[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106902-98]

RIN 1545-AW08

Consolidated returns -- Consolidated overall foreign losses and separate limitation losses

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of proposed rulemaking by cross-reference to temporary regulations; and notice of public hearing

SUMMARY: This document contains proposed consolidated return regulations relating to the treatment of overall foreign losses and separate limitation losses in the computation of the foreign tax credit limitation. The proposed rules are necessary to modify existing guidance with respect to overall foreign losses and to provide guidance with respect to separate limitation losses. These proposed regulations affect consolidated groups that compute the foreign tax credit limitation or that dispose of property used in a foreign trade or business. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by February 10, 1999. Outlines of oral comments to be discussed at the public hearing scheduled for 10 a.m. on February 17, 1999, must be received by January 27, 1999.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG-106902-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-106902-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments. html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations in general, Trina Dang of the Office of Associate Chief Counsel (International), (202) 622-3850; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of**

Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by March 1, 1999. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in this proposed regulation is in §1.1502-9(c)(2)(iv). This information is required to help the Internal Revenue Service monitor compliance with the provisions of the proposed regulations and to ensure that taxpayers use consistent asset valuations in applying the proposed regulations. This information will be used for tax administration purposes.

The collection of information is mandatory. The likely respondents are business or other for-profit institutions.
Estimated total annual reporting burden: 3,000 hours.
Estimated average annual burden per respondent: 1.5 hours.
Estimated number of respondents: 2,000.
Estimated annual frequency of responses: on occasion.
An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.
Books or records relating to a collection of information must be retained so long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed consolidated return regulations under section 1502 of the Internal Revenue Code. The regulations provide guidance concerning the application of the overall foreign loss (OFL) and separate limitation loss (SLL) rules of section 904(f) in the context of a consolidated group.

On January 12, 1998, the IRS and Treasury published in the **Federal Register** (TD 8751, 63 FR 1740) temporary regulations modifying the rules governing the absorption of certain tax attributes, including OFL accounts and foreign tax credit carryovers and carrybacks. The temporary regulations eliminated

the limitation on OFL recapture and foreign tax credit utilization with respect to separate return limitation years (SRLYs). As explained in the preamble to those temporary regulations, one reason for the repeal of the SRLY limitation for the foreign tax credit attributes was the conceptual and practical difficulty of measuring a member’s contribution to a group’s ability to absorb these attributes in light of foreign tax credit provisions that allocate interest expense and certain other expenses (and intercompany interest income) of a member based upon the entire group’s assets or activities. The preamble to those regulations noted that these expense allocation provisions also create similar problems with respect to the notional account method of apportioning OFL accounts to a member ceasing to be a member of a group and stated that the IRS and Treasury expected to modify these rules in the near future.

Overview

The proposed regulations modify the existing regulations under §1.1502-9, which were promulgated in 1987 (the 1987 regulations). The 1987 regulations are proposed to be amended in three major respects: the notional account method for apportioning OFL accounts to a departing member is replaced by an asset-based allocation method, the interaction between the intercompany transaction rules and the disposition rules of section 904(f)(3) and (5)(F) is simplified and refined, and guidance is provided concerning the computation of a group's SLLs (whereas the 1987 regulations addressed only OFLs).

The 1987 regulations allocated an OFL account to a departing member based upon the member's "notional" OFL account. A separate notional account was established for each member of a group that contributed to a consolidated OFL account. The accounts were adjusted annually. A member was considered to have contributed to a group's OFL account if the member had an overall foreign loss (deductions allocated against foreign-source income exceeded foreign-source gross income) in a year in which the group added to its consolidated OFL account.

At the time the 1987 regulations were being drafted, however, Congress substantially changed the rules for allocating interest expense in the Tax Reform Act of 1986. Congress believed that corporations were borrowing in ways designed to inappropriately minimize the amount of interest expense allocated against foreign-source income, thus inflating the amount of foreign-source income that could be sheltered from U.S. tax by foreign tax credits. In the case of an affiliated group, Congress was concerned that interest expense allocation could be manipulated by placing the borrowing function in group members with no foreign assets, while diverting available equity in the group to members with substantial foreign assets. Congress therefore enacted section 864(e), which requires an affiliated group to allocate interest expense of each member as if all such members were a single corporation. Under this rule, although the borrowing corporation incurs the interest expense, that expense is allocated among U.S. and foreign income based upon the assets

of the group as a whole. (Group-based expense allocation is also required for research and experimental expenditures under section 864(f) and expenses not directly allocable to specific income under section 864(e)(6).)

Due in large measure to these group-based expense allocation provisions, the notional account method can result in a member taking from a group an OFL or SLL account that is unrelated to either the member’s activities or future income. For example, assume that P holds all the stock of S and S holds all the stock of R. P, S, and R file a consolidated return. P has no assets other than the stock of S. S’s operations are foreign and R’s operations are entirely domestic. S’s assets have a tax book value of $600 and R’s assets have a tax book value of $400. S is entirely equity financed, but R borrows funds from an unrelated lender. S earns $100 foreign-source income and incurs $100 of foreign-allocated expense. R earns $200 U.S.-source income and incurs $100 of interest expense. Under section 864(e)(1) and §1.861-11T, the $100 of interest expense is allocated to R’s U.S. and foreign-source gross income based upon the assets of the group as a whole. Thus R, with no foreign operations, is treated as having a $60 foreign loss (no foreign income and $60 foreign expense), but S, the only member with foreign operations, does not have a foreign loss. R's notional OFL account would thus be $60 (100 percent of the consolidated OFL account) and, if R left the group, R would take the entire consolidated OFL account with it. The group, however, would retain the foreign assets and the

OFL account might never be recaptured.

As described in more detail below, the proposed regulations do not apply the notional account approach, but instead apportion accounts to a departing member based upon the member’s share of the group’s foreign assets that produce foreign-source income that would be subject to recapture. The new approach does not attempt to measure a member’s "contribution" to the group’s consolidated account; rather, the asset approach associates an OFL or SLL account with a member’s foreign assets that produce income subject to recapture and measures each member's share of the group OFL or SLL account based upon the member's share of these assets. This approach is more in keeping with the interest allocation provisions for affiliated groups enacted in 1986.

The proposed regulations also modify the interaction between section 904(f) and the intercompany transaction rules of §1.1502-13. Under the 1987 regulations, a consolidated OFL account could trigger gain recognition with respect to an otherwise tax-free intercompany transaction (such as a member's contribution under section 351 to another member of the group) that is a disposition subject to section 904(f)(3) or (5)(F). This gain recognition could occur even though the gain would not be taken into account currently under §1.1502-13. Because the gain is not taken into account, however, the consolidated OFL account is not reduced. Since the consolidated OFL account is not reduced, it can continue to recharacterize foreign-source income or trigger gain recognition with respect to subsequent dispositions subject to

section 904(f)(3) or (5)(F). This regime thus has the potential to multiply the effects of a consolidated OFL account. This rule was necessary under the notional account system of apportioning OFL accounts to a departing member because otherwise a member with a notional OFL account could contribute appreciated foreign assets to a new subsidiary, and the new subsidiary could then leave the group unencumbered by the OFL account, contrary to the purpose of section 904(f)(3). As described in more detail below, the proposed regulations ease the section 904(f)(3) and (5)(F) disposition rules in the case of intercompany transactions.

Finally, the proposed regulations provide computational rules and nomenclature for SLLs as well as OFLs. Because the regulations issued in 1987 were actually drafted prior to the enactment of the SLL rules in 1986, the 1987 regulations provide rules only for OFLs, although rules for SLLs could be derived by analogy.

Explanation of Provisions

The proposed regulations do not provide comprehensive guidance under section 904(f) and address only particular section 904(f) issues that arise in the context of a consolidated group. The proposed regulations must be read in conjunction with general guidance under section 904(f), such as Notice 89-3 (1989-1 C.B. 623).

Proposed §1.1502-9(b)(1) through (4) provides computational rules for consolidated OFL and SLL accounts. Generally, a group applies section 904(f) on a group-wide basis. Thus, it nets

together all members' income and losses from the same separate limitation income category (or basket) to determine its consolidated separate limitation income or loss for the basket. Pursuant to section 904(f)(5), the group then nets any consolidated separate limitation loss for a basket (a loss basket) against consolidated separate limitation income for all other baskets (the income baskets) on a proportionate basis. Such netting creates a consolidated SLL account (a CSLL account) for the loss basket with respect to one or more income baskets. The group then nets any remaining consolidated separate limitation loss for a loss basket against its U.S.-source income. Such netting creates a consolidated OFL account (a COFL account) for the loss basket. The group recaptures a COFL or CSLL account as required by section 904(f).

Proposed §1.1502-9(b)(5) addresses the interaction between section 904(f) and the intercompany transaction rules. In the case of an intercompany transaction in which gain is recognized but not currently taken into account, the gain is treated as subject to section 904(f)(3) or (5)(F) only when taken into account under §1.1502-13, to the extent of the COFL or CSLL account existing at that time. In the case of an intercompany transaction in which gain is not recognized (such as a section 351 contribution), section 904(f) will not trigger gain recognition.

Proposed §1.1502-9(c) provides rules for members becoming or ceasing to be members of a group. Consistent with the temporary

regulations issued in January 1998, and modified in March 1998 and in temporary regulations published elsewhere in this issue of the **Federal Register**, a member that enters a group with an OFL or SLL account adds this account to the consolidated account, without any SRLY limitation. A departing member takes a portion of the group’s COFL and CSLL accounts based upon the member’s share of the group’s assets that generate income subject to recapture (i.e., assets that generate income in the same basket as the loss basket). The proposed regulations rely on the characterization principles of §§1.861-9T(g)(3) and 1.861-12T to identify the member’s share of assets that generate foreign-source income subject to recapture in each basket. The value of the foreign assets is determined under the asset valuation rules of §1.861-9T(g)(1) and (2) using either tax book value or fair market value under the method chosen by the group for purposes of interest apportionment as provided in §1.861-9T(g)(1)(ii). Although actual market values generally provide a better means of apportioning accounts than tax book values (since market values more accurately represent the projected future earnings of an asset), apportionment based upon tax book value is permitted in the interest of administrative convenience. For groups using tax book value, however, an upper limitation is placed upon a member's share of the consolidated accounts to prevent extreme situations in which disparities between tax book value and fair market value could result in the removal of excessive OFL or SLL accounts from the group. The proposed regulations provide an

anti-abuse rule that is designed to prevent taxpayers from manipulating the COFL and CSLL account apportionment rules to achieve results inconsistent with the purpose of the OFL and SLL rules.

Proposed §1.1502-9(c)(2)(i) provides that a group apportions COFL and CSLL accounts to a departing member only after the group makes the annual additions or reductions to the accounts to reflect current-year foreign-source income or loss. To the extent this rule conflicts with the ordering rules of §1.904(f)-1(e)(1), the proposed rule, when finalized, is intended to supersede the existing regulations.

Proposed Effective Dates

These regulations are proposed to apply to consolidated return years for which a return is due after the date final regulations are published in the **Federal Register**. However, §1.1502-9(b)(5) (intercompany transactions) is not applicable for intercompany transactions that occur before January 28, 1999. Also, §1.1502-9(c)(2) (apportionment of consolidated account to departing member) is not applicable for members ceasing to be members of a group before January 28, 1999.

Election to Defer Repeal of SRLY Limitation

Temporary regulations published elsewhere in this issue of the **Federal Register** permit consolidated groups to elect to continue to apply the SRLY limitation for overall foreign loss accounts for consolidated years beginning before January 1, 1998, as announced in Notice 98-40 (1998-35 I.R.B. 7). The text of

those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory impact analysis is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations principally affect corporations filing consolidated federal income tax returns that have overall foreign losses or separate limitation losses. Available data indicates that many consolidated return filers are large companies (not small businesses). In addition, the data indicates that an insubstantial number of consolidated return filers that are smaller companies have overall foreign losses or separate limitation losses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments

that are submitted timely to the IRS (a signed original and eight (8) copies). In particular, the IRS and Treasury request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 17, 1999, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by January 27, 1999. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Seth B. Goldstein and Trina Dang, of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1502-9 also issued under 26 U.S.C. 1502. * * *

Section 1.1502-9A also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.1502-3, as proposed to be amended at 63 FR 12717, March 16, 1998, is further amended by removing the last sentence of paragraph (c)(4) and adding two sentences in its place to read as follows:

<u>§1.1502-3 Consolidated investment credit</u>.

* * * * *

(c) * * *

(4) * * * [The last two sentences of proposed paragraph (c)(4) is the same as the last two sentences of §1.1502-3T(c)(4) published elsewhere in this issue of the **Federal Register**.]

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Par. 3. Immediately following §1.1504-4 an undesignated center heading is added to read as follows:

REGULATIONS APPLICABLE FOR TAX YEARS FOR WHICH A RETURN IS DUE ON OR BEFORE THE DATE FINAL REGULATIONS ARE PUBLISHED IN THE FEDERAL REGISTER

Par. 4. Section 1.1502-9 is redesignated as §1.1502-9A and added under the new undesignated center heading.

Par. 5. Newly designated §1.1502-9A is amended by:

1. Revising the section heading.

2. Redesignating the heading and text of paragraph (a) as the heading and text of paragraph (a)(2).

3. Adding a new heading to paragraph (a), and new paragraphs (a)(1), (b)(1)(v) and (b)(1)(vi).

The revisions and additions read as follows:

§1.1502-9A Application of overall foreign loss recapture rules to corporations filing consolidated returns due on or before the date final regulations are published in the **Federal Register**.

(a) Scope--(1) Effective date. This section applies only to consolidated return years for which the due date of the income tax return (without extensions) is on or before the date final regulations are published in the **Federal Register.**

(2) In general. * * *

(b) * * *

(1) * * *

(v) [The text of this proposed paragraph (b)(1)(v) is the same as the text of §1.1502-9T(b)(1)(v) published elsewhere in

this issue of the **Federal Register**.]

(vi) [The text of this proposed paragraph (b)(1)(vi) is the same as the text of §1.1502-9T(b)(1)(vi) published elsewhere in this issue of the **Federal Register**.]

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Par. 6. New §1.1502-9 is added to read as follows:

§1.1502-9 Consolidated overall foreign losses and separate limitation losses.

(a) In general. This section provides rules for applying section 904(f) (including its definitions and nomenclature) to a group and its members. Generally, section 904(f) concerns rules relating to overall foreign losses (OFLs) and separate limitation losses (SLLs) and the consequences of such losses. As provided in section 904(f)(5), losses are computed separately in each category of income described in section 904(d)(1) (basket). Paragraph (b) of this section defines terms and provides computational and accounting rules, including rules regarding recapture. Paragraph (c) of this section provides rules that apply to OFLs and SLLs when a member becomes or ceases to be a member of a group. Paragraph (d) of this section provides a predecessor and successor rule. Paragraph (e) of this section provides effective dates.

(b) Consolidated application of section 904(f). A group applies section 904(f) for a consolidated return year in accordance with that section, subject to the following rules:

(1) Computation of CSLI or CSLL and consolidated U.S. source

income or loss. The group computes its consolidated separate limitation income (CSLI) or consolidated separate limitation loss (CSLL) for each basket under the principles of §1.1502-11 by aggregating each member's foreign-source taxable income or loss in such basket computed under the principles of §1.1502-12, and taking into account the foreign portion of the consolidated items described in §1.1502-11(a)(2) through (8) for such basket. The group computes its consolidated U.S.-source taxable income or loss under similar principles.

(2) Netting CSLLs, CSLIs, and consolidated U.S. source taxable income or loss. The group applies section 904(f)(5) to determine the extent to which a CSLL for a basket reduces CSLI for another basket or consolidated U.S.-source taxable income.

(3) CSLL and COFL accounts. To the extent provided in section 904(f), the amount by which a CSLL for a basket (the loss basket) reduces CSLI for another basket (the income basket) shall result in the creation of (or addition to) a CSLL account for the loss basket with respect to the income basket. Likewise, the amount by which a CSLL for a loss basket reduces consolidated U.S.-source income will create (or add to) a consolidated overall foreign loss account (a COFL account).

(4) Recapture of COFL and CSLL accounts. In the case of a COFL account for a loss basket, section 904(f)(1) and (3) recharacterizes some or all of the foreign-source income in the loss basket as U.S.-source income. In the case of a CSLL account for a loss basket with respect to an income basket, section 904(f)(5)(C) and (F) recharacterizes some or all of the foreign-

source income in the loss basket as foreign-source income in the income basket. The COFL account or CSLL account is reduced to the extent amounts are recharacterized with respect to such account.

(5) Intercompany transactions--(i) Nonapplication of section 904(f) disposition rules. Neither section 904(f)(3) (in the case of a COFL account) nor (5)(F) (in the case of a CSLL account) applies at the time of a disposition that is an intercompany transaction to which §1.1502-13 applies. Instead, section 904(f)(3) and (5)(F) applies only at such time and only to the extent that the group is required under §1.1502-13 (without regard to section 904(f)(3) and (5)(F)) to take into account any intercompany items resulting from the disposition, based on the COFL or CSLL account existing at the end of the consolidated return year during which the group takes the intercompany items into account.

(ii) Example. Paragraph (b)(5)(i) of this section is illustrated by the following examples. The identity of the parties and the basic assumptions set forth in §1.1502-13(c)(7)(i) apply to the examples. Except as otherwise stated, assume further that the consolidated group recognizes no foreign-source income other than as a result of the transactions described. The examples are as follows:

Example 1. (i) On June 10, Year 1, S transfers nondepreciable property with a basis of $100 and a fair market value of $250 to B in a transaction to which section 351 applies. The property was predominantly used without the United States in a trade or business, within the meaning of section 904(f)(3). B continues to use the property without the United States. The group has a COFL account in the relevant loss basket of $120 as

of December 31, Year 1.

(ii) Because the contribution from S to B is an intercompany transaction, section 904(f)(3) does not apply to result in any gain recognition in Year 1. See paragraph (b)(5)(i) of this section.

(iii) On January 10, Year 4, B ceases to be a member of the group. Because S did not recognize gain in Year 1 under section 351, no gain is taken into account in Year 4 under §1.1502-13(d). Thus, no portion of the group's COFL account is recaptured in Year 4. For rules requiring apportionment of a portion of the COFL account to B, see paragraph (c)(2) of this section.

Example 2. (i) The facts are the same as in paragraph (i) of Example 1. On January 10, Year 4, B sells the property to X for $300. As of December 31, Year 4, the group's COFL account is $40. (The COFL account was reduced between Year 1 and Year 4 due to unrelated foreign-source income taken into account by the group.)

(ii) B takes into account gain of $200 in Year 4. The $40 COFL account in Year 4 recharacterizes $40 of the gain as U.S. source. See section 904(f)(3).

Example 3. (i) On June 10, Year 1, S sells nondepreciable property with a basis of $100 and a fair market value of $250 to B for $250 cash. The property was predominantly used without the United States in a trade or business, within the meaning of section 904(f)(3). The group has a COFL account in the relevant loss basket of $120 as of December 31, Year 1. B predominately uses the property in a trade or business without the United States.

(ii) Because the sale is an intercompany transaction, section 904(f)(3) does not require the group to take into account any gain in Year 1. Thus, under paragraph (b)(5)(i) of this section, the COFL account is not reduced in Year 1.

(iii) On January 10, Year 4, B sells the property to X for $300. As of December 31, Year 4, the group's COFL account is $60. (The COFL account was reduced between Year 1 and Year 4 due to unrelated foreign-source income taken into account by the group.)

(iv) In Year 4, S's $150 intercompany gain and B's $50 corresponding gain are taken into account to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation. See §1.1502-13(c). All of B's $50 corresponding gain is recharacterized under section 904(f)(3). If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's $100 basis in the property and would have

$200 of gain ($60 of which would be recharacterized under section 904(f)(3)), instead of a $50 gain. Consequently, S's $150 intercompany gain and B's $50 corresponding gain are taken into account, and $10 of S's gain is recharacterized under section 904(f)(3) as U.S. source to reflect the $10 difference between B's $50 recharacterized gain and the $60 recomputed gain that would have been recharacterized.

(c) Becoming or ceasing to be a member of a group--(1) Adding separate accounts on becoming a member. At the time that a corporation becomes a member of a group (a new member), the group adds to the balance of its COFL or CSLL account the balance of the new member's corresponding OFL account or SLL account. A new member's OFL account corresponds to a COFL account if the account is for the same loss basket. A new member's SLL account corresponds to a CSLL account if the account is for the same loss basket and with respect to the same income basket. If the group does not have a COFL or CSLL account corresponding to the new member's account, it creates a COFL or CSLL account with a balance equal to the balance of the member's account.

(2) Apportionment of consolidated account to departing member--(i) In general. A group apportions to a member that ceases to be a member (a departing member) a portion of each COFL and CSLL account as of the end of the year during which the member ceases to be a member and after the group makes the additions or reductions to such account required under paragraphs (b)(3), (b)(4) and (c)(1) of this section (other than an addition under paragraph (c)(1) of this section attributable to a member becoming a member after the departing member ceases to be a member). The group computes such portion under paragraph (c)(2)(ii) of this section, as limited by paragraph (c)(2)(iii)

of this section. The departing member carries such portion to its first separate return year after it ceases to be a member. Also, the group reduces each account by such portion and carries such reduced amount to its first consolidated return year beginning after the year in which the member ceases to be a member. If two or more members cease to be members in the same year, the group computes the portion allocable to each such member (and reduces its accounts by such portion) in the order that the members cease to be members.

(ii) Departing member’s portion of group’s account. A departing member’s portion of a group’s COFL or CSLL account for a loss basket is computed based upon the member’s share of the group’s assets that generate income subject to recapture at the time that the member ceases to be a member. Under the characterization principles of §§1.861-9T(g)(3) and 1.861-12T, the group identifies the assets of the departing member and the remaining members that generate foreign-source income (foreign assets) in each basket. The assets are characterized based upon the income that the assets are reasonably expected to generate after the member ceases to be a member. The member's portion of a group's COFL or CSLL account for a loss basket is the group's COFL or CSLL account, respectively, multiplied by a fraction, the numerator of which is the value of the member's foreign assets for the loss basket and the denominator of which is the value of the foreign assets of the group (including the departing member) for the loss basket. The value of the foreign assets is determined under the asset valuation rules of §1.861-9T(g)(1) and

(2) using either tax book value or fair market value under the method chosen by the group for purposes of interest apportionment as provided in §1.861-9T(g)(1)(ii). For purposes of this paragraph (c)(2)(ii), §1.861-9T(g)(2)(iv) (assets in intercompany transactions) shall apply, but §1.861-9T(g)(2)(iii) (adjustments for directly allocated interest) shall not apply. If the group uses the tax book value method, the member's portions of COFL and CSLL accounts are limited by paragraph (c)(2)(iii) of this section. The assets should be valued at the time the member ceases to be a member, but values on other dates may be used unless this creates substantial distortions. For example, if a member ceases to be a member in the middle of the group's consolidated return year, an average of the values of assets at the beginning and end of the year (as provided in §1.861-9T(g)(2)) may be used or, if a member ceases to be a member in the early part of the group's consolidated return year, values at the beginning of the year may be used, unless this creates substantial distortions.

(iii) Limitation on member's portion for groups using tax book value method. If a group uses the tax book value method of valuing assets for purposes of paragraph (c)(2)(ii) of this section and the aggregate of a member's portions of COFL and CSLL accounts for a loss basket (with respect to one or more income baskets) determined under paragraph (c)(2)(ii) of this section exceeds 150 percent of the actual fair market value of the member's foreign assets in the loss basket, the member's portion of the COFL or CSLL accounts for the loss basket shall be reduced

(proportionately, in the case of multiple accounts) by such excess. This rule does not apply if the departing member and all other members that cease to be members as part of the same transaction own all (or substantially all) the foreign assets in the loss basket.

(iv) Determination of values of foreign assets binding on departing member. The group's determination of the value of the member's and the group's foreign assets for a loss basket is binding on the member, unless the District Director concludes that the determination is not appropriate. The common parent of the group must attach a statement to the return for the taxable year that the departing member ceases to be a member of the group that sets forth the name and taxpayer identification number of the departing member, the amount of each COFL or CSLL for each loss basket that is apportioned to the departing member under this paragraph (c)(2), the method used to determine the value of the member's and the group's foreign assets in each such loss basket, and the value of the member's and the group's foreign assets in each such loss basket. The common parent must also furnish a copy of the statement to the departing member.

(v) Anti-abuse rule. If a corporation becomes a member and ceases to be a member, and a principal purpose of the corporation becoming and ceasing to be a member is to transfer the corporation's OFL account or SLL account to the group or to transfer the group's COFL or CSLL account to the corporation, appropriate adjustments will be made to eliminate the benefit of such a transfer of accounts. Similarly, if any member acquires

assets or disposes of assets (including a transfer of assets between members of the group and the departing member) with a principal purpose of affecting the apportionment of accounts under paragraph (c)(2)(i) of this section, appropriate adjustments will be made to eliminate the benefit of such acquisition or disposition.

(vi) Examples. The following examples illustrate this paragraph (c):

Example 1. (i) On November 6, Year 1, S, a member of the P group, a consolidated group with a calendar consolidated return year, ceases to be a member of the group. On December 31, Year 1, the P group has a $40 COFL account for the general limitation basket, a $20 CSLL account for the general limitation basket (i.e., the loss basket) with respect to the passive basket (i.e., the income basket), and a $10 CSLL account for the shipping income basket (i.e., the loss basket) with respect to the passive basket, (i.e., the income basket). No member of the group has foreign-source income or loss in Year 1. The group apportions its interest expense according to the tax book value method.

(ii) On November 6, Year 1, the group identifies S's assets and its own assets (including S's assets) expected to produce foreign general limitation income. Use of end-of-the-year values will not create substantial distortions in determining the relative values of S's and the group's relevant assets on November 6, Year 1. The group determines that S's relevant assets have a tax book value of $2,000 and a fair market value of $2,200. Also, the group's relevant assets (including S's assets) have a tax book value of $8,000. On November 6, Year 1, S has no assets expected to produce foreign shipping income.

(iii) Under paragraph (c)(2)(ii) of this section, S takes a $10 COFL account for the general limitation basket ($40 x $2000/$8000) and a $5 CSLL account for the general limitation basket with respect to the passive basket ($20 x $2000/$8000). S does not take any portion of the shipping income basket CSLL account. The limitation described in paragraph (c)(2)(iii) of this section does not apply because the aggregate of the COFL and CSLL accounts for the general limitation basket that are apportioned to S ($15) is less than 150 percent of the actual fair market value of S's general limitation foreign assets ($2,200 x 150%).

Example 2. (i) Assume the same facts as in Example 1, except that the fair market value of S's general limitation

foreign assets is $4 as of November 6, Year 1.

(ii) Under paragraph (c)(2)(iii) of this section, S's COFL and CSLL accounts for the general limitation basket must be reduced by $9, which is the excess of $15 (the aggregate amount of the accounts apportioned under paragraph (c)(2)(ii) of this section) over $6 (150 percent of the $4 actual fair market value of S's general limitation foreign assets). S thus takes a $4 COFL account for the general limitation basket ($10 - ($9 x $10/$15)) and a $2 CSLL account for the general limitation basket with respect to the passive basket ($5 - ($9 x $5/$15)).

(d) Predecessor and successor. A reference to a member includes, as the context may require, a reference to a predecessor or successor of the member. See §1.1502-1(f).

(e) Effective dates. This section applies to consolidated return years for which the due date of the income tax return (without extensions) is after the date final regulations are published in the **Federal Register**. However, paragraph (b)(5) of this section (intercompany transactions) is not applicable for intercompany transactions that occur before January 28, 1999. A group applies the principles of §1.1502-9A(e) to a disposition which is an intercompany transaction to which §1.1502-13 applies and that occurs before January 28, 1999. Also, paragraph (c)(2) of this section (apportionment of consolidated account to departing member) is not applicable for members ceasing to be members of a group before January 28, 1999. A group applies the principles of §1.1502-9A (rather than paragraph (c)(2) of this section) to determine the amount of a consolidated account that is apportioned to a member that ceases to be a member of the group before January 28, 1999 (and reduces its consolidated account by such apportioned amount) before applying paragraph

(c)(2) of this section to members that cease to be members on or after January 28, 1999.

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Deputy Commissioner of Internal Revenue