compute their overall foreign losses for pre-1983 years on a combined basis.

(2) *Separate limitation defined.* For purposes of paragraph (c)(1) of this section and these regulations, the term separate limitation means any of the separate limitations under former section 904(d)(1)(A) (passive interest limitation), (B) (DISC dividend limitation), (C) (foreign trade income limitation), (D) (FSC distributions limitation), and (E) (general limitation) and the separate limitation under section 907(b) (FORI limitation) (for taxable years ending after December 31, 1975, and beginning before January 1, 1983).

(3) *Method of allocation and apportionment of deductions.* In determining its overall foreign loss, a taxpayer shall allocate and apportion expenses, losses, and other deductions to the appropriate category of gross income in accordance with section 862(b) and § 1.861–8 of the regulations. However, the following deductions shall not be taken into account:

(i) The amount of any net operating loss deduction for such year under section 172(a); and

(ii) To the extent such losses are not compensated for by insurance or otherwise, the amount of any—

(A) Expropriation losses for such year (as defined in section 172(h)), or

(B) Losses for such year which arise from fire, storm, shipwreck, or other casualty, or from theft.

(d) *Additions to the overall foreign loss account*—(1) *General rule.* A taxpayer's overall foreign loss as determined under paragraph (c) of this section shall be added to the applicable overall foreign loss account at the end of its taxable year to the extent that the overall foreign loss has reduced United States source income during the taxable year or during a year to which the loss has been carried back. For rules with respect to carryovers see paragraph (d)(4) of this section and § 1.904(f)–3.

(2) *Overall foreign net capital loss.* An overall foreign net capital loss shall be added to the applicable overall foreign loss account at the end of the taxable year to the extent that the foreign source capital loss has reduced United States source capital gain net income during the taxable year or during a year to which the loss has been carried back, subject to the adjustments in paragraph (d)(5) of this section. For rules with respect to carryovers, see paragraph (d)(4) of this section and § 1.904(f)–3. As provided under section 1211(b), to the extent that a foreign source net capital loss has reduced United States source income other than United States source capital gain net income, this additional amount would be added to the taxpayer's overall foreign loss account as if the United States source income had been offset by a foreign net operating loss that is not a capital loss.

(3) *Overall foreign losses of another taxpayer.* If any portion of any overall foreign loss of another taxpayer is

allocated to the taxpayer in accordance with § 1.904(f)–5 (relating to overall foreign losses of domestic trusts) or § 1.1502–9 (relating to consolidated overall foreign losses), the taxpayer shall add such amount to its applicable overall foreign loss account.

(4) *Additions to overall foreign loss account created by loss carryovers.* Subject to the adjustments under § 1.904(f)–1(d)(5), the taxpayer shall add to each overall foreign loss account—

(i) All net operating loss carryovers to the current taxable year attributable to the same limitation to the extent that overall foreign losses included in the net operating loss carryovers reduced United States source income for the taxable year, and

(ii) All capital loss carryovers to the current taxable year attributable to the same limitation to the extent that foreign source capital loss carryovers reduced United States source capital gain net income for the taxable year.

(5) *Adjustments.* The amount of overall foreign loss determined in paragraph (d)(1) of this section and the amount of overall foreign net capital loss determined in paragraph (d)(2) of this section which shall be added to a taxpayer's overall foreign loss account shall be adjusted as follows prior to being added to an account.

(i) *Adjustment due to reduction in foreign source income under section 904(b).* A taxpayer's overall foreign loss account shall not include any net capital loss from sources without the United States to the extent that the application of section 904(b) would result in a reduction of foreign source taxable income (but not below zero) for purposes of the numerator of the foreign tax credit limitation fraction.

(ii) *Adjustment to account for rate differential between ordinary income rate and capital gain rate.* Subject to the provisions of paragraph (d)(5)(i) of this section, if an overall foreign loss for a taxable year includes an overall foreign net capital loss, such amount shall be reduced as follows, in accordance with the provisions of section 904(b), before being added to the overall foreign loss account:

(A) In the case of a corporate taxpayer, to the extent that the United States source capital gain net income reduced by the foreign source net capital loss consists of United States source net capital gain, by an amount equal to the rate differential portion (as defined in section 904(b)(3)(D) of the Code and the regulations thereunder) of the United States source net capital gain; or

(B) In the case of a taxpayer other than a corporate taxpayer, for taxable years beginning prior to January 1, 1979, an amount equal to the taxpayer's United States source net capital gain that is offset by such foreign source net capital loss reduced by 50 percent of such gain, and for taxable years beginning after December 31, 1978, and before January 1, 1987, reduced by an amount equal to 60 percent of such gain.

(e) *Reductions of overall foreign loss accounts.* The taxpayer shall subtract the following amounts from its overall foreign loss accounts at the end of its taxable year in the following order, if applicable:

(1) *Pre-recapture reduction for amounts allocated to other taxpayers.* An overall foreign loss account is reduced by the amount of any overall foreign loss which is allocated to another taxpayer in accordance with § 1.904(f)–5 (relating to overall foreign losses of domestic trusts) or § 1.1502–9 (relating to consolidated overall foreign losses).

(2) *Reduction for amounts recaptured.* An overall foreign loss account is reduced by the amount of any foreign source income that is subject to the same limitation as the loss that resulted in the account and that is recaptured in accordance with § 1.904(f)–2 (c) (relating to recapture under section 904(f)(1)); 1.904(f)–2 (d) (relating to recapture when the taxpayer disposes of certain properties under section 904(f)(3)); and 1.904(f)–4 (relating to recapture when the taxpayer receives an accumulation distribution from a foreign trust under section 904(f)(4)).

(f) *Illustrations.* The rules of this section are illustrated by the following examples.

Example (1). X Corporation is a domestic corporation with foreign branch operations in country C. X's taxable income and losses for its taxable year 1983 are as follows:

U.S. Source taxable income	$1,000
Foreign source taxable income (loss) subject to the general limitation	($500)
Foreign source taxable income subject to the passive interest limitation	$200

X has a general limitation overall foreign loss of $500 for 1983 in accordance with paragraph (c)(1) of this section. Since the general limitation overall foreign loss is not considered to offset income under the separate limitation for passive interest income, it therefore offsets $500 of United States source taxable income. This amount is added to X's general limitation overall foreign loss account at the end of 1983 in accordance with paragraphs (c) (1) and (d) (1) of this section.

Example (2). Y Corporation is a domestic corporation with foreign branch operations in Country C. Y's taxable income and losses for its taxable year 1982 are as follows:

U.S. source taxable income	$1,000
Foreign source taxable income subject to the general limitation	($500)
Foreign source taxable income subject to the passive interest limitation	$250

For its pre-1983 taxable years, Y filed its returns determining its overall foreign losses on a combined basis. In accordance with paragraphs (a) and (c) (1) of this section, Y may net the foreign source income and loss before offsetting the United States source income. Y therefore has a section 904(d)(1)(A–C) overall foreign loss account of $250 at the end of 1982.

Example (3). X Corporation is a domestic corporation with foreign branch operations in country C. For its taxable year 1985, X has taxable income (loss) determined as follows:

U.S. source taxable income	$200
Foreign source taxable income (loss) subject to the general limitation	($1,000)
Foreign source taxable income (loss) subject to the passive limitation	$1,800

X has a general limitation overall foreign loss of $1,000 in accordance with paragraph (c)(1) of this section. The overall foreign loss offsets $200 of United States source taxable income in 1985 and, therefore, X has a $200 general limitation overall foreign loss account at the end of 1985. The remaining $800 general limitation loss is offset by the passive interest limitation income 1985 so that X has no net operating loss carryover that is attributable to the general limitation loss and no additional amount attributable to that loss will be added to the overall foreign loss account in 1985 or in any other year.

Example (4). In 1986, V Corporation has $1000 of general limitation foreign source taxable income and $500 of general limitation foreign source net capital loss which has reduced $500 of United States source capital gain net income ("short term gain") (none of which is net capital gain). Under section 904(b), the numerator of V's foreign tax credit limitation fraction for income subject to the general limitation is reduced by $500 (see § 1.904 (b)–1 (a)(3)). Under paragraph (d)(5)(i) of this section, none of that $500 goes into its general limitation overall foreign loss account.

Example (5). Z Corporation is a domestic corporation with foreign branch operations. For the taxable year 1984, Z's taxable income and (losses) are as follows:

U.S. source taxable ordinary income	$1,000
U.S. source net capital gain	$460
Foreign source taxable ordinary income subject to the general limitation	$200
Foreign source net capital loss subject to the general limitation	($800)

Z had no capital gain net income in any prior taxable year. Under paragraph (d)(2) and (5) of this section, the amount to be added to Z's general limitation overall foreign loss account is the excess of the amount which has reduced United States source capital gain net income for the taxable year ($460), adjusted for the rate differential because it has reduced United States source net capital gain ($460 x 28/46 = $280), over the amount which has reduced the numerator of Z's foreign tax credit limitation fraction under section 904(b)(2), which is $200. (The $200 amount is foreign source net capital loss that has reduced United States source net

capital gain in the denominator of the fraction, but not exceeding the amount of foreign source income in the numerator before the section 904(b)(2) adjustment.) Thus, Z must add $80 (the excess of the $280 over $200) to its general limitation overall foreign loss account in 1984.

§ 1.904(f)–2 Recapture of overall foreign losses.

(a) *In general.* A taxpayer shall be required to recapture an overall foreign loss as provided in this section. Recapture is accomplished by treating as United States source income a portion of the taxpayer's foreign source taxable income of the same limitation as the foreign source loss that resulted in an overall foreign loss account. As a result, if the taxpayer elects the benefits of section 901 or section 936, the taxpayer's foreign tax credit limitation with respect to such income is decreased. As provided in § 1.904 (f)–1(e)(2), the balance in a taxpayer's overall foreign loss account is reduced by the amount of loss recaptured. Recapture continues until such time as the amount of foreign source taxable income recharacterized as United States source income equals the amount in the overall foreign loss account. As provided in § 1.904 (f)–1(e)(2), the balance in a overall foreign loss account is reduced at the end of each taxable year by the amount of the loss recaptured during that taxable year. Regardless of whether recapture occurs in a year in which a taxpayer elects the benefits of section 901 or in a year in which a taxpayer deducts its foreign taxes under section 164, the overall foreign loss account is recaptured only to the extent of foreign source taxable income remaining after applying the appropriate section 904(b) adjustments, if any, as provided in paragraph (b) of this section.

(b) *Determination of taxable income from sources without the United States for purposes of recapture*—(1) *In general.* For purposes of determining the amount of an overall foreign loss subject to recapture, the taxpayer's taxable income from sources without the United States shall be computed with respect to each of the separate limitations described in § 1.904 (f)–1(c)(2) in accordance with the rules set forth in § 1.904 (f)–1(c) (1) and (3). This computation is made without taking into account foreign source taxable income (and deductions properly allocated and apportioned thereto) subject to other separate limitations. Before applying the recapture rules to foreign source taxable income, the following provisions shall be applied to such income in the following order:

(i) Former section 904(b)(3)(C) (prior to its removal by the Tax Reform Act of 1986) and the regulations thereunder shall be applied to treat certain foreign source gain as United States source gain; and

(ii) Section 904(b)(2) and the regulations thereunder shall be applied to make adjustments in the foreign tax credit limitation fraction for certain capital gains and losses.

(c) *Section 904(f)(1) recapture*—(1) *In general.* In a year in which a taxpayer elects the benefits of sections 901 or 936, the amount of any foreign source taxable income subject to recapture in a taxable year in which paragraph (a) of this section is applicable is the lesser of the balance in the applicable overall foreign loss account (after reduction of such account in accordance with § 1.904 (f)–1(e)) or fifty percent of the taxpayer's foreign source taxable income of the same limitation as the loss that resulted in the overall foreign loss account (as determined under paragraph (b) of this section). If, in any year, in accordance with sections 164(a) and section 275(a)(4)(A), a taxpayer deducts rather than credits its foreign taxes, recapture is applied to the extent of the lesser of (i) the balance in the applicable overall foreign loss account or (ii) foreign source taxable income of the same limitation type that resulted in the overall foreign loss minus foreign taxes imposed on such income.

(2) *Election to recapture more of the overall foreign loss than is required under paragraph (c)(1).* In a year in which a taxpayer elects the benefits of sections 901 or 936, a taxpayer may make an annual revocable election to recapture a greater portion of the balance in an overall foreign loss account than is required to be recaptured under paragraph (c)(1) of this section. A taxpayer may make such an election or amend a prior election by attaching a statement to its annual Form 1116 or 1118. If an amendment is made to a prior year's election, an amended tax return should be filed. The statement attached to the Form 1116 or 1118 must indicate the percentage and dollar amount of the taxpayer's foreign source taxable income that is being recharacterized as United States source income and the percentage and dollar amount of the balance (both before and after recapture) in the overall foreign loss account that is being recaptured. Except for the special recapture rules for section 936 corporations and for recapture of pre-1983 overall foreign losses determined on a combined basis, the taxpayer that elects to credit its foreign taxes may not elect to recapture an amount in excess of the taxpayer's foreign source taxable income subject to the same limitation as the loss that resulted in the overall foreign loss account.

(3) *Special rule for recapture of losses incurred prior to section 936 election.* If a corporation elects the application of section 936 and at the time of the election has a balance in any overall foreign loss account, such losses will be recaptured from the possessions source income of the electing section 936 corporation that qualifies for the section 936 credit, including qualified possession source investment income as defined in section 936(d)(2), even though the overall foreign loss to be recaptured may not be attributable to a loss in an income category of a type that would meet the definition of qualified possession source investment income. For purposes of recapturing an overall foreign loss incurred by a consolidated group including a corporation that subsequently elects to use section 936, the electing section 936 corporation's possession source income that qualifies for the section 936 credit, including qualified possession source investment income, shall be used to recapture the section 936 corporation's share of previously incurred overall foreign loss accounts. Rules for determining the section 936 corporation's share of the consolidated groups overall foreign loss accounts are provided in § 1.1502–9(c).

(4) *Recapture of pre-1983 overall foreign losses determined on a combined basis.* If a taxpayer computed its overall foreign losses on a combined basis in accordance with § 1.904(f)–1(c)(1) for taxable years beginning before January 1, 1983, any losses recaptured in taxable years beginning after December 31, 1982, shall be recaptured from income subject to the general limitation, subject to the rules in § 1.904(f)–6 (a) and (b). Ordering rules for recapture of these losses are provided in § 1.904(f)–6(c).

(5) *Illustrations.* The rules of this paragraph (c) are illustrated by the following examples, all of which assume a United States corporate tax rate of 50 percent unless otherwise stated.

Example (1) X Corporation is a domestic corporation that does business in the United States and abroad. On December 31, 1983, the balance in X's general limitation overall foreign loss account is $600, all of which is attributable to a loss incurred in 1983. For 1984, X has United States source taxable income of $500 and foreign source taxable income subject to the general limitation of $500. For 1984, X pays $200 in foreign taxes and elects section 901. Under paragraph (c)(1) of this section, X is required to recapture $250 (the lesser of $600 or 50 percent of $500) of its overall foreign loss. As a consequence, X's

foreign tax credit limitation under the general limitation is $250/$1,000×$500, or $125, instead of $500/$1,000×$500, or $250. The balance in X's general limitation overall foreign loss account is reduced by $250 in accordance with § 1.904(f)–1(e)(2).

Example (2). The facts are the same as in example (1) except that X makes an election to recapture its overall foreign loss to the extent of 80 percent of its foreign source taxable income subject to the general limitation (or $400) in accordance with paragraph (c)(2) of this section. As a result of recapture, X's 1984 foreign tax credit limitation for income subject to the general limitation is $100/$1,000×$500, or $50, instead of $500/$1,000×$500, or $250. X's general limitation overall foreign loss account is reduced by $400 in accordance with § 1.904(f)–1(e)(2).

Example (3). The facts are the same as in example (1) except that X does not elect the benefits of section 901 in 1984 and instead deducts its foreign taxes paid. In 1984, X recaptures $300 of its overall foreign loss, the difference between X's foreign source taxable income of $500 and $200 of foreign taxes paid. The balance in X's general limitation overall foreign loss account is reduced by $300 in accordance with § 1.904(f)–1(e)(2).

Example (4). The facts are the same as in example (1) except that in 1984, X also has $1,000 of foreign source DISC dividend income subject to the separate limitation for DISC dividends which carries a foreign tax of $50. Under paragraph (c)(1) of this section the amount of X's general limitation overall foreign loss subject to recapture is $250 (the lesser of the balance in the overall foreign loss account or 50 percent of the foreign source taxable income subject to the general limitation). There is no recapture with respect to the DISC dividend income. X's separate limitation for DISC dividend income is $1,000/$2,000×$1,000, or $500. Its general limitation is $250/$2,000×$1,000, or $125, instead of $500/$2,000×$1,000, or $250. The balance in X's general limitation overall foreign loss account is reduced by $250 in accordance with § 1.904(f)–1(e)(2).

Example (5). On December 31, 1980, V, a domestic corporation that does business in the United States and abroad, has a balance in its section 904(d)(1)(A–C) overall foreign loss account of $600. V also has a balance in its FORI limitation overall foreign loss account of $900. For 1981, V has foreign source taxable income subject to the general limitation of $500 and $500 of United States source income. V also has foreign source taxable income subject to the FORI limitation of $800. V is required to recapture $250 of its section 904(d)(1)(A–C) overall foreign loss account (the lesser of $600 or 50% of $500) and its general limitation foreign tax credit limitation is $250/$1,800×$900, or $125 instead of $500/$1,800×$900, or $250. V is also required to recapture $400 of its FORI limitation overall foreign loss account (the lesser of $900 or 50% of $800). V's foreign tax credit limitation for FORI is $400/$1,800×$900, or $200, instead of $800/$1,800×$900, or $400. The balance in V's FORI limitation overall foreign loss account is reduced to $500 and the balance in V's section 904(d)(1)(A–C) account is reduced to $350, in accordance with § 1.904(f)–1(e)(2).

Example (6). This example assumes a United States corporate tax rate of 46 percent (under section 11(b)) and an alternative rate of tax under section 1201(a) of 28 percent. W is a domestic corporation that does business in the United States and abroad. On December 31, 1984, W has $350 in its general limitation overall foreign loss account. For 1985, W has $500 of United States source taxable income, and has foreign source income subject to the general limitation as follows:

Foreign source taxable income other than net capital gain	$720
Foreign source net capital gain	$460

Under paragraph (b)(2) of this section, foreign source taxable income for purposes of recapture includes foreign source capital gain net income, reduced, under section 904(b)(2), by the rate differential portion of foreign source net capital gain, which adjusts for the reduced tax rate for net capital gain under section 1201(a):

Foreign source capital gain net income	$460
Rate differential portion of foreign source net capital gain (18/46 of $460)	−180
Foreign source capital gain included in foreign source taxable income	$280

The total foreign source taxable income of W for purposes of recapture in 1985 is $1,000 ($720+$280). Under paragraph (c)(1) of this section, W is required to recapture $350 (the lesser of $350 or 50 percent of $1,000), and W's general limitation overall foreign loss account is reduced to zero. W's foreign tax credit limitation for income subject to the general limitation is $650/$1,500×$690 [(.46) (500+720)+(.28) (460)], or $299, instead of $1,000/$1,500×$690, or $460.

(d) *Recapture of overall foreign losses from dispositions under section 904(f)(3)*—(1) *In general.* If a taxpayer disposes of property used or held for use predominantly without the United States in a trade or business during a taxable year and that property generates foreign source taxable income subject to a separate limitation to which paragraph (a) of this section is applicable, (i) gain will be recognized on the disposition of such property, (ii) such gain will be treated as foreign source income subject to the same limitation as the income the property generated, and (iii) the applicable overall foreign loss account shall be recaptured as provided in paragraphs (d)(2), (d)(3), and (d)(4) of this section. See paragraph (d)(5) of this section for definitions.

(2) *Treatment of net capital gain.* If the gain from a disposition of property to which this paragraph (d) applies is treated as net capital gain, all references to such gain in paragraphs (d)(3) and (d)(4) of this section shall mean such gain as adjusted under paragraph (b) of this section. The amount by which the overall foreign loss account shall be reduced shall be determined from such adjusted gain.

(3) *Dispositions where gain is recognized irrespective of section 904(f)(3).* If a taxpayer recognizes foreign source gain subject to a separate limitation on the disposition of property described in paragraph (d)(1) of this section, and there is a balance in a taxpayer's overall foreign loss account that is attributable to a loss under such limitation after applying paragraph (c) of this section, an additional portion of such balance shall be recaptured in accordance with paragraphs (a) and (b) of this section. The amount recaptured shall be the lesser of such balance or 100 percent of the foreign source gain recognized on the disposition that was not previously recharacterized.

(4) *Dispositions in which gain would not otherwise be recognized*—(i) *Recognition of gain to the extent of the overall foreign loss account.* If a taxpayer makes a disposition of property described in paragraph (d)(1) of this section in which any amount of gain otherwise would not be recognized in the year of the disposition, and such property was used or held for use to generate foreign source taxable income subject to a separate limitation under which the taxpayer had a balance in its overall foreign loss account (including a balance that arose in the year of the disposition), the taxpayer shall recognize foreign source taxable income in an amount equal to the lesser of:

(A) The sum of the balance in the applicable overall foreign loss account (but only after such balance has been increased by amounts added to the account for the year of the disposition or has been reduced by amounts recaptured for the year of the disposition under paragraph (c) and paragraph (d)(3) of this section) plus the amount of any overall foreign loss that would be part of a net operating loss for the year of the disposition if gain from the disposition were not recognized under section 904(f)(3), plus the amount of any overall foreign loss that is part of a net operating loss carryover from a prior year, or

(B) The excess of the fair market value of such property over the taxpayer's adjusted basis in such property.

The excess of the fair market value of such property over its adjusted basis shall be determined on an asset by asset basis. Losses from the disposition of an asset shall not be recognized. Any foreign source taxable income deemed received and recognized under this

paragraph (d)(4)(i) will have the same character as if the property had been sold or exchanged in a taxable transaction and will constitute gain for all purposes.

(ii) *Basis adjustment.* The basis of the property received in an exchange to which this paragraph (d)(4) applies shall be increased by the amount of gain deemed recognized, in accordance with applicable sections of subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), O (relating to gain or loss on the disposition of property), and P (relating to capital gains and losses). If the property to which this paragraph (d)(4) applies was transferred by gift, the basis of such property in the hands of the donor immediately preceding such gift shall be increased by the amount of the gain deemed recognized.

(iii) *Recapture of overall foreign loss to the extent of amount recognized.* The provisions of paragraphs (a) and (b) of this section shall be applied to the extent of 100 percent of the foreign source taxable income which is recognized under paragraph (d)(4)(i) of this section. However, amounts of foreign source gain that would not be recognized except by application of section 904(f)(3) and paragraph (d)(4)(i) of this section, and which are treated as United States source gain by application of section 904(b)(3)(C) (prior to its removal by the Tax Reform Act of 1986) and paragraph (b)(1) of this section, shall reduce the overall foreign loss account (subject to the adjustments described in paragraph (d)(2) of this section) if such gain is net capital gain, notwithstanding the fact that such amounts would otherwise not be recaptured under the ordering rules in paragraph (b) of this section.

(iv) *Priorities among dispositions in which gain is deemed to be recognized.* If, in a single taxable year, a taxpayer makes more than one disposition to which this paragraph (d)(4) is applicable, the rules of this paragraph (d)(4) shall be applied to each disposition in succession starting with the disposition which occurred earliest, until the balance in the applicable overall foreign loss account is reduced to zero. If the taxpayer simultaneously makes more than one disposition to which this paragraph (d)(4) is applicable, the rules of paragraph (d)(4) shall be applied so that the balance in the applicable overall foreign loss account to be recaptured will be allocated pro rata among the assets in proportion to the excess of the fair market value of each asset over the adjusted basis of each asset.

(5) *Definitions*—(i) *Disposition.* A disposition to which this paragraph (d) applies includes a sale; exchange; distribution; gift; transfer upon the foreclosure of a security interest (but not a mere transfer of title to a creditor upon creation of a security interest or to a debtor upon termination of a security interest); involuntary conversion; contribution to a partnership, trust, or corporation; transfer at death; or any other transfer of property whether or not gain or loss is recognized under other provisions of the Code. However, a disposition to which this paragraph (d) applies does not include:

(A) A distribution or transfer of property to a domestic corporation described in section 381 (a) (provided that paragraph (d)(6) of this section (d)(5)(iv) of this section);

(B) A disposition of property which is not a material factor in the realization of income by the taxpayer (as defined in paragraph (d)(5)(iv) of this section);

(C) A transaction in which gross income is not realized; or

(D) The entering into of a unitization or pooling agreement (as defined in § 1.614–8(b)(6) of the regulations) containing a valid election under section 761(a)(2), and in which the source of the entire gain from any disposition of the interest created by the agreement would be determined to be foreign source under section 862(a)(5) if the disposition occurred presently.

(ii) *Property used in a trade or business.* Property is used in a trade or business if it is held for the principal purpose of promoting the present or future conduct of the trade or business. This generally includes property acquired and held in the ordinary course of a trade or business or otherwise held in a direct relationship to a trade or business. In determining whether an asset is held in a direct relationship to a trade or business, principal consideration shall be given to whether the asset is used in the trade or business. Property will be treated as held in a direct relationship to a trade or business if the property was acquired with funds generated by that trade or business or if income generated from the asset is available for use in that trade or business. Property used in a trade or business may be tangible or intangible, real or personal property. It includes property, such as equipment, which is subject to an allowance for depreciation under section 167 or cost recovery under section 168. Property may be considered used in a trade or business even if it is a capital asset in the hands of the taxpayer. However, stock of another corporation shall not be considered property used in a trade or business if a substantial investment motive exists for acquiring and holding the stock. On the other hand, stock acquired or held to assure a source of supply for a trade or business shall be considered property used in that trade or business. Inventory is generally not considered property used in a trade or business. However, when disposed of in a manner not in the ordinary course of a trade or business, inventory will be considered property used in the trade or business. A partnership interest will be treated as property used in a trade or business if the underlying assets of the partnership would be property used in a trade or business. For purposes of section 904(f)(3) and § 1.904(f)–2 (d) (1) and (5), a disposition of a partnership interest to which this section applies will be treated as a disposition of a proportionate share of each of the assets of the partnership. For purposes of allocating the purchase price of the interest and the seller's basis in the interest to those assets, the principles of § 1.751–1(a) will apply.

(iii) *Property used predominantly outside the United States.* Property will be considered used predominantly outside the United States if for a 3-year period ending on the date of the disposition (or, if shorter, the period during which the property has been used in the trade or business) such property was located outside the United States more than 50 percent of the time. An aircraft, railroad rolling stock, vessel, motor vehicle, container, or other property used for transportation purposes is deemed to be used predominantly outside the United States if, during the 3-year (or shorter) period, either such property is located outside the United States more than 50 percent of the time or more than 50 percent of the miles traversed in the use of such property are traversed outside the United States.

(iv) *Property which is a material factor in the realization of income.* For purposes of this section, property used in a trade or business will be considered a material factor in the realization of income unless the taxpayer establishes that it is not (or, if the taxpayer did not realize income from the trade or business in the taxable year, would not be expected to be) necessary to the realization of income by the taxpayer.

(6) *Carryover of overall foreign loss accounts in a corporate acquisition to which section 381(a) applies.* In the case of a distribution or transfer described in section 381(a), an overall foreign loss account of the distributing or transferor corporation shall be treated as an

overall foreign loss account of the acquiring or transferee corporation as of the close of the date of the distribution or transfer. If the transferee corporation had an overall foreign loss account under the same separate limitation prior to the distribution or transfer, the balance in the transferor's account must be added to the transferee's account. If not, the transferee must adopt the transferor's overall foreign loss account. An overall foreign loss of the transferor will be treated as incurred by the transferee in the year prior to the year of the transfer.

(7) *Illustrations.* The rules of this paragraph (d) are illustrated by the following examples which assume that the United States corporate tax rate is 50 percent (unless otherwise stated). For purposes of these examples, none of the foreign source gains are treated as net capital gains (unless so stated).

Example (1). X Corporation has a balance in its general limitation overall foreign loss account of $600 at the close of its taxable year ending December 31, 1984. In 1985, X sells assets used predominantly outside the United States in a trade or business and recognizes $1,000 of gain on the sale under section 1001. This gain is subject to the general limitation. This sale is a disposition within the meaning of paragraph (d)(5)(i) of this section, and to which this paragraph (d) applies. X has no other foreign source taxable income in 1985 and has $1,000 of United States source taxable income. Under paragraph (c), X is required to recapture $500 (the lesser of the balance in X's general limitation overall foreign loss account ($600) or 50 percent of $1,000) of its overall foreign loss account. The balance in X's general limitation overall foreign loss account is reduced to $100 in accordance with § 1.904(f)–1(e)(2). In addition, under paragraph (d)(3) of this section, X is required to recapture $100 (the lesser of the remaining balance in its general limitation overall foreign loss account ($100) or 100 percent of its foreign source taxable income recognized on such disposition that has not been previously recharacterized ($500)). The total amount recaptured is $600. X's foreign tax credit limitation for income subject to the general limitation in 1985 is $200 ($400/$2,000 x $1,000) instead of $500 ($1,000/$2,000 x $1,000). The balance in X's general limitation overall foreign loss account is reduced to zero in accordance with § 1.904(f)–1(e)(2).

Example (2). On December 31, 1984, Y Corporation has a balance in its general limitation overall foreign loss account of $1,500. In 1985, Y has $500 of United States source taxable income and $200 of foreign source taxable income subject to the general limitation. Y's foreign source taxable income is from the sale of property used predominantly outside of the United States in a trade or business. This sale is a disposition to which this paragraph (d) is applicable. In 1985, Y also transferred property used predominantly outside of the United States in a trade or business to another corporation. Under section 351, no gain was recognized on this transfer. Such property had been used to generate foreign source taxable income subject to the general limitation. The excess of the fair market value of the property transferred over Y's adjusted basis in such property was $2,000. In accordance with paragraph (c) of this section, Y is required to recapture $100 (the lesser of $1,500, the amount in Y's general limitation overall foreign loss account, or 50 percent of $200, the amount of general limitation foreign source taxable income for the current year) of its general limitation overall foreign loss. Y is then required to recapture an additional $100 of its general limitation overall foreign loss account under paragraph (d)(3) of this section out of the remaining gain recognized on the sale of assets, because 100 percent of such gain is subject to recapture. The balance in Y's general limitation overall foreign loss account is reduced to $1,300 in accordance with § 1.904(f)–1(e)(2). Y corporation is then required to recognize $1,300 of foreign source taxable income on its section 351 transfer under paragraph (d)(4) of this section. The remaining $700 of potential gain associated with the section 351 transfer is not recognized. Under paragraph (d)(4), 100 percent of the $1,300 is recharacterized as United States source taxable income, and Y's general limitation overall foreign loss account is reduced to zero. Y's entire taxable income for 1985 is:

U.S. source taxable income	$500
Foreign source taxable income subject to the general limitation that is recharacterized as U.S. source income by paragraphs (c) and (d)(3) of this section	200
Gain recognized under section 904(f)(3) and paragraph (d)(4) of this section, and recharacterized as U.S. source income	1,300
Total	$2,000

Y's foreign tax credit limitation for 1985 for income subject to the general limitation is $0 ($0/$2,000×$1,000) instead of $100 ($200/$700×$350).

Example (3). W Corporation is a calendar year domestic corporation with foreign branch operations in country C. As of December 31, 1984, W has no overall foreign loss accounts and has no net operating loss carryovers. W's entire taxable income in 1985 is:

U.S. source taxable income	$800
Foreign source taxable income (loss) subject to the general limitation	($1,000)

W cannot carry back its 1985 NOL to any earlier year. As of December 31, 1985, W therefore has $800 in its general limitation overall foreign loss account. In 1986, W earns $400 United States source taxable income and has an additional $1,000 loss from the operations of the foreign branch. Income in the loss category would be subject to the general limitation. Also in 1986, W disposes of property used predominately outside the United States in a trade or business. Such property generated income subject to the general limitation. The excess of the property's fair market value over its adjusted basis is $3,000. The disposition is of a type described in § 1.904 (f)–2(d)(4)(i). W has no other income in 1986. Under § 1.904 (f)–2(d)(4)(i), W is required to recognize foreign source taxable income on the disposition in an amount equal to the lesser of $2,000 [$800 (the balance in the general limitation overall foreign loss account as of 1985) + $400 (the increase in the general limitation overall foreign loss account attributable to the disposition year) + $600 (the general limitation overall foreign loss that is part of the NOL from 1986) + $200 (the general limitation overall foreign loss that is part of the NOL from 1985)] or $3,000. The $2,000 foreign source income required to be recognized under section 904(f)(3) is reduced to $1,200 by the remaining $600 loss in 1986 and the $200 net operating loss carried forward from 1985. This $1,200 of income is subject to the general limitation. In computing foreign tax credit limitation for general limitation income, the $1,200 of foreign source income is treated as United States source income and, therefore, W's foreign tax credit limitation for income subject to the general limitation is zero. W's overall foreign loss account is reduced to zero.

Example (4). Z Corporation has a balance in its FORI overall foreign loss account of $1,500 at the end of its taxable year 1980. In 1981, Z has $1,600 of foreign oil related income subject to the separate limitation for FORI income and no United States source income. In addition, in 1981, Z makes two dispositions of property used predominantly outside the United States in a trade or business on which no gain was recognized. Such 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×$1,150) instead of $800 ($1,600/$1,600×$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− ($575×18/46)). 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 dispostion 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.

§ 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) and 1.1502–79 (a)), 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 new 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 and 1.1502–79(b)), 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 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.

§ 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 1.904(f)-6), and the denominator of the fraction is the entire amount of foreign source taxable income deemed distributed under section 666. However, the numerator of this fraction shall not exceed the denominator of the fraction.

(c) *Recapture if taxpayer deducts foreign taxes deemed distributed.* If paragaph (a) of this section is applicable and if, in accordance with section 667(d)(1)(B), the beneficiary deducted rather than credited its taxes in the computation year, the beneficiary shall reduce its overall foreign loss account (but not below zero) by an amount equal to the lesser of the balance in the applicable overall foreign loss account or the amount of the actual distribution deemed distributed in the computation year (without regard to the foreign taxes deemed distributed).

(d) *Illustrations.* The provisions of this section are illustrated by the following examples:

Example (1). X Corporation is a domestic corporation that has a balance of $10,000 in its general limitation overall foreign loss account on December 31, 1980. For its taxable year beginning January 1, 1981, X's only income is an accumulation distribution from a foreign trust of $20,000 of general limitation foreign source taxable income. Under section 666, the amount distributed and the foreign taxes paid on such amount ($4,000) are deemed distributed in two prior taxable years. In determining the partial tax on such distribution under section 667(b), the amount added to each computation year is $12,000 (the sum of the actual distribution plus the taxes deemed distributed ($24,000) divided by the number of accumulation years (2)). Of that amount, $5,000 ($10,000/$24,000×$12,000) is treated as United States source taxable income in accordance with paragraph (b) of this section. Assuming the United States tax rate is 50 percent, X's separate foreign tax credit limitation against the increase in tax in each computation year is $3,500 ($7,000/$12,000×$6,000) instead of $6,000 ($12,000/$12,000×$6,000). X's overall foreign loss account is reduced to zero in accordance with paragraph (a) of this section.

Example (2). Assume the same facts as in Example (1), except that X deducted rather than credited its foreign taxes in the computation years. In 1979, the amount added to X's income is $12,000 under section 667(b), $2,000 of which is deductible under section 667(d)(1)(B). X must reduce its overall foreign loss account by $10,000, the amount of the actual distribution that is deemed distributed in 1979 (without regard to the $2,000 foreign taxes also deemed distributed). The entire overall foreign loss account is therefore reduced to $0 in 1979.

§ 1.904(f)-5 Special rules for recapture of overall foreign losses of a domestic trust.

(a) *In general.* Except as provided in this section, the rules contained in §§ 1.904(f)-1, 1.904(f)-2, 1.904(f)-3, 1.904(f)-4, and 1.904(f)-s6 apply to domestic trusts.

(b) *Recapture of trust's overall foreign loss.* In taxable years in which a trust has foreign source taxable income subject to a separate limitation in which the trust has a balance in its overall foreign loss account, the balance in the trust's overall foreign loss account shall be recaptured as follows:

(1) *Trust accumulates income.* If the trust accumulates all of its foreign source taxable income subject to the same limitation as the loss that created the balance in the overall foreign loss account, its overall foreign loss shall be recaptured out of such income in accordance with §§ 1.904(f)-1, 1.904(f)-2, 1.904(f)-3, 1.904(f)-4, and 1.904(f)-6.

(2) *Trust distributes income.* If the trust distributes all of its foreign source taxable income subject to the same limitation as the loss that created the overall foreign loss account, the amount of the overall foreign loss that would be subject to recapture by the trust under paragraph (b)(1) of this section shall be allocated to the beneficiaries in proportion to the amount of such income which is distributed to each beneficiary in that year.

(3) *Trust accumulates and distributes income.* If the trust accumulates part of its foreign source taxable income subject to the same limitation as the loss that created the overall foreign loss account and distributes part of such income, the portion of the overall foreign loss that would be subject to recapture by the trust under paragraph (b)(1) of this section if the distributed income were accumulated shall be allocated to the beneficiaries receiving income distributions. The amount of overall foreign loss to be allocated to such beneficiaries shall be the same portion of the total amount of such overall foreign loss that would be recaptured as the amount of such income which is distributed to each beneficiary bears to the total amount of such income of the trust for such year. That portion of the overall foreign loss subject to recapture in such year that is not allocated to the beneficiaries in accordance with this paragraph (b)(3) shall be recaptured by the trust in accordance with paragraph (b)(1).

(c) *Amounts allocated to beneficiaries.* Amounts of a trust's overall foreign loss allocated to any beneficiary in accordance with paragraph (b)(2) or (3) of this section shall be added to the beneficiary's applicable overall foreign loss account and treated as an overall foreign loss of the beneficiary incurred in the taxable year preceding the year of such allocation. Such amounts shall be recaptured in accordance with §§ 1.904(f)-1, 1.904(f)-2, 1.904(f)-3, 1.904(f)-4, and 1.904(f)-6 out of foreign source taxable income distributed by the trust which is subject to the same separate limitation.

(d) *Section 904(f)(3) dispositions to which § 1.904(f)-2(d)(4)(i) is applicable.* Foreign source taxable income recognized by a trust under § 1.904(f)-2(d)(4) on a disposition of property used in a trade or business outside the United States shall be deemed to be accumulated by the trust. All such income shall be used to recapture the trust's overall foreign loss in accordance with § 1.904(f)-2(d)(4).

(e) *Illustrations.* The provisions of this section are illustrated by the following examples:

Example (1). T, a domestic trust, has a balance of $2,000 in a general limitation overall foreign loss account on December 31, 1983. For its taxable year ending on December 31, 1984, T has foreign source taxable income subject to the general limitation of $1,600, all of which it accumulates. Under paragraph (b)(1) of this section, T is required to recapture $800 in 1984 (the lesser of the overall foreign loss or 50 percent of the foreign source taxable income). This amount is treated as United States source income for purposes of taxing T in 1984 and upon subsequent distribution to T's beneficiaries. At the end of its 1984 taxable year, T has a balance of $1,200 in its overall foreign loss account.

Example (2). The facts are the same as in example (1). In 1985, T has general limitation foreign source taxable income of $1,000, which it distributes to its beneficiaries as follows: $500 to A, $250 to B, and $250 to C. Under paragraph (b)(1) of this section, T would have been required to recapture $500 of its overall foreign loss if it had accumulated all of such income. Therefore, under paragraph (b)(2) of this section, T must allocate $500 of its overall foreign loss to A, B, and C as follows: $250 to A ($500×$500/$1,000), $125 to B ($500×$250/$1,000), and $125 to C ($500×$250/$1,000). Under paragraph (c) of this section and § 1.904(f)-1(d)(4), A, B, and C must add the amounts of general limitation overall foreign loss allocated to them from T to their overall foreign loss accounts and treat such amounts as overall foreign losses incurred in 1984. A, B, and C must then apply the rules of §§ 1.904(f)-1, 1.904(f)-2, 1.904(f)-3, 1.904(f)-4, and 1.904(f)-6 to recapture their overall foreign losses. T's overall foreign loss account is reduced in accordance with § 1.904(f)–1(e)(1) by the $500 that is allocated to A, B, and C. At the end of 1985, T's general limitation overall foreign loss account has a balance of $700.

Example (3). The facts are the same as in example (2), including an overall foreign loss account at the end of 1984 of $1,200, except that in 1985 T's general limitation foreign source taxable income is $1,500 instead of $1,000, and T accumulates the additional $500. Under paragraph (b)(1) of this section, T would be required to recapture $750 of its overall foreign loss if it accumulated all of the $1,500. Under paragraph (b)(3) of this section, T must allocate $500 of its overall foreign loss to A, B, and C as follows: $250 to A ($750×$500/$1,500) and $125 each to B and C (750×$250/$1,500). T must also recapture $250 of its overall foreign loss, which is the amount subject to recapture in 1985 that is not allocated to the beneficiaries ($750−$500=$250). Under § 1.904(f)-1(e)(1), T reduces its general limitation overall foreign loss account by $500. Under § 1.904(f)-1(e)(2), T reduces its general limitation overall foreign loss account by $250. At the end of 1985 there is a balance in the general limitation overall foreign loss account of $450 (($1,200−$500)−$250).

§ 1.904(f)–6 Transitional rule for recapture of FORI and general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983, from foreign source taxable income subject to the general limitation in taxable years beginning after December 31, 1982.

(a) *General rule.* For taxable years beginning after December 31, 1982, foreign source taxable income subject to the general limitation includes foreign oil related income (as defined in section 907(c)(2) prior to its amendment by section 211 of the Tax Equity and Fiscal Responsibility Act of 1982). However, for purposes of recapturing general limitation overall foreign losses incurred in taxable years beginning before January 1, 1983 (pre-1983) out of foreign source taxable income subject to the general limitation in taxable years beginning after December 31, 1982 (post-1982), the taxpayer shall make separate determinations of foreign oil related income and other general limitation income (as if the FORI limitation under "old section 907(b)" (prior to its amendment by section 211 of the Tax Equity and Fiscal Responsibility Act of 1982) were still in effect), and shall apply the rules set forth in this section. The taxpayer shall maintain separate accounts for its pre-1983 FORI limitation overall foreign losses, its pre-1983 general limitation overall foreign losses (or its pre-1983 section 904(d)(1)(A–C) overall foreign losses if such losses were computed on a combined basis), and its post-1982 general limitation overall foreign losses. The taxpayer shall continue to maintain such separate accounts, make such separate determinations, and apply the rules of this section separately to each account until the earlier of—

(1) Such time as the taxpayer's entire pre-1983 FORI limitation overall foreign loss account and pre-1983 general limitation overall foreign loss account (or, if the taxpayer determined pre-1983 overall foreign losses on a combined basis, the section 904(d)(1)(A–C) account) have been recaptured, or

(2) The end of the taxpayer's 8th post-1982 taxable year, at which time the taxpayer shall add any remaining balance in its pre-1983 FORI limitation account and pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A-C) account) to its post-1982 general limitation overall foreign loss account.

(b) *Recapture of pre-1983 FORI and general limitation overall foreign losses from post-1982 income.* A taxpayer having a balance in its pre-1983 FORI limitation overall foreign loss account or its pre-1983 general limitation overall foreign loss account (or its pre-1983 section 904(d)(1)(A–C) account) in a post-1982 taxable year shall recapture such overall foreign loss as follows:

(1) *Recapture from income subject to the same limitation.* The taxpayer shall first apply the rules of §§ 1.904(f)–1 through 1.904(f)–5 to the taxpayer's separately determined foreign oil related income to recapture the pre-1983 FORI limitation overall foreign loss account, and shall apply such rules to the taxpayer's separately determined general limitation income (exclusive of

foreign oil related income) to recapture the pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A–C) overall foreign loss account. Rules for determining the recapture of the pre-1983 section 904 (d)(1)(A–C) losses are contained in § 1.904(f)–2(c)(4).

(2) *Recapture from income subject to the other limitation.* The taxpayer shall next apply the rules of § 1.904(f)–1 through –5 to the taxpayer's separately determined foreign oil related income to recapture the pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A–C) overall foreign loss account) and shall apply such rules to the taxpayer's separately determined general limitation income to recapture foreign oil related losses to the extent that—

(i) The amount recaptured from such separately determined income under paragraph (b)(1) of this section is less than 50 percent (or such larger percentage as the taxpayer elects) of such separately determined income, and

(ii) The amount recaptured from such separately determined income under this paragraph (b)(2) does not exceed an amount equal to 12½ percent of the balance in the taxpayer's pre-1983 FORI limitation overall foreign loss account or the pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A-C) overall foreign loss account) at the beginning of the taxpayer's first post-1982 taxable year, multiplied by the number of post-1982 taxable years (including the year to which this rule is being applied) which have elapsed, less the amount (if any) recaptured in prior post-1982 taxable years under this paragraph (b)(2) from such separately determined income.

The taxpayer may elect to recapture a pre-1983 overall foreign loss from post-1982 income subject to the general limitation at a faster rate than is required by this paragraph (b)(2). This election shall be made in the same manner as an election to recapture more than 50 percent of the income subject to recapture under section 904(f)(1), as provided in § 1.904(f)–2(c)(2).

(c) *Coordination of recapture of pre-1983 and post-1982 overall foreign losses.* A taxpayer incurring a general limitation overall foreign loss in any post-1982 taxable year in which the taxpayer has a balance in a pre-1983 FORI limitation or its pre-1983 general limitation overall foreign loss account (or the section 904(d)(1)(A-C) overall foreign loss account) shall establish a separate overall foreign loss account for such loss. The taxpayer shall recapture its overall foreign losses in succeeding taxable years by first applying the rules of this section to recapture its pre-1983 overall foreign losses, and then applying the rules of §§ 1.904(f)–1 through 1.904(f)–5 to recapture its post-1982 general limitation overall foreign loss. A post-1982 general limitation overall foreign loss is required to be recaptured only to the extent that the amount of foreign source taxable income recharacterized under paragraph (b) of this section is less than 50 percent of the taxpayer's total general limitation foreign source taxable income (including foreign oil related income)) for such taxable year (except as required by section 904(f)(3)). However, a taxpayer may elect to recapture at a faster rate.

(d) *Illustrations.* The provisions of this section are illustrated by the following examples:

Example (1). X Corporation is a domestic corporation which has the calendar year as its taxable year. On December 31, 1982, X has a balance of $1,000 in its section 904(d)(1)(A-C) overall foreign loss account. X does not have a balance in a FORI limitation overall foreign loss account. For 1983, X has income of $1,200, which was subject to the general limitation and includes foreign oil related income of $1,000 and other general limitation income of $200. In 1983, X is required to recapture $225 of its pre-1983 section 904(d)(1)(A-C) overall foreign loss account computed as follows:

Amount recaptured under paragraph (b)(1) of this section $100

The amount recaptured from general limitation income exclusive of foreign oil related income is the lesser of $1,000 (the pre-1983 loss reflected in the section 904(d)(1)(A-C) overall foreign loss account) or 50 pecent of $200 (the separately determined general limitation income (exclusive of foreign oil related income).

Amount recaptured under paragraph (b)(2) of this section $125

The amount recaptured from foreign oil related income is the lesser of $900 (the remaining pre-1983 section 904(d)(1)(A-C) overall foreign loss account after recapture under paragraph (b)(1) of this section) or 50 percent of $1,000 (the separately determined foreign oil related income), but as limited by paragraph (b)(2)(ii) of this section to (12½ percent of $1,000 x 1)—$0, which is $125.

Total amount recaptured in 1983 ..... $225

Example (2). The facts are the same as in example (1), except that X has general limitation income of $50 for 1984 and $600 for 1985, all of which is foreign oil related income. X is required to recapture $25 in 1984 and $225 in 1985 of its pre-1983 section 904(d)(1)(A-C) overall foreign loss account computed as follows:

Amount recaptured under paragraph (b)(2) of this section in 1984 ..... $25

The amount recaptured from foreign oil related income is the lesser of $775 (the remaining pre-1983 section 904(d)(1)(A-C) overall foreign loss account or 50 percent of $50 (the separately determined foreign oil related income).This amount is within the limitation of paragraph (b)(2)(ii) of this section, (12½ percent of $1,000 x 2)—$125, which is $125.

Amount recaptured under paragraph (b)(2) of this section in 1985 ..... $225

The amount recaptured from foreign oil related income is the lesser of $750 (the remaining pre-1983 section 904(d)(1)(A–C) overall foreign loss account) or 50 percent of $600 (the separately determined foreign oil related income), but as limited by paragraph (b)(2)(ii) of this section to (12½ percent of $1,000×3)–($125+$25), which is $225. ($125 is the amount recaptured in 1983 under paragraph (b)(2) of this section, and $25 is the amount recaptured in 1984 under paragraph (b)(2) of this section.)

Example (3). Y Corporation is a domestic corporation which has the calendar year as its taxable year. On December 31, 1982, Y has a balance of $400 in its section 904(d)(1)(A–C) overall foreign loss account. Y does not have a balance in a FORI overall foreign loss account. For 1983, Y has a general limitation overall foreign loss of $200. For 1984, Y has general limitation income of $1,200, all of which is foreign oil related income. In 1984, Y is required to recapture a total of $300 computed as follows:

Amount of pre-1983 overall foreign loss recaptured under paragraph (b)(2) of this section $100

The amount of the pre-1983 section 904(d)(1)(A–C) overall foreign loss account attributable to a general limitation loss recaptured from foreign oil related income is the lesser of $400 (the loss) or 50 percent of $1,200 (the separately determined foreign oil related income), but as limited by paragraph (b)(2)(ii) of this section to (12½ percent of $400×2) − $0, which is $100.

Amount of post-1982 overall foreign loss recaptured under paragraph (c) of this section $200

The amount of post-1982 general limitation overall foreign loss recaptured is the amount computed under § 1.904 (f)−2(c)(1), which is the lesser of $200 (the post-1982 loss) or 50 percent of $1,200 (the income), but only to the extent that the amount of pre-1983 loss recaptured under paragraph (b) of this section is less than 50 percent of such income ((50 percent of $1,200)—$100 recaptured under paragraph (b) = $500).

Total amount recaptured in 1984 ..... $300

At the end of 1984, Y has a balance in its pre-1983 section 904(d)(1)(A–C) overall foreign loss account of $300, and has reduced its post-1982 general limitation overall foreign loss account to zero.

Example (4). Z is a domestic corporation which has the calendar year as its taxable year. On December 31, 1982, Z has a balance of $400 in its section 904 (d)(1)(A–C) overall foreign loss account, and a balance of $1,000 in its FORI limitation overall foreign loss account. For 1983, Z has general limitation income of $2,000, which includes foreign oil related income of $1,000 and other general limitation income of $1,000. Keeping these amounts separate for purposes of this section, Z is required to recapture a total of $1,000 in 1983, computed as follows:

Amount recaptured under paragraph (b)(1) of this section.....$900

The amount of pre-1983 section 904(d)(1)(A–C) overall foreign loss account recaptured from general limitation income exclusive of foreign oil related income, in accordance with §1.904 (f)–2(c)(1), is the lesser of $400 (the section 904(d)(1)(A–C) overall foreign loss) or 50 percent of $1,000, the general limitation income exclusive of foreign oil related income), which is $400.

The amount of pre-1983 FORI overall foreign loss recaptured from foreign oil related income, in accordance with § 1.904(f)–2(c)(1), is the lesser of $1,000 (the FORI overall foreign loss) or 50 percent of $1,000 (the foreign oil related income), which is $500.

Amount recaptured under paragraph (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.

Par. 3. A new § 1.1502–9 is added immediately following § 1.1502–7 to read as set forth below:

§ 1.1502–9 Application of overall foreign loss recapture rules to corporations filing consolidated returns.

(a) *In general.* An affiliated group of corporations filing a consolidated return sustains an overall foreign loss (a consolidated overall foreign loss) in any taxable year in which its gross income from sources without the United States subject to a separate limitation (as defined in § 1.904(f)–1(c)(2)) is exceeded by the sum of the deductions properly allocated and apportioned thereto. However, for taxable years prior to 1983, affiliated groups may have determined their overall foreign losses for income subject to the passive interest limitation, DISC dividend limitation, and general limitation on a combined basis in accordance with the rules in § 1.904(f)–1(c)(1). The rules contained in §§ 1.904(f)–1 through 1.904(f)–6 are applicable to affiliated groups filing consolidated returns. This section provides special rules for applying those sections to such groups. Paragraph (b) provides rules for additions and subtractions of a portion of overall foreign losses to and from consolidated overall foreign loss accounts. Paragraph (c) requires that separate notional overall foreign loss accounts be kept for each member of the group that contributes to a consolidated overall foreign loss account and provides for allocation of a portion of the group's overall foreign loss account to a member when the member leaves the group prior to recapture of the entire amount of the loss account. These rules are similar to the rules provided in § 1.1502–79 concerning the apportionment of consolidated net operating losses to a member who leaves the group. However, the rules differ somewhat because the absorption rule of § 1.1502–79 is applied year-by-year, consistently with the sequence rules of section 172(b), and recapture of overall foreign losses is based on overall foreign loss accounts that may consist of losses in more than one year. Paragraph (d) provides rules for recapture of amounts in consolidated overall foreign loss accounts. Paragraph (e) provides special rules pertaining to section 904(f)(3) dispositions between members of a group. Paragraphs (b), (c), and (e) also contain special rules that apply to overall foreign losses that arise in separate return limitation years; the principles therein also apply to overall foreign losses when there has been a consolidated return change of ownership (as defined in § 1.1502–1(g)).

(b) *Consolidated overall foreign loss accounts.* Any group that sustains an overall foreign loss (or acquires a member with a balance in an overall foreign loss account) must establish a consolidated overall foreign loss account for such loss, and amounts shall be added to and subtracted from such account as provided in §§ 1.904(f)–1 through 1.904(f)–6 and this section.

(1) *Additions to the consolidated overall foreign loss accounts*—(i) *Consolidated overall foreign losses.* Any consolidated overall foreign loss shall be added to the applicable consolidated overall foreign loss account for such separate limitation, to the extent that the overall foreign loss has reduced United States source income, in accordance with the rules of §§ 1.904(f)–1 and 1.904(f)–3.

(ii) *Overall foreign losses from separate return years.* If a corporation joins in the filing of a consolidated return in a taxable year in which such corporation has a balance in an overall foreign loss account from a prior separate return year that is not a separate return limitation year, such balance shall be added to the applicable consolidated overall foreign loss account in such year and treated as a consolidated overall foreign loss incurred in the previous year (and shall therefore be subject to recapture, in accordance with paragraph (d) of this section, beginning in the same year in which it is added to the consolidated overall foreign loss account).

(iii) *Overall foreign losses from separate return limitation years.* If a corporation joins in the filing of a consolidated return in a taxable year in which such corporation has a balance in an overall foreign loss account from a prior separate return limitation year, such balance shall be added to the applicable consolidated overall foreign loss account in such consolidated return year to the extent of the lesser of the balance in the overall foreign loss account from the separate return limitation year or 50 percent (or such larger percentage as the taxpayer may elect) of the difference between the consolidated foreign source taxable income subject to the same separate limitation (computed in accordance with §§ 1.904(f)–2(b) and 1.1502–4(d)(1)) minus such consolidated foreign source taxable income recomputed by excluding the items of income and deduction of such corporation (but not less than zero). The amount added to a consolidated overall foreign loss account in any taxable year under this paragraph (b)(1)(iii) shall be treated as a consolidated overall foreign loss in the previous year (and shall therefore be subject to recapture, in accordance with paragraph (d) of this section, beginning in the same year in which it is added to the consolidated overall foreign loss account).

(iv) *Overall foreign losses that are part of a net operating loss or net capital loss carried over from a separate return limitation year.* Overall foreign losses that are part of a net operating loss or net capital loss carryover from a separate return limitation year of a member that is absorbed in a consolidated return year shall be treated as though they were added to an overall foreign loss account in a separate return limitation year of such member and will be subject to the limitation on recapture of SRLY losses contained in paragraph (b)(1)(iii) of this section. See paragraph (c)(2) of this section for rules regarding the addition of such losses to the applicable overall foreign loss account of such member.

(2) *Reductions of the consolidated overall foreign loss accounts*—(i) *Amounts allocated to members leaving the group.* When a member leaves the group, each applicable consolidated overall foreign loss account shall be

reduced by the amount allocated from such account to such member in accordance with paragraph (c)(3)(i) of this section.

(ii) *Amounts recaptured.* A consolidated overall foreign loss account shall be reduced by the amount of any overall foreign loss under the same separate limitation that is recaptured from consolidated income in accordance with § 1.904(f)–2.

(c) *Allocation of overall foreign losses among members of an affiliated group*—(1) *Notional overall foreign loss accounts.* Separate notional overall foreign loss accounts shall be established for each member of a group that contributes to a consolidated overall foreign loss account. Additions to and reductions of such notional accounts shall be made when additions or reductions are made to consolidated overall foreign loss accounts in accordance with paragraph (b) of this section and § 1.904(f)–1.

(i) *Additions to notional accounts*—(A) *Consolidated overall foreign losses.* When a consolidated overall foreign loss is added to a consolidated overall foreign loss account, each member shall add its pro rata share of the amount of such loss to the member's notional overall foreign loss account. A member's pro rata share of a consolidated overall foreign loss for any taxable year is determined by multiplying the consolidated loss by a fraction.The numerator of this fraction is the amount by which the member's separate gross income for the taxable year from sources without the United States subject to the applicable separate limitation is exceeded by the sum of the deductions properly allocated and apportioned thereto (including such member's share of any consolidated net operating loss deduction and consolidated net capital loss carryovers and carrybacks to the taxable year), for each member with such deductions in excess of such income. The denominator of this fraction is the sum of the numerators of this fraction for all such members of the group.

(B) *Overall foreign losses from separate return years and separate return limitation years.* When an amount from a member's overall foreign loss account from a separate return year or separate return limitation year is added to a consolidated overall foreign loss account in accordance with paragraph (b)(1) (ii) or (iii) of this section, such amount shall also be added to that member's notional overall foreign loss account for such separate limitation.

(ii) *Reductions of notional accounts.* When a consolidated overall foreign loss account is reduced by recapture, in accordance with paragraph (b)(2)(ii) of this section, each member of the group shall reduce its notional overall foreign loss account for that separate limitation by its pro rata share of the amount by which the consolidated overall foreign loss account is reduced. A member's pro rata share of the amount by which a consolidated overall foreign loss account is reduced and determined by multiplying the amount recaptured by a fraction, the numerator of which is the amount in such member's notional account under such separate limitation, and the denominator of which is the amount in the consolidated overall foreign loss account under such separate limitation before reduction for the amount recaptured for that taxable year.

(2) *Overall foreign losses that are part of a net operating loss or net capital loss from a separate return limitation year.* An overall foreign loss that is part of a net operating loss or net capital loss carryover from a separate return limitation year of a member that is absorbed in a consolidated return year shall be treated as an overall foreign loss of such member (rather than the group) and shall be added to such member's separate overall foreign loss account to the extent it reduces United States source income, in accordance with § 1.904(f)–1(d)(5). Such overall foreign losses shall be added to the appropriate consolidated overall foreign loss account in later years in accordance with paragraph (b)(1)(iii) of this section.

(3) *Allocation of a portion of overall foreign loss accounts to a member leaving the group*—(i) *Consolidated overall foreign losses.* When a corporation ceases to be a member of an affiliated group filing consolidated returns, a portion of the balance in each applicable consolidated overall foreign loss account shall be allocated to such corporation. The amount allocated to such corporation shall be equal to the amount, if any, in such member's notional overall foreign loss account under the same separate limitation.

(ii) *Overall foreign losses from separate return limitation years.* When a corporation ceases to be a member of an affiliated group filing consolidated returns, it shall take with it the remaining portion of each separate overall foreign loss account for overall foreign losses from separate return limitation years (including amounts added to such accounts under paragraph (c)(2) of this section).

(d) *Recapture of consolidated overall foreign losses.* The amount in any consolidated overall foreign loss account shall be recaptured under §§ 1.904(f)–1 through 1.904(f)–6 by recharacterizing consolidated foreign source taxable income subject to the separate limitation under which the loss arose as United States source taxable income. For purposes of recapture, consolidated foreign source taxable income subject to the separate limitation under which the loss arose shall be determined in accordance with §§ 1.904(f)–2 and 1.1502–4. Amounts in a member's excess loss account that are included in income under § 1.1502–19 shall be subject to recapture to the extent that they are included in consolidated foreign source taxable income subject to the separate limitation under which the loss arose.

(e) *Dispositions of property between members of the same affiliated group during a consolidated return year*—(1) *In general.* Except as provided in paragraph (2) with respect to overall foreign losses of a selling member from a separate return limitation year, the rules of § 1.1502–13 with respect to intercompany transactions will apply to dispositions of property to which section 904(f)(3)(A) applies.

(2) *Recapture of overall foreign loss from a separate return limitation year.* Paragraph (1) will not apply and gain will be recognized to the extent that the selling member has a balance in its overall foreign loss account from a separate return limitation year unless the selling member adds the entire amount of its overall foreign loss account from separate return limitation years to the applicable consolidated overall foreign loss account and treats such amount as an overall foreign loss incurred in the previous year. Such loss shall be subject to recapture, in accordance with paragraph (d) of § 1.1502–9, beginning in the same year in which it is added to the consolidated overall foreign loss account.

(f) *Illustrations.* The provisions of this section are illustrated by the following examples. All foreign source income or loss in these examples is subject to the general limitation.

Example (1). A, B, and C are the members of an affiliated group of corporations (as defined in section 1504), and all use the calendar year as their taxable year. For 1983, A, B, and C file a consolidated return. ABC has United States source income of $1,000 and foreign source losses (overall foreign loss) of $400. In accordance with paragraph (b)(1)(i) of this section, ABC adds $400 to its consolidated overall foreign loss account at the end of 1983. For 1983, the separate foreign source taxable income (or loss) of A is $400, of B is ($200), and of C is ($600). Under paragraph (c)(1) of this section, B and C must establish separate notional overall foreign loss accounts. Under paragraph (c)(1)(i)(A) of

this section, the amount added to each notional account is the pro rata share of the consolidated overall foreign loss of each member contributing to such loss. The pro rata share is determined by multiplying the consolidated loss by the member's proportionate share of the total foreign source losses of all members having such losses. B's foreign source loss if $200 and C's foreign source loss is $600, totaling $800. B must add $400x200/800, or $100, to its notional overall foreign loss account. C must add $400x600/800, or $300, to its notional overall foreign loss account.

Example (2). The facts are the same as in example (1). In 1984, ABC has consolidated foreign source taxable income of $200. Under paragraph (d) of this section and § 1.904(f)–2, ABC is required to recapture $100 of the amount in its consolidated overall foreign loss account, which reduces that account by $100 under paragraph (b)(2)(ii) of this section. In accordance with paragraph (c)(1)(ii) of this section, B reduces its notional account by $100x100/400, or $25, and C reduces it notional account by $100x300/400, or $75. At the end of 1984 ABC has $300 in its consolidated overall foreign loss account, B has $75 in its notional account, and C has $225 in its notional account.

Example (3). D and E are members of an affiliated group and file separate returns using the calendar year as their taxable year for 1980. In 1980, D has an overall foreign loss of $200, which it adds to its overall foreign loss account, and E has no overall foreign losses. For 1981, D and E file a consolidated return, and DE must establish a consolidated overall foreign loss account, to which D's overall foreign loss from 1980 is added under paragraph (b)(1)(ii) of this section. D also adds the same amount $200 to its notional account under paragraph (c)(1)(i)(B) of this section. In 1981, DE has consolidated foreign source taxable income of $300. Since the amount added to the consolidated overall foreign loss account in 1981 is treated as a consolidated overall foreign loss from 1980, DE must recapture $150 in 1981 under paragraph (d) of this section and § 1.904(f)–2. DE's consolidated overall foreign loss account is reduced by $150 under paragraph (b)(2)(ii) of this section, and D's notional account is reduced by $150 under paragraph (c)(1)(ii) of this section, leaving balances of $50 in each of those accounts at the end of 1981.

Example (4). F and G are not members of an affiliated group in 1980, and G has an overall foreign loss of $200, which it adds to its overall foreign loss account. F has no overall foreign loss. On January 1, 1981, F acquires G, and FG files a consolidated return for the calendar year 1981. In 1981, F has no foreign source taxable income or loss, and G has $100 of foreign source taxable income. FG's consolidated foreign source taxable income, $100, minus such income without G's items of income and deduction, $0, is $100. Therefore 50% of that amount, $50, of G's overall foreign loss from its 1980 separate return limitation year is added to FG's consolidated overall foreign loss account under paragraph (b)(1)(iii) of this section, and the same amount is added to G's notional account under paragraph (c)(1)(i)(B) of this section. In accordance with paragraph (d) of this section and § 1.904(f)–2, FG must recapture the $50 balance in its consolidated overall foreign loss account in 1981 because the amount added from G's separate return limitation year is treated as a 1980 consolidated overall foreign loss. At the end of 1981, FG has a balance of $0 in its consolidated overall foreign loss account, G has $0 in its notional account, and G also has $150 remaining from its 1980 overall foreign loss that has not yet been added to the consolidated overall foreign loss account.

On January 1, 1982, F sells G and G leaves the affiliated group. Under paragraph (c)(3)(i) of this section, G takes with it the balance in its overall foreign loss account from 1980 (its prior separate return limitation year) that has not been added to the consolidated account. G has $150 of overall foreign loss in its overall foreign loss account. Because the amount in the consolidated overall foreign loss account is zero, no amount from that account is allocated to G.

Example (5). (i) In 1982 corporation H has United States source income of $300 and foreign source losses of $500, resulting in a net operating loss of $200 and a balance in H's overall foreign loss account at the end of 1982 of $300.

(ii) On January 1, 1983, H is acquired by J, and for the calendar year 1983 JH files a consolidated return. JH has consolidated taxable income of $700 in 1983, including a consolidated net operating loss deduction of $100. This net operating loss deduction is $100 of H's $200 net operating loss from 1982 (a separate return limitation year), which is limited by § 1.1502–21(c). For 1983, H has separate taxable income of $100, comprised of $100 of United States source taxable income and zero foreign source taxable income, and J has separate taxable income of $700, comprised of $700 of United States source taxable income and zero foreign source taxable income. Under paragraph (c)(2) of this section, H adds $100 to its separate overall foreign loss account, since that amount of its net operating loss has reduced United States source income. H has $400 in its separate overall foreign loss account at the end of 1983, none of which has been added to a consolidated overall foreign loss account.

(iii) In 1984, H has separate taxable income of $400, comprised of $100 of United States source taxable income and $300 of foreign source taxable income. J has separate taxable income of $900, comprised of $700 of United States source taxable income and $200 of foreign source taxable income. JH has consolidated taxable income of $1200, which includes $100 of consolidated net operating loss deduction from H's 1982 net operating loss. Since this net operating loss deduction is allocated to foreign source income, it does not reduce United States source income and will not be added to an overall foreign loss account. Under paragraph (b)(1)(iii) of this section, $100, from H's overall foreign loss is added to the consolidated overall foreign loss account computed as follows:

Consolidated foreign source taxable income	$400
Consolidated foreign source taxable income recomputed by excluding H's foreign source income and deduction	−200
$200	
× 50%	$100
Amount from H's separate return limitation year overall foreign loss account added to the consolidated overall foreign loss account	$100

This amount is subject to recapture beginning in the same taxable year, as it is treated as a consolidated overall foreign loss incurred in a previous year. Therefore, under paragraph (d) of this section and § 1.904(f)–2 JH also recaptures this $100, reducing the consolidated overall foreign loss account to $0. H has $300 remaining in its separate overall foreign loss account at the end of 1984.

(iv) In 1985, H has separate taxable income of $400, comprised of $100 of United States source taxable income and $300 of foreign source taxable income. J has separate taxable income of $300 comprised of $600 of United States source taxable income and $300 of foreign source losses. JH has consolidated taxable income of $700, all of which is United States source. Under paragraph (b)(1)(iii) of this section an additional $150 from H's separate overall foreign loss is added to the consolidated overall foreign loss account, computed as follows:

Consolidated foreign source taxable income	$0
Consolidated foreign source taxable income recomputed by excluding H's foreign source income and deductions	=(300)
300	
× 50%	$150
Amount from H's separate return limitation year overall foreign loss account added to the consolidated overall foreign loss account	$150

Thus, an additional $150 of H's separate overall foreign loss is added to the consolidated overall foreign loss account, and, under paragraph (c)(1)(i)(B) of this section, the same amount is added to J's notional account. While this amount is subject to recapture beginning in the same taxable year, JH has no consolidated foreign source taxable income on 1985, so no overall foreign loss is recaptured. H has a remaining balance of $150 in its separate return limitation year overall foreign loss account and HJ has $150 in its consolidated overall foreign loss account.

Example (6). A, B, and C are members of an affiliated group of corporations (as defined in section 1504), and all use the calendar year as their taxable year. For 1986, A, B, and C file a consolidated return. A has an overall foreign loss account which arose in a separate return limitation year. The amount in the overall foreign loss account is $2,000. A makes a disposition of all its assets to B on January 1, 1986. The gain on the transfer is $1,500, all of which would be recognized under section 904(f)(3). However,

if A adds the total amount of its overall foreign loss from separate return limitation years to ABC's consolidated overall foreign loss account, no gain will be recognized on the transfer until a restoration event under section 1.1502-13(f) occurs. In the interim, any foreign source gain of the purchasing member (or any other member of the consolidated group) may be used to recapture on a consolidated basis the amount in ABC's consolidated overall foreign loss account.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 5. Section 602.101 (c) is amended by inserting in the appropriate place in the table "§ 1.904(f)-1 . . . 1545-0121", "§ 1.904(f)-2 . . . 1545-0121", "§ 1.904(f)-3 . . . 1545-0121", "§ 1.904(f)-4 . . . 1545-0121", "§ 1.904(f)-5 . . . 1545-0121", "§ 1.904(f)-6 . . . 1545-0121", and "§ 1.1502-9 . . . 1545-0121".

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved:

J. Roger Mentz

Assistant Secretary of the Treasury.

July 30, 1987.

[FR Doc. 87-19337 Filed 8-21-87; 8:45 am]

BILLING CODE 4830-01-M

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26 CFR Parts 48 and 602

[T.D. 8154]

Excise Taxes; Sales of Diesel and Special Motor Fuel From Unattended Locations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to sales of liquid fuel from unattended locations. The regulations affect retailers of diesel fuel, special motor fuel, and fuel used in noncommercial aviation and provide them with the guidance needed to comply with the law.

DATE: The regulations are effective on or after January 2, 1986.

FOR FURTHER INFORMATION CONTACT: William A. Jackson of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224 (Attention: CC:LR:T), (202) 566-4336, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

This document contains temporary regulations amending the Excise Tax Regulations (26 CFR Part 48) under section 4041 of the Internal Revenue Code of 1986 (Code). These regulations are intended to clarify treatment of sales of liquid fuel from unattended locations.

In General

Under section 4041(a)(1) of the Code, excise taxes are imposed on the sale of any liquid sold for use as fuel in a diesel-powered highway vehicle. The taxes are imposed when the liquid is sold to an owner, lessee, or other operator of a diesel powered highway vehicle for use as fuel in such vehicle.

Sales From Unattended Locations

Section 48.4041-5(a)(1) of the regulations provides that the sale of diesel fuel, special motor fuel, or fuel used in noncommercial aviation is considered a taxable sale if the seller delivers the fuel into the fuel supply tank of a vehicle, motorboat, or aircraft. Section 48.4041-5(a)(1) further provides that for this purpose, fuel sold at a location unattended by the seller is considered to be delivered into the fuel supply tank by the seller. This provision regarding sales from unattended locations was added to the regulations by T.D. 8066, published on January 2, 1986 (51 FR 11).

The regulations clarify that the rule in §48.4041-5(a)(1) regarding sales from unattended locations only applies to sales on or after January 2, 1986. In addition, § 48.4041-5(a)(1)(ii) of the regulations provides that sales of fuel for nontaxable uses from unattended locations will not be considered taxable if the seller maintains special devices to accurately account for sales to customers who regularly purchase fuel for nontaxable uses. The regulations further provide that the seller must maintain accurate records of such nontaxable sales.

This amendment to the regulations is effective for sales of fuel on or after January 2, 1986.

Need for Temporary Regulations

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it was found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Special Analysis

Executive Order 12291

The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291. Accordingly, a Regulatory Impact Analysis is not required.

Regulatory Flexibility Analysis

No notice of proposed rulemaking is required by 5 U.S.C 553 (b) for temporary regulations. Accordingly, the Regulatory Flexibility Act does not apply and no Regulatory Flexibility Analysis is required for this rule.

Paperwork Reduction Act

The collection of information requirements contained in these temporary regulations have been submitted to the Office of Management and Budget (OMB) for review under the Paperwork Reduction Act of 1980. These regulations have been approved by OMB.

Drafting Information

The principal author of these temporary regulations is William A. Jackson of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel fom other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

List of Subjects in 26 CFR Part 48

Agriculture, Arms and munitions, Coal, Excise taxes, Gasohol, Gasoline, Motor vehicles, Petroleum, Sporting goods, Tires.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Parts 48 and 602 are amended as follows:

PART 48—[AMENDED]

Paragraph 1. The authority for Part 48 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 2. Section 48.4041-5 is amended as follows:

1. The text of paragraph (a) (1) is redesignated as paragraph (a) (1) (i).

2. The second sentence of newly designated paragraph (a) (1) (i) is revised to read as set forth below.