

aggregate balance of the taxpayer's overall domestic loss accounts or 50 percent of the taxpayer's U.S. source taxable income (as determined under paragraph (b) of this section).

(d) *Effective/applicability date.* This section applies to taxpayers that sustain an overall domestic loss for a taxable year beginning on or after January 1, 2012. Taxpayers may choose to apply this section to overall domestic losses sustained in other taxable years beginning after December 31, 2006, including periods covered by 26 CFR 1.904(g)-2T (revised as of April 1, 2010).

[T.D. 9595, 77 FR 37581, June 22, 2012]

§ 1.904(g)-3 Ordering rules for the allocation of net operating losses, net capital losses, U.S. source losses, and separate limitation losses, and for the recapture of separate limitation losses, overall foreign losses, and overall domestic losses.

(a) *In general.* This section provides ordering rules for the allocation of net operating losses, net capital losses, U.S. source losses, and separate limitation losses, and for the recapture of separate limitation losses, overall foreign losses, and overall domestic losses. The rules must be applied in the order set forth in paragraphs (b) through (i) of this section.

(b) *Step One: Allocation of net operating loss and net capital loss carryovers*—(1) *In general.* Net operating losses from a current taxable year are carried forward or back to a taxable year in the following manner. Net operating losses that are carried forward pursuant to section 172 are combined with income or loss in the carryover year in the manner described in this paragraph (b). The combined amounts are then subject to the ordering rules provided in paragraphs (c) through (i) of this section. Net operating losses that are carried back to a prior taxable year pursuant to section 172 are allocated to income in the carryback year in the manner set forth in paragraphs (b)(2), (b)(3), (c), (d), and (e) of this section. The income in the carryback year to which the net operating loss is allocated is the foreign source income in each separate category and the U.S. source income after the application of sections 904(f) and 904(g) to income and

loss in that previous year, including as a result of net operating loss carryovers or carrybacks from taxable years prior to the current taxable year.

(2) *Full net operating loss carryover.* If the full net operating loss (that remains after carryovers to other taxable years) is less than or equal to the taxable income in a particular taxable year (carryover year), and so can be carried forward in its entirety to such carryover year, U.S. source losses and foreign source losses in separate categories that are part of a net operating loss from a particular taxable year that is carried forward in its entirety shall be combined with the U.S. source income or loss and the foreign source income or loss in the same separate categories in the carryover year.

(3) *Partial net operating loss carryover.* If the full net operating loss (that remains after carryovers to other taxable years) exceeds the taxable income in a carryover year, and so cannot be carried forward in its entirety to such carryover year, the following rules apply:

(i) Any U.S. source loss (not to exceed the net operating loss carryover) shall be carried over to the extent of any U.S. source income in the carryover year.

(ii) If the net operating loss carryover exceeds the U.S. source loss carryover determined under paragraph (b)(3)(i) of this section, then separate limitation losses that are part of the net operating loss shall be tentatively carried over to the extent of separate limitation income in the same separate category in the carryover year. If the sum of the potential separate limitation loss carryovers determined under the preceding sentence exceeds the amount of the net operating loss carryover reduced by any U.S. source loss carried over under paragraph (b)(3)(i) of this section, then the potential separate limitation loss carryovers shall be reduced pro rata so that their sum equals such amount.

(iii) If the net operating loss carryover exceeds the sum of the U.S. and separate limitation loss carryovers determined under paragraphs (b)(3)(i) and (ii) of this section, then a proportionate part of the remaining loss from each separate category shall be carried over to the extent of such excess and

combined with the foreign source loss, if any, in the same separate categories in the carryover year.

(iv) If the net operating loss carryover exceeds the sum of all the loss carryovers determined under paragraphs (b)(3)(i), (ii), and (iii) of this section, then any U.S. source loss not carried over under paragraph (b)(3)(i) of this section shall be carried over to the extent of such excess and combined with the U.S. source loss, if any, in the carryover year.

(4) *Net capital loss carryovers.* Rules similar to the rules of paragraphs (b)(1) through (3) of this section apply for purposes of determining the components of a net capital loss carryover to a taxable year.

(c) *Step Two: Section 904(b) adjustments.* The taxpayer shall make any required adjustments to capital gains and losses and qualified dividend income under section 904(b)(2).

(d) *Step Three: Allocation of separate limitation losses.* The taxpayer shall allocate separate limitation losses sustained during the taxable year (increased, if appropriate, by any losses carried over under paragraph (b) of this section), in the following manner—

(1) The taxpayer shall allocate its separate limitation losses for the taxable year to reduce its separate limitation income in other separate categories on a proportionate basis, and increase its separate limitation loss accounts appropriately. To the extent a separate limitation loss in one separate category is allocated to reduce separate limitation income in a second separate category, and the second category has a separate limitation loss account from a prior taxable year with respect to the first category, the two separate limitation loss accounts shall be netted against each other.

(2) If the taxpayer's separate limitation losses for the taxable year exceed the taxpayer's separate limitation income for the year, so that the taxpayer has separate limitation losses remaining after the application of paragraph (d)(1) of this section, the taxpayer shall allocate those losses to its U.S. source income for the taxable year, to the extent thereof, and shall increase its overall foreign loss accounts to that extent in accordance with § 1.904(f)-1.

(e) *Step Four: Allocation of U.S. source losses.* The taxpayer shall allocate U.S. source losses sustained during the taxable year (increased, if appropriate, by any losses carried over under paragraph (b) of this section) to separate limitation income on a proportionate basis, and shall increase its overall domestic loss accounts to the extent of such allocation in accordance with § 1.904(g)-1.

(f) *Step Five: Recapture of overall foreign loss accounts.* If the taxpayer's separate limitation income for the taxable year (reduced by any losses carried over under paragraph (b) of this section) exceeds the sum of the taxpayer's U.S. source loss and separate limitation losses for the year, so that the taxpayer has separate limitation income remaining after the application of paragraphs (d)(1) and (e) of this section, then the taxpayer shall recapture prior year overall foreign losses, if any, and reduce overall foreign loss accounts in accordance with § 1.904(f)-2.

(g) *Step Six: Recapture of separate limitation loss accounts.* To the extent the taxpayer has remaining separate limitation income for the year after the application of paragraph (f) of this section, then the taxpayer shall recapture prior year separate limitation losses, if any, in accordance with § 1.904(f)-8 and reduce separate limitation loss accounts in accordance with § 1.904(f)-7.

(h) *Step Seven: Recapture of overall domestic loss accounts.* If the taxpayer's U.S. source income for the year (reduced by any losses carried over under paragraph (b) of this section or allocated under paragraph (d) of this section, but not increased by any recapture of overall foreign loss accounts under paragraph (f) of this section) exceeds the taxpayer's separate limitation losses for the year, so that the taxpayer has U.S. source income remaining after the application of paragraph (d)(2) of this section, then the taxpayer shall recapture its prior year overall domestic losses, if any, and reduce overall domestic loss accounts in accordance with § 1.904(g)-2.

(i) [Reserved]

(j) *Examples.* The following examples illustrate the rules of this section. Unless otherwise noted, all corporations

use the calendar year as the U.S. taxable year.

Example 1. (i) *Facts.* (A) Z Corporation is a domestic corporation with foreign branch operations in Country B. For 2009, Z has a net operating loss of (\$500), determined as follows:

| General | Passive | U.S. |
|---------|---------|---------|
| (\$300) | \$0 | (\$200) |

(B) For 2008, Z had the following taxable income and losses after application of section 904(f) and (g) to income and loss in 2008:

| General | Passive | U.S. |
|---------|---------|-------|
| \$400 | \$200 | \$110 |

(ii) *Net operating loss allocation.* Because Z's taxable income for 2008 exceeds its total net operating loss for 2009, the full net operating loss is carried back. Under Step 1, each component of the net operating loss is carried back and combined with its same category in 2008. See paragraph (b)(2) of this section. After allocation of the net operating loss, Z has the following taxable income and losses for 2008:

| General | Passive | U.S. |
|---------|---------|--------|
| \$100 | \$200 | (\$90) |

(iii) *Loss allocation.* Under Step 4, the (\$90) of U.S. loss is allocated proportionately to reduce the general category and passive category income. Accordingly, \$30 ($\$90 \times \$100/\300) of the U.S. loss is allocated to general category income and \$60 ($\$90 \times \$200/\300) of the U.S. loss is allocated to passive category income, with a corresponding creation or increase to Z's overall domestic loss accounts.

Example 2. (i) *Facts.* (A) X Corporation is a domestic corporation with foreign branch operations in Country C. As of January 1, 2007, X has no loss accounts subject to recapture. For 2007, X has a net operating loss of (\$1400), determined as follows:

| General | Passive | U.S. |
|---------|---------|---------|
| (\$400) | (\$200) | (\$800) |

(B) X has no taxable income in 2005 or 2006 available for offset by a net operating loss carryback. For 2008, X has the following taxable income and losses:

| General | Passive | U.S. |
|---------|---------|--------|
| \$500 | (\$100) | \$1200 |

(ii) *Net operating loss allocation.* Under Step 1, because X's total taxable income for 2008 of \$1600 ($\$1200 + \$500 - \100) exceeds the total 2007 net operating loss, the full \$1400 net op-

erating loss is carried forward. Under paragraph (b)(2) of this section, each component of the net operating loss is carried forward and combined with its same category in 2008. After allocation of the net operating loss, X has the following taxable income and losses:

| General | Passive | U.S. |
|---------|---------|-------|
| \$100 | (\$300) | \$400 |

(iii) *Loss allocation.* Under Step 3, \$100 of the passive category loss offsets the \$100 of general category income, resulting in a passive category separate limitation loss account with respect to general category income, and the other \$200 of passive category loss offsets \$200 of the U.S. source taxable income, resulting in the creation of an overall foreign loss account in the passive category.

Example 3. (i) *Facts.* Assume the same facts as in *Example 2*, except that in 2008, X had the following taxable income and losses:

| General | Passive | U.S. |
|---------|---------|--------|
| \$200 | (\$100) | \$1200 |

(ii) *Net operating loss allocation.* Under Step 1, because the total net operating loss for 2007 of (\$1400) exceeds total taxable income for 2008 of \$1300 ($\$1200 + \$200 - \100), X has a partial net operating loss carryover to 2008 of \$1300. Under paragraph (b)(3)(i) of this section, first, the \$800 U.S. source component of the net operating loss is allocated to U.S. income for 2008. The tentative general category carryover under paragraph (b)(3)(ii) of this section (\$200) does not exceed the remaining net operating loss carryover amount (\$500). Therefore, \$200 of the general category component of the net operating loss is next allocated to the general category income for 2008. Under paragraph (b)(3)(iii) of this section, the remaining \$300 of net operating loss carryover ($\$1300 - \$800 - \$200$) is carried over proportionally from the remaining net operating loss components in the general category (\$200, or \$400 total general category loss - \$200 general category loss already allocated) and passive category (\$200). Therefore, \$150 ($\$300 \times \$200/\$400$) of the remaining net operating loss carryover is carried over from the general category for 2007 and combined with the general category for 2008, and \$150 ($\$300 \times \$200/\400) of the remaining net operating loss carryover is carried over from the passive category for 2007 and combined with the passive category for 2008. After allocation of the net operating loss carryover from 2007 to the appropriate categories for 2008, X has the following taxable income and losses:

| General | Passive | U.S. |
|---------|---------|-------|
| (\$150) | (\$250) | \$400 |

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(iii) *Loss allocation.* Under Step 3, the losses in the general and passive categories fully offset the U.S. source income, resulting in the creation of general category and passive category overall foreign loss accounts.

Example 4. (i) *Facts.* Assume the same facts as in *Example 2*, except that in 2008, X has the following taxable income and losses:

| General | Passive | U.S. |
|---------|---------|---------|
| \$200 | \$200 | (\$200) |

(ii) *Net operating loss allocation.* Under Step 1, because the total net operating loss of (\$1400) exceeds total taxable income for 2008 of \$200 (\$200 + \$200 - \$200), X has a partial net operating loss carryover to 2008 of \$200. Because X has no U.S. source income in 2008, under paragraph (b)(3)(i) of this section no portion of the U.S. source component of the net operating loss is initially carried into 2008. Because the total tentative carryover under paragraph (b)(3)(ii) of this section of \$400 (\$200 in each of the general and passive categories) exceeds the net operating loss carryover amount, the tentative carryover from each separate category is reduced proportionately by \$100 (\$200 × \$200/\$400). Accordingly, \$100 (\$200 - \$100) of the general category component of the net operating loss is carried forward and \$100 (\$200 - \$100) of the passive category component of the net operating loss is carried forward and combined with income in the same respective categories for 2008. After allocation of the net operating loss carryover from 2007, X has the following taxable income and losses:

| General | Passive | U.S. |
|---------|---------|---------|
| \$100 | \$100 | (\$200) |

(iii) *Loss allocation.* Under Step 4, the \$200 U.S. source loss offsets the remaining \$100 of general category income and \$100 of passive category income, resulting in the creation of overall domestic loss accounts with respect to the general and passive categories.

Example 5. (i) *Facts.* Assume the same facts as in *Example 2*, except that in 2008, X has the following taxable income and losses:

| General | Passive | U.S. |
|---------|---------|-------|
| \$800 | (\$100) | \$100 |

(ii) *Net operating loss allocation.* Under Step 1, because X's total net operating loss in 2007 of (\$1400) exceeds its total taxable income for 2008 of \$800 (\$100 + \$800 - \$100), X has a partial net operating loss carryover to 2008 of \$800. Under paragraph (b)(3)(i) of this section, \$100 of the U.S. source component of the net operating loss is allocated to U.S. income for 2008. The tentative general category carryover under paragraph (b)(3)(ii) of this section does not exceed the remaining net operating

loss carryover amount. Therefore, \$400 of the general category component of the net operating loss is allocated to reduce general category income in 2008. Under paragraph (b)(3)(iii) of this section, of the remaining \$300 of net operating loss carryover (\$800 - \$100 - \$400), \$200 is carried forward from the passive category component of the net operating loss and combined with the passive category for 2008. Under paragraph (b)(3)(iv) of this section, the remaining \$100 (\$300 - \$200) of net operating loss carryover is carried forward from the U.S. source component of the net operating loss and combined with the U.S. source income (loss) for 2008. After allocation of the net operating loss carryover from 2007, X has the following taxable income and losses:

| General | Passive | U.S. |
|---------|---------|---------|
| \$400 | (\$300) | (\$100) |

(iii) *Loss allocation.* (A) Under Step 3, the \$300 passive category loss offsets the \$300 of income in the general category, resulting in the creation of a passive category separate limitation loss account with respect to the general category.

(B) Under Step 4, the \$100 U.S. source loss offsets the remaining \$100 of the general category income, resulting in the creation of an overall domestic loss account with respect to the general category.

Example 6. (i) *Facts.* (A) Y Corporation is a domestic corporation with foreign branch operations in Country D. Y has no net operating losses and does not make an election to recapture more than the required amount of overall foreign losses. As of January 1, 2007, Y has a (\$200) general category overall foreign loss (OFL) account and a (\$200) general category separate limitation loss (SLL) account with respect to the passive category. For 2007, Y has \$400 of passive category income that is fully offset by a (\$400) domestic loss in that taxable year, giving rise to the creation of an overall domestic loss (ODL) account with respect to the passive category. As of January 1, 2008, Y has the following balances in its OFL, SLL, and ODL accounts:

| General | | U.S. |
|---------|-------------------|---------------|
| OFL | OFL SLL (Passive) | ODL (Passive) |
| \$200 | \$200 | \$400 |

(B) In 2008, Y has the following taxable income and losses:

| General | Passive | U.S. |
|---------|---------|-------|
| \$400 | (\$100) | \$600 |

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(ii) *Loss allocation.* Under Step 3, the \$100 of passive category loss offsets \$100 of the general category income, creating a passive category SLL account of \$100 with respect to the general category. Because there is an offsetting general category SLL account of \$200 with respect to the passive category from a prior taxable year, the two accounts are netted against each other so that all that remains is a \$100 general category SLL account with respect to the passive category.

(iii) *OFL account recapture.* Under Step 5, 50% of the remaining \$300, or \$150, of income in the general category is subject to recharacterization as U.S. source income as a recapture of part of the OFL account in the general category.

(iv) *SLL account recapture.* Under Step 6, \$100 of the remaining \$150 of income in the general category is recharacterized as passive category income as a recapture of the general category SLL account with respect to the passive category.

(v) *ODL account recapture.* Under Step 7, 50% of the \$600, or \$300, of U.S. source income is subject to recharacterization as foreign source passive category income as a recapture of a part of the ODL account with respect to the passive category. None of the \$150 of general category income that was recharacterized as U.S. source income under Step 5 is included here as income subject to recharacterization in connection with recapture of the overall domestic loss account.

(vi) *Results.* (A) After the allocation of loss and recapture of loss accounts, X has the following taxable income and losses for 2008:

| General | Passive | U.S. |
|---------|---------|-------|
| \$50 | \$400 | \$450 |

(B) As of January 1, 2009, Y has the following balances in its OFL, SLL and ODL accounts:

| General | | Passive | U.S. |
|---------|---------------|---------------|---------------|
| OFL | SLL (Passive) | SLL (General) | ODL (Passive) |
| \$50 | \$0 | \$0 | \$100 |

(k) *Effective/applicability date.* This section applies to taxable years beginning on or after January 1, 2012. Taxpayers may choose to apply this section to other taxable years beginning after December 31, 2006, including periods covered by 26 CFR § 1.904(g)-3T (revised as of April 1, 2010).

[T.D. 9595, 77 FR 37582, June 22, 2012]

§ 1.904(i)-0 Outline of regulation provisions.

This section lists the headings for § 1.904(i)-1.

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

- (a) General rule.
 - (1) Determination of taxable income.
 - (2) Allocation.
- (b) Definitions and special rules.
 - (1) Affiliate.
 - (i) Generally.
 - (ii) Rules for consolidated groups.
 - (iii) Exception for newly acquired affiliates.
 - (2) Includible corporation.
- (c) Taxable years.
- (d) Consistent treatment of foreign taxes paid.

(e) Effective date.

[T.D. 9371, 72 FR 72603, Dec. 21, 2007]

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

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

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