

(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 in 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 ( $\$460 \times 28/46 = \$280$ ), 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.

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### § 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 possession 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 sepa-

rate 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
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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  $\$650/\$1,500 \times \$690$   $((.46)(500+720) + (.28)(460))$ , or \$299, instead of  $\$1,000/\$1,500 \times \$690$ , 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*—(1) *Recogni-*

*tion 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 applies);

(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 × \$1,000) instead of \$500 (\$1,000/\$2,000 × \$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

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

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

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

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

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

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

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