Corporation, $75,000 is excludable from his gross income under section 959(a)(1) as previously taxed earnings and profits; the remaining $15,000 is includible in his gross income for 1963 as a dividend.

Example 4. (a) A, a United States shareholder, owns 100 percent of the only class of stock of controlled foreign corporation P, organized on January 1, 1963. Both A and P Corporation use the calendar year as a taxable year. During 1963, 1964, and 1965, P Corporation is not a foreign personal holding company as defined in section 552(a); in each of such years, P Corporation derives dividend income of $10,000 which constitutes foreign personal holding company income (within the meaning of §1.954–2) but under 26 CFR 1.954–1(b)(1) (Revised as of April 1, 1975) excludes such amounts from foreign base company income as dividends received from, and reinvested in, qualified investments in less developed countries. Corporation P's earnings and profits accumulated for 1963, 1964, and 1965 and determined under paragraph (b)(2) of §1.955–1 are $40,000. For 1966, P Corporation is a foreign personal holding company, has predistribution earnings and profits of $10,000, derives $10,000 of income which is both foreign personal holding company income within the meaning of section 553 and subpart F income within the meaning of section 952, distributes $8,000 to A, and has undistributed foreign personal holding company income of $2,000 within the meaning of section 556. In addition, for 1966 P Corporation has a withdrawal (determined under section 955(a) as in effect before the enactment of the Tax Reduction Act of 1975 but without regard to its earnings and profits for such year) of $25,000 of previously excluded subpart F income from investment in less developed countries. A is required under section 551(b) to include in his gross income for 1966 as a dividend the $2,000 undistributed foreign personal holding company income. The $8,000 distribution is includible in A's gross income for 1966 under sections 61(a)(7) and 301 as a distribution to which section 316(a)(2) applies. Corporation P's $25,000 withdrawal of previously excluded subpart F income from investment in less developed countries is includible in A's gross income for 1966 under section 951(a)(1)(A)(ii) and paragraph (a)(2) of §1.951–1.

(b) If P Corporation's earnings and profits accumulated for 1963, 1964, and 1965 were $15,000, instead of $40,000, the result would be the same as in paragraph (a) of this example, except that a withdrawal of only $15,000 of previously excluded subpart F income from investment in less developed countries would be includible in A's gross income for 1966 under section 951(a)(1)(A)(ii) and paragraph (a)(2) of §1.951–1.

(c) The principles of this example also apply to withdrawals (determined under section 955(a), as in effect before the enactment of the Tax Reduction Act of 1975) of previously excluded subpart F income from investment in less developed countries effected after the effective date of such Act, and to withdrawals (determined under section 955(a), as amended by such Act) of previously excluded subpart F income from investment in foreign base company shipping operations.

Example 5. (a) The facts are the same as in paragraph (a) of example 4, except that, instead of having a $25,000 decrease in qualified investments in less developed countries for 1966, P Corporation invests $20,000 in tangible property (not described in section 956(b)(2)) located in the United States and such investment constitutes an increase (determined under section 956(a) but without regard to the earnings and profits of P Corporation for 1966) in earnings invested in United States property. Corporation P's earnings and profits accumulated for 1963, 1964, and 1965 and determined under paragraph (b)(1) of §1.956–1 are $22,000. The result is the same as in paragraph (a) of example 4, except that instead of including the $25,000 withdrawal, A must include $20,000 in his gross income for 1966 under section 951(a)(1)(B) and paragraph (a)(2)(iv) of §1.951–1 as an investment of earnings in United States property.

(b) If P Corporation's earnings and profits accumulated for 1963, 1964, and 1965 were $9,000 instead of $22,000, the result would be the same as in paragraph (a) of this example, except that only $9,000 would be includible in A's gross income for 1966 under section 951(a)(1)(B) and paragraph (a)(2)(iv) of §1.951–1 as an investment of earnings in United States property.

[T.D. 6795, 30 FR 937, Jan. 29, 1965, as amended by T.D. 7893, 48 FR 22508, May 19, 1983]

§ 1.952–1 Subpart F income defined.

(a) *In general.* For purposes of sections 951 through 964, a controlled foreign corporation's subpart F income for any taxable year shall, except as provided in paragraph (b) of this section and subject to the limitations of paragraphs (c) and (d) of this section, consist of the sum of—

(1) The income derived by such corporation for such year from the insurance of United States risks (determined in accordance with the provisions of section 953 and §§1.953–1 through 1.953–6),

(2) The income derived by such corporation for such year which constitutes foreign base company income (determined in accordance with the provisions of section 954 and §§1.954–1 through 1.954–8),

(3)(i) An amount equal to the product of—

(A) The income of such corporation other than income which—

(*1*) Is attributable to earnings and profits of the foreign corporation included in the gross income of a United States person under section 951 (other than by reason of this paragraph) (determined in accordance with the provisions of section 951 and §1.951–1), or

(*2*) Is described in section 952(b),

multiplied by

(B) The international boycott factor determined in accordance with the provisions of section 999(c)(1), or

(ii) In lieu of the amount determined under paragraph (a)(3)(i) of this section, the amount described under section 999(c)(2) of such international boycott income, and

(4) The sum of the amount of any illegal bribes, kickbacks, or other payments paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government. An amount is paid by a controlled foreign corporation where it is paid by an officer, director, employee, shareholder or agent of such corporation for the benefit of such corporation. For purposes of this section, the principles of section 162(c) and the regulations thereunder shall apply. In the case of payments made after September 3, 1982, a payment is illegal if the payment would be unlawful under the Foreign Corrupt Practices Act of 1977 if the payor were a United States person. The fair market value of an illegal payment made in the form of property or services shall be considered the amount of such illegal payment.

Pursuant to section 951(a)(1)(A)(i) and §1.951–1, a United States shareholder of such controlled foreign corporation must include his pro rata share of such subpart F income in his gross income for his taxable year in which or with which such taxable year of the foreign corporation ends. See section 952(a). However, see paragraph (a) of §1.957–2 for special rule limiting the subpart F income to the income derived from the insurance of United States risks in the case of certain controlled foreign corporations described in section 957(b).

(b) *Exclusion of U.S. income*—(1) *Taxable years beginning before January 1, 1967*. For rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.952–1(b)(1) (Revisedof April 1, 1975).

(2) *Taxable years beginning after December 31, 1966*. Notwithstanding paragraph (a) of this section, a controlled foreign corporation's subpart F income for any taxable year beginning after December 31, 1966, shall not include any item of income from sources within the United States which is effectively connected for that year with the conduct by such corporation of a trade or business in the United States unless, pursuant to a treaty to which the United States is a party, such item of income either is exempt from the income tax imposed by chapter 1 (relating to normal taxes and surtaxes) of the Code or is subject to such tax at a reduced rate.

Thus, for example, dividends received from sources within the United States by a foreign corporation engaged in business in the United States during the taxable year, which are not effectively connected for that year with the conduct of a trade or business in the United States by that corporation, shall not be excluded from subpart F income under section 952(b) and this subparagraph even though such dividends are subject to the tax of 30 percent imposed by section 881 (a). Also, for example, if, by reason of an income tax convention to which the United States is a party, an amount of interest from sources within the United States which is effectively connected for the taxable year with the conduct of a business in the United States by a foreign corporation is subject to tax under chapter 1 at a flat rate of 15 percent, as provided in §1.871–12, such interest is not excluded from subpart F income under section 952(b) and this subparagraph. The deductions attributable to items of income which are excluded from subpart F income under this subparagraph shall not be taken into account for purposes of section 952.

(3) *Rule applicable under section 956 (b)(2)*. For purposes only of paragraph (b)(1))(viii) of §1.956–2, an item of income derived by a controlled foreign

corporation from sources within the United States with respect to which for the taxable year a tax is imposed in accordance with section 882(a) shall be considered described in section 952(b) whether or not such item of income would have constituted subpart F income for such year.

(c) *Limitation on a controlled foreign corporation's subpart F income*—(1) *In general.* A United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of §1.951–1) of a controlled foreign corporation's subpart F income for any taxable year shall not exceed his pro rata share of the earnings and profits (as defined in section 964(a) and §1.964–1) of such corporation for such taxable year, computed as of the close of such taxable year without diminution by reason of any distributions made during such taxable year, minus the sum of—

(i) The amount, if any, by which such shareholder's pro rata share of—

(*a*) The sum of such corporation's deficits in earnings and profits for prior taxable years beginning after December 31, 1962, plus

(*b*) The sum of such corporation's deficits in earnings and profits for taxable years beginning after December 31, 1959, and before January 1, 1963 (reduced by the sum of the earnings and profits (as so defined) of such corporation for any of such taxable years) exceeds

(*c*) The sum of such corporation's earnings and profits for prior taxable years beginning after December 31, 1962, which, with respect to such shareholder, are allocated to other earnings and profits under section 959(c)(3) and §1.959–3; and

(ii) Such shareholder's pro rata share of any deficits in earnings and profits of other foreign corporations for a taxable year beginning after December 31, 1962, which are attributable to stock of such other foreign corporations owned by such shareholder within the meaning of section 958(a) and which, in accordance with section 952(d) and paragraph (d) of this section, are taken into account as a reduction in the controlled foreign corporation's earnings and profits for such taxable year.

For purposes of applying this subparagraph, the reduction (if any) provided by subdivision (i) of this subparagraph in a United States shareholder's pro rata share of the earnings and profits of a controlled foreign corporation shall be taken into account before the reduction provided by subdivision (ii) of this subparagraph. See section 952(c).

(2) *Special rules.* For purposes only of determining the limitation under subparagraph (1) of this paragraph on a United States shareholder's pro rata share of a controlled foreign corporation's subpart F income for any taxable year—

(i) *Status of foreign corporation.* The earnings and profits, or deficit in earnings and profits, of a foreign corporation for any taxable year shall be taken into account whether or not such foreign corporation is a controlled foreign corporation at the time such earnings and profits are derived or such deficit in earnings and profits is incurred.

(ii) *Deficits in earnings and profits taken into account only once.* A controlled foreign corporation's deficit in earnings and profits for any taxable year preceding the taxable year shall be taken into account for the taxable year only to the extent such deficit has not been taken into account under this paragraph, paragraph (d) of this section, or paragraph (d)(2)(ii) of §1.963–2 (applied as if section 963 had not been repealed by the Tax Reduction Act of 1975) in computing a minimum distribution, for any taxable year preceding the taxable year, to reduce earnings and profits of such preceding year of such controlled foreign corporation or of any other controlled foreign corporation. To the extent a controlled foreign corporation's (the ''first corporation'') excess foreign base company shipping deductions for any taxable year (determined under §1.955A–3(c)(2)(i)) reduce the foreign base company shipping income of another member of a related group (as defined in §1.955A–2(b)), such deductions shall not be taken into account in determining the earnings and profits or deficits in earnings and profits of such first corporation for such taxable year for purposes of this paragraph (c) and paragraph (d) of this section. The rule of the preceding sentence shall not apply to the extent the excess foreign base company shipping deductions of the first corporation reduce the foreign base company shipping income of another member of a related group below zero.

(iii) *Determination of pro rata share.* A United States shareholder's pro rata share of a controlled foreign corporation's earnings and profits, or deficit in earnings and profits, for any taxable year shall be determined in accordance with the principles of paragraph (e) of § 1.951–1 and paragraph (d)(2)(ii) of § 1.963–2.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. (a) A is a United States shareholder who owns 100 percent of the only class of stock of M Corporation, a controlled foreign corporation organized on January 1, 1963. Both A and M Corporation use the calandar year as a taxable year.

(b) During 1963, M Corporation derives $20,000 of subpart F income and has earnings and profits of $30,000. Corporation M makes no distributions to A during such year. The limitation under section 952(c) on M Corporation's subpart F income for 1963 is $30,000; and $20,000 is includible in A's gross income for such year under section 951(a)(1)(A)(i).

(c) On January 1, 1964, M Corporation acquires 100 percent of the only class of stock of N Corporation, a controlled foreign corporation which uses the calendar year as a taxable year. During 1964, N Corporation derives $6,000 of subpart F income, has $7,000 of earnings and profits, and distributes $5,000 to M Corporation. The limitation under section 952(c) on N Corporation's subpart F income for 1964 is $7,000; and $6,000 of subpart F income is includible in A's gross income for such year under section 951(a)(1)(A)(i).

(d) During 1964, M Corporation derives $8,000 of rents which constitute subpart F income, makes a $10,000 distribution to A, and has earnings and profits of $12,000 (including the $5,000 dividend received from N Corporation). The limitation under section 952(c) on M Corporation's subpart F income for 1964 is $7,000, determined as follows:

Corporation M's earnings and profits for 1964 (determined under section 964(a) and § 1.964–1 as of the close of such year without diminution for any distributions made during such year)	$12,000
Less: Corporation M's earnings and profits for 1964 described in section 959(b)	5,000
Limitation on M Corporation's Subpart F income for 1964	7,000

Thus, for 1964 with respect to A's interest in M Corporation, $7,000 of subpart F income is includible in his gross income under section 951(a)(1)(A)(i). The $10,000 dividend received from M Corporation is excludible from A's gross income for 1964 under section 959(a)(1) and paragraph (b) of § 1.959–1.

Example 2. A is a United States shareholder who owns 100 percent of the only class of stock of R Corporation which was organized on January 1, 1961. R Corporation is a controlled foreign corporation for the entire period after December 31, 1962, here involved. Both A and R Corporation use the calendar year as a taxable year. During 1963, R Corporation derives $25,000 of subpart F income and has $50,000 of earnings and profits. Corporation R has $15,000 of earnings and profits for 1961, and a deficit in earnings and profits of $45,000 for 1962. Thus, R Corporation has as of December 31, 1963, a net deficit in earnings and profits of $30,000 for the years 1961 and 1962. Corporation R makes no distributions to A during 1963. The limitation under section 952(c) on R Corporation's subpart F income for 1963 is $20,000 ($50,000 minus $30,000), and $20,000 of subpart F income is includible in A's gross income for 1963 under section 951(a)(1)(A)(i). During 1964, R Corporation derives $18,000 of subpart F income and has $30,000 of earnings and profits. Corporation R makes no distributions to A during 1964. The entire $18,000 of subpart F income is includible in A's gross income for 1964 under section 951(a)(1)(A)(i).

(d) *Treatment of deficits in earnings and profits attributable to stock of other foreign corporation indirectly owned by a United States shareholder*—(1) *In general.* For purposes of paragraph (c)(1)(ii) of this section, if—

(i) A United States shareholder owns (within the meaning of section 958(a)) stock in two or more foreign corporations in a chain of foreign corporations (as defined in subparagraph (2)(ii) of this paragraph), and

(ii) Any of the corporations in such chain has a deficit in earnings and profits for a taxable year beginning after December 31, 1962,

then, with respect to such shareholder and only for purposes of determining the limitation on subpart F income under paragraph (c) of this section, the earnings and profits for the taxable year of each such foreign corporation which is a controlled foreign corporation shall, in accordance with the rules of subparagraph (2) of this paragraph, be reduced to take into account any deficit in earnings and profits referred to in subdivision (ii) of this subparagraph. See section 952(d).

(2) *Special rules.* For purposes of this paragraph—

(i) *Applicable rules.* The special rules set forth in paragraph (c)(2) of this section shall apply.

(ii) *''Chain'' defined.* A chain of foreign corporations shall, with respect to a United States shareholder, include—

(*a*) Any foreign corporation in which such shareholder owns (within the meaning of section 958(a)(1)(A)) stock but, only to the extent of the stock so owned and

(*b*) All foreign corporations in which such shareholder owns (within the meaning of section 958(a)(2)) stock, but only to the extent of the stock so owned by reason of his ownership of the stock referred to in (*a*) of this subdivision.

(iii) *Allocation of deficit.* If one or more foreign corporations (whether or not a controlled foreign corporation) includible in a chain of foreign corporations has a deficit in earnings and profits (determined under section 964(a) and §1.964–1) for the taxable year, the amount of deficit taken into account under section 952(d) with respect to a United States shareholder in such chain as a reduction in earnings and profits for the taxable year of a controlled foreign corporation includible in such chain shall be an amount which bears the same ratio to such shareholder's pro rata share of the total deficit in earnings and profits for the taxable year of all includible foreign corporations as his pro rata share of the earnings and profits (determined under paragraph (c) of this section but without regard to the provisions of subparagraph (1)(ii) of such paragraph) for the taxable year of such includible controlled foreign corporation bears to his pro rata share of the total earnings and profits (as so determined under paragraph (c) of this section) for the taxable year of all includible controlled foreign corporations. The amount of deficit taken into account under this subdivision with respect to any controlled foreign corporation includible in a chain of foreign corporations shall not exceed the United States shareholder's pro rata share of the controlled foreign corporation's earnings and profits for the taxable year.

(iv) *Taxable year.* The taxable year from which a deficit is allocated under this paragraph, and the taxable year to which such deficit is allocated to reduce earnings and profits, shall be the taxable year of the foreign corporation ending with or within the taxable year of the United States shareholder described in subparagraph (1)(i) of this paragraph.

(3) *Illustration.* The application of this paragraph may be illustrated by the following examples:

Example 1. (a) Domestic corporation M owns 100 percent, 20 percent, and 100 percent, respectively, of the only class of stock of foreign corporations A, B, and F, respectively. Corporation A owns 80 percent of the only class of stock of each of foreign corporations B and C, respectively. Corporation F owns 20 percent of such stock of C Corporation. Corporation B owns 75 percent of the only class of stock of foreign corporation D, and 50 percent of the only class of stock of each of foreign corporations G and H, respectively. C Corporation owns 75 percent of the only class of stock of foreign corporation E. All the corporations use the calendar year as a taxable year, and all of the foreign corporations, except corporations G and H, are controlled foreign corporations throughout the period here involved.

(b) The subpart F income, and the earnings and profits (determined under paragraph (c) of this section but without regard to subparagraph (1)(ii) of such paragraph) or deficit in earnings and profits (determined under section 964(a) and §1.964–1), of each of the foreign corporations for 1963 are as follows, the deficits being set forth in parentheses:

	Subpart F income	Earnings and profits (deficits)
A Corporation	$6,000	$18,000
B Corporation	....	(7,500)
C Corporation	....	(2,500)
D Corporation	4,000	5,000
E Corporation	12,000	15,000
F Corporation	8,000	20,250
G Corporation	....	(10,000)
H Corporation	....	7,000

(c) The chains of foreign corporations (within the meaning of subparagraph (2)(ii) of this paragraph) for 1963 are the ''A'' chain, consisting of corporations, A, B, C, D, E, G, and H, but only to the extent of M Corporation's stock interest in such corporations under section 958(a) by reason of its ownership of stock in A Corporation; the "B" chain, consisting of corporations B, D, G, and H, but only to the extent of M Corporation's stock interest in such corporations under section 958(a) by reason of its ownership of stock in B Corporation; and the "F" chain, consisting of corporations F, C, and E, but only to the extent of M Corporation's stock interest in such corporations under section 958(a) by reason of its ownership of stock in F Corporation.

(d) Corporation M's stock interest under section 958(a) in each of the chains of foreign corporations is as follows for 1963:

[In percent]

	A	B	C	D	E	F	G	H
A chain:								
Direct interest	100							
(100%×80%)		80						
(100%×80%)			80					
(80%×75%)				60				
(80%×75%)					60			
(80%×50%)							40	
(80%×50%)								40
B chain:								
Direct interest		20						
(20%×75%)				15				
(20%×50%)							10	
(20%×50%)								10
F chain:								
Direct interest						100		
(100%×20%)			20					
(20%×75%)					15			
Total interests	100	100	100	75	75	100	50	50

(e) Corporation M's pro rata share of the earnings and profits (determined under paragraph (c) of this section but without regard to subparagraph (1)(ii) of such paragraph), or of the deficit, of each controlled foreign corporation of each foreign corporation, respectively, includible in the respective chains for 1963 is as follows:

	Earnings and profits	Deficit
A chain:		
A Corporation (100%)	$18,000	
B Corporation (80%)		($6,000)
C Corporation (80%)		(2,000)
D Corporation (60%)	3,000	
E Corporation (60%)	9,000	
G Corporation (40%)		(4,000)
H Corporation (40%)	([1])	
Total	30,000	(12,000)
B chain:		
B Corporation (20%)		($1,500)
D Corporation (15%)	$750	
G Corporation (10%)		(1,000)
H Corporation (10%)	([1])	
Total	$750	($2,500)
F chain:		
F Corporation (100%)	20,250	
C Corporation (20%)		(500)
E Corporation (15%)	2,250	
Total	$22,500	(500)

[1] The earnings and profits of H Corporation are not included in the total earnings and profits for the chain because H Corporation is not a controlled foreign corporation.

(f) The amount by which M Corporation's pro rata share of the earnings and profits for 1963 of the controlled foreign corporations in each respective chain shall be reduced under section 952(d) by M Corporation's pro rata share of the deficits of corporations B, C, and G for 1963 is determined as follows:

		Amount of reduction
A chain:		
A Corporation ($12,000×$18,000/$30,000)		$7,200
D Corporation ($12,000×$3,000/$30,000)		1,200
E Corporation ($12,000×$9,000/$30,000)		3,600
Total		12,000
B chain:		
D Corporation ($2,500×$750/$750)	$2,500	
Limitation: M Corporation's pro-rata share of D Corporation's earnings and profits	750	
Allocation of used deficit ($750) to M Corporation's pro rata share of the deficits of corporations B and G:		
B Corporation ($750×($1,500/$2,500))	$450	

		Amount of reduction
G Corporation ($750× ($1,000/$2,500))	300	
Total	750	$750
F chain:		
F Corporation ($500×$20,250/$22,500)		450
E Corporation ($500×$2,250/$22,500)		50
Total		500

(g) Corporation M's pro rata share of the earnings and profits (determined after reduction for deficits under section 952(d)) for 1963 of each controlled foreign corporation in the respective chains, determined on a chain-by-chain basis, is determined as follows:

	Earnings and profits before reduction	Reduction (sec. 952(d))	Reduced earnings and profits
A chain:			
A Corporation	$18,000	$7,200	$10,800
D Corporation	3,000	1,200	1,800
E Corporation	9,000	3,600	5,400
B chain: D Corporation	750	750	....
F chain:			
F Corporation	20,250	450	19,800
E Corporation	2,250	50	2,200

(h) Corporation M's pro rata share of each controlled foreign corporation's subpart F income, limited as provided by section 952(c) and paragraph (c) of this section, for 1963 which is includible in its gross income for such year under section 951(a)(1)(A)(i) and §1.951–1 is determined as follows:

	Subpart F income (before limitation)	Earnings and profit (sec. 952 (c))	Amount includible in income
A Corporation (100%)	$6,000	$10,800	$6,000
D Corporation (75%)	3,000	1,800	1,800
E Corporation (75%)	9,000	7,600	7,600
F Corporation (100%)	8,000	19,800	8,000
Total includible under sec. 951(a)(1)(A)(i)	....	....	23,400

Example 2. The facts are the same as in example 1 except that, in addition, for 1964, foreign corporations C, D, and E have no subpart F income and no earnings and profits and foreign corporations G and H have no earnings and profits. For 1964, B Corporation has subpart F income of $1,000 and earnings and profits (determined in accordance with section 964(a) and §1.964–1) of $1,500; A Corporation has subpart F income of $800 and earnings and profits of $1,000; and F Corporation has subpart F income of $500 and earnings and profits of $1,000. Such earnings and profits are determined without regard to distributions for 1964. Corporation B has an unused deficit in earnings and profits of $1,050 for 1963 ($1,500 minus $450) applicable to M Corporation's interest in such corporation (paragraph (f) of example 1), and, under paragraph (c)(1)(i)(*a*) of this section, with respect to M Corporation, such deficit reduces B Corporation's earnings and profits for 1964 to $450. Inasmuch as G Corporation is not a controlled foreign corporation for 1964, such corporation's unused deficit in earnings and profits of $700 for 1963 ($1,000 minus $300) applicable to M Corporation's interest in such corporation (paragraph (f) of example 1) may be used under paragraph (c)(1)(i)(*a*) of this section to reduce M Corporation's interest in G Corporation's earnings and profits in a later year or years for which G Corporation is a controlled foreign corporation. Corporation M's pro rata share of each controlled foreign corporation's subpart F income, limited as provided by section 952(c) and paragraph (c) of this section, for 1964 which is includible in its gross income for such year under section 951(a)(1)(A)(i) and §1.951–1 is determined as follows:

	Subpart F income (before limitation)	Earnings and profits (sec. 952(c))	Amount includible in income
A Corporation	$800	$1,000	$800
B Corporation	1,000	450	450
F Corporation	500	1,000	500

Example 3. The facts are the same as in example 2, except that for 1964 B Corporation has subpart F income of $550 and earnings and profits (determined in accordance with section 964(a) and §1.964–1) of $550; such earnings and profits are determined without regard to distributions for 1964. Under paragraph (c)(1)(i)(a) of this section, B Corporation's unused deficit of $1,050 for 1963 reduces its earnings and profits for 1964 with respect to M Corporation to zero. The remaining $500 of the unused deficit for 1963 applicable to M Corporation's interest in B Corporation may be used under paragraph (c)(1)(i)(*a*) of this section in later years to reduce M Corporation's interest in B Corporation's earnings and profits.

(e) *Application of current earnings and profits limitation*—(1) *In general.* If the subpart F income (as defined in section 952(a)) of a controlled foreign corporation exceeds the foreign corporation's earnings and profits for the taxable year, the subpart F income includible in the income of the corporation's United States shareholders is reduced under section 952(c)(1)(A) in accordance with the following rules. The excess of subpart F income over current year earnings and profits shall—

(i) First, proportionately reduce subpart F income in each separate category of the controlled foreign corporation, as defined in §1.904–5(a)(1), in which current earnings and profits are zero or less than zero;

(ii) Second, proportionately reduce subpart F income in each separate category in which subpart F income exceeds current earnings and profits; and

(iii) Third, proportionately reduce subpart F income in other separate categories.

(2) *Allocation to a category of subpart F income.* An excess amount that is allocated under paragraph (e)(1) of this section to a separate category must be further allocated to a category of subpart F income if the separate category contains more than one category of subpart F income described in section 952(a) or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*). In such case, the excess amount that is allocated to the separate category must be allocated to the various categories of subpart F income within that separate category on a proportionate basis.

(3) *Recapture of subpart F income reduced by operation of earnings and profits limitation.* Any amount in a category of subpart F income described in section 952(a) or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*) that is reduced by operation of the current year earnings and profits limitation of section 952(c)(1)(A) and this paragraph (e) shall be subject to recapture in a subsequent year under the rules of section 952(c)(2) and paragraph (f) of this section.

(4) *Coordination with sections 953 and 954.* The rules of this paragraph (e) shall be applied after the application of sections 953 and 954 and the regulations under those sections, except as provided in §1.954–1(d)(4)(ii).

(5) *Earnings and deficits retain separate limitation character.* The income reduction rules of paragraph (e)(1) of this section shall apply only for purposes of determining the amount of an inclusion under section 951(a)(1)(A) from each separate category as defined in §1.904–5(a)(1) and the separate categories in which recapture accounts are established under section 952(c)(2) and paragraph (f) of this section. For rules applicable in computing post-1986 undistributed earnings, see generally section 902 and the regulations under that section. For rules relating to the allocation of deficits for purposes of computing foreign taxes deemed paid under section 960 with respect to an inclusion under section 951(a)(1)(A), see §1.960–1(i).

(f) *Recapture of subpart F income in subsequent taxable year*—(1) *In general.* If a controlled foreign corporation's subpart F income for a taxable year is reduced under the current year earnings and profits limitation of section 952(c)(1)(A) and paragraph (e) of this section, recapture accounts will be established and subject to recharacterization in any subsequent taxable year to the extent the recapture accounts were not previously recharacterized or distributed, as provided in paragraphs (f)(2) and (3) of this section.

(2) *Rules of recapture*—(i) *Recapture account.* If a category of subpart F income described in section 952(a) or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A) (*1*) or (*2*) is reduced under the current year earnings and profits limitation of section 952(c)(1)(A) and paragraph (e) of this section for a taxable year, the amount of such reduction shall constitute a recapture account.

(ii) *Recapture.* Each recapture account of the controlled foreign corporation will be recharacterized, on a proportionate basis, as subpart F income in the same separate category (as defined in §1.904–5(a)(1)) as the recapture account to the extent that current year earnings and profits exceed subpart F income in a taxable year. The United States shareholder must include his pro rata share (determined under the rules of §1.951–1(e)) of each recharacterized amount in income as subpart F income in such separate category for the taxable year.

(iii) *Reduction of recapture account and corresponding earnings.* Each recapture account, and post-1986 undistributed earnings in the separate category containing the recapture account, will be reduced in any taxable year by the amount which is recharacterized under paragraph (f)(2)(ii) of this section. In addition, each recapture account, and post-1986 undistributed earnings in the separate category containing the recapture account, will be reduced in the amount of any distribution out of that account (as determined under the ordering rules of section 959(c) and paragraph (f)(3)(ii) of this section).

(3) *Distribution ordering rules*—(i) *Coordination of recapture and distribution rules.* If a controlled foreign corporation distributes an amount out of earnings and profits described in section 959(c)(3) in a year in which current year earnings and profits exceed subpart F income and there is an amount in a recapture account for such year, the recapture rules will apply first.

(ii) *Distributions reduce recapture accounts first.* Any distribution made by a controlled foreign corporation out of earnings and profits described in section 959(c)(3) shall be treated as made first on a proportionate basis out of the recapture accounts in each separate category to the extent thereof (even if the amount in the recapture account exceeds post-1986 undistributed earnings in the separate category containing the recapture account). Any remaining distribution shall be treated as made on a proportionate basis out of the remaining earnings and profits of the controlled foreign corporation in each separate category. See section 904(d)(3)(D).

(4) *Examples.* The application of paragraphs (e) and (f) of this section may be illustrated by the following examples:

Example 1. (i) A, a U.S. person, is the sole shareholder of CFC, a controlled foreign corporation formed on January 1, 1998, whose functional currency is the u. In 1998, CFC earns 100u of foreign base company sales income that is general limitation income described in section 904(d)(1)(I) and incurs a (200u) loss attributable to activities that would have produced general limitation income that is not subpart F income. In 1998 CFC also earns 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A), and 100u of foreign personal holding company income that is dividend income subject to a separate limitation described in section 904(d)(1)(E) for dividends from a noncontrolled section 902 corporation. CFC's subpart F income for 1998, 300u, exceeds CFC's current earnings and profits, 100u, by 200u. Under section 952(c)(1)(A) and paragraph (e) of this section, subpart F income is limited to CFC's current earnings and profits of 100u, all of which is included in A's gross income under section 951(a)(1)(A). The 200u of CFC's 1998 subpart F income that is not included in A's income in 1998 by reason of section 952(c)(1)(A) is subject to recapture under section 952(c)(2) and paragraph (f) of this section.

(ii) For purposes of determining the amount and type of income included in A's gross income and the amount and type of income in CFC's recapture account, the rules of paragraphs (e)(1) and (2) of this section apply. Under paragraph (e)(1)(i) of this section, the amount by which CFC's subpart F income exceeds its earnings and profits for 1998, 200u, first reduces from 100u to 0 CFC's subpart F income in the general limitation category, which has a current year deficit of (100u) in earnings and profits. Next, under paragraph (e)(1)(iii) of this section, the remaining 100u by which CFC's 1998 subpart F income exceeds earnings and profits is applied proportionately to reduce CFC's subpart F income in the separate categories for passive income (100u) and dividends from the noncontrolled section 902 corporation (100u). Thus, A includes 50u of passive limitation/foreign personal holding company income and 50u of dividends from the noncontrolled section 902 corporation/foreign personal holding company income in gross income in 1998. CFC has 100u in its general limitation/foreign base company sales income recapture account attributable to the 100u of foreign base company sales income that is not included in A's income by reason of the earnings and profits limitation of section 952(c)(1)(A). CFC also has 50u in its passive limitation recapture account, all of which is attributable to foreign personal holding company income, and 50u in its recapture account for dividends from the noncontrolled section 902 corporation, all of which is attributable to foreign personal holding company income.

(iii) For purposes of computing post-1986 undistributed earnings, the rules of sections 902 and 960, including the rules of § 1.960–1(i), apply. Under § 1.960–1(i), the general limitation deficit of (100u) is allocated proportionately to reduce passive limitation earnings of 100u and noncontrolled section 902 dividend earnings of 100u. Thus, passive limitation earnings are reduced by 50u to 50u (100u passive limitation earnings/200u total earnings in positive separate categories × (100u) general limitation deficit=50u reduction), and the noncontrolled section 902 corporation earnings are reduced by 50u to 50u (100u noncontrolled section 902 corporation earnings/200u total earnings in positive separate categories × (100u) general limitation deficit=50u reduction). All of CFC's post-1986 foreign income taxes with respect to passive limitation income and dividends from the noncontrolled section 902 corporation are deemed paid by A under section 960 with respect to the subpart F inclusions (50u inclusion/50u earnings in each separate category). After the inclusion and deemed-paid taxes are computed, at the close of 1998 CFC has a (100u) deficit in general limitation earnings (100u subpart F earnings + (200u) nonsubpart F loss), 50u of passive limitation earnings (100u of earnings attributable to foreign personal holding company income −50u inclusion) with a corresponding passive limitation/foreign personal holding company income recapture account of 50u, and 50u of earnings subject to a separate limitation for dividends from the noncontrolled section 902 corporation (100u earnings −50u inclusion) with a corresponding noncontrolled section 902 corporation/foreign personal holding company income recapture account of 50u.

Example 2. (i) The facts are the same as in *Example 1* with the addition of the following facts. In 1999, CFC earns 100u of foreign base company sales income that is general limitation income and 100u of foreign personal holding company income that is passive limitation income. In addition, CFC incurs (10u) of expenses that are allocable to its separate limitation for dividends from the noncontrolled section 902 corporation. Thus, CFC's subpart F income for 1999, 200u, exceeds CFC's current earnings and profits, 190u, by 10u. Under section 952(c)(1)(A) and paragraph (e) of this section, subpart F income is limited to CFC's current earnings and profits of 190u, all of which is included in A's gross income under section 951(a)(1)(A).

(ii) For purposes of determining the amount and type of income included in A's gross income and the amount and type of income in CFC's recapture accounts, the rules of paragraphs (e)(1) and (2) of this section apply. While CFC's general limitation post-1986 undistributed earnings for 1999 are 0 ((100u) opening balance + 100u subpart F income), CFC's general limitation subpart F income (100u) does not exceed its general limitation current earnings and profits (100u) for 1999. Accordingly, under paragraph (e)(1)(iii) of this section, the amount by which CFC's subpart F income exceeds its earnings and profits for 1999, 10u, is applied proportionately to reduce CFC's subpart F income in the separate categories for general limitation income, 100u, and passive income, 100u. Thus, A includes 95u of general limitation foreign base company sales income and 95u of passive limitation foreign personal holding company income in gross income in 1999. At the close of 1999 CFC has 105u in its general limitation/foreign base company sales income recapture account (100u from 1998 + 5u from 1999), 55u in its passive limitation/foreign personal holding company income recapture account (50u from 1998 + 5u from 1999), and 50u in its dividends from the noncontrolled section 902 corporation/foreign personal holding company income recapture account (all from 1998).

(iii) For purposes of computing post-1986 undistributed earnings in each separate category, the rules of sections 902 and 960, including the rules of §1.960–1(i), apply. Thus, post-1986 undistributed earnings (or an accumulated deficit) in each separate category are increased (or reduced) by current earnings and profits or current deficits in each separate category. The accumulated deficit in CFC's general limitation earnings and profits (100u) is reduced to 0 by the addition of 100u of 1999 earnings and profits. CFC's passive limitation earnings of 50u are increased by 100u to 150u, and CFC's noncontrolled section 902 corporation earnings of 50u are decreased by (10u) to 40u. After the addition of current year earnings and profits and deficits to the separate categories there are no deficits remaining in any separate category. Thus, the allocation rules of §1.960–1(i)(4) do not apply in 1999. Accordingly, in determining the post-1986 foreign income taxes deemed paid by A, post-1986 undistributed earnings in each separate category are unaffected by earnings in the other categories. Foreign taxes deemed paid under section 960 for 1999 would be determined as follows for each separate category: with respect to the inclusion of 95u of foreign base company sales income out of general limitation earnings, the section 960 fraction is 95u inclusion/0 total earnings; with respect to the inclusion of 95u of passive limitation income the section 960 fraction is 95u inclusion/150u passive earnings. Thus, no general limitation taxes would be associated with the inclusion of the general limitation earnings because there are no accumulated earnings in the general limitation category. After the deemed-paid taxes are computed, at the close of 1999 CFC has a (95u) deficit in general limitation earnings and profits ((100u) opening balance + 100u current earnings −95u inclusion), 55u of passive limitation earnings and profits (50u opening balance + 100u current foreign personal holding company income −95u inclusion), and 40u of earnings and profits subject to the separate limitation for dividends from the noncontrolled section 902 corporation (50u opening balance + (10u) expense).

Example 3. (i) A, a U.S. person, is the sole shareholder of *CFC*, a controlled foreign corporation whose functional currency is the u. At the beginning of 1998, CFC has post-1986 undistributed earnings of 275u, all of which are general limitation earnings described in section 904(d)(1)(I). CFC has no previously-taxed earnings and profits described in section 959(c)(1) or (c)(2). In 1998, CFC has a (200u) loss in the shipping category described in section 904(d)(1)(D), 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A), and 125u of general limitation manufacturing earnings that are not subpart F income. CFC's subpart F income for 1998, 100u, exceeds CFC's current earnings and profits, 25u, by 75u. Under section 952(c)(1)(A) and paragraph (e) of this section, subpart F income is limited to CFC's current earnings and profits of 25u, all of which is included in A's gross income under section 951(a)(1)(A). The 75u of CFC's 1998 subpart F income that is not included in A's income in 1998 by reason of section 952(c)(1)(A) is subject to recapture under section 952(c)(2) and paragraph (f) of this section.

(ii) For purposes of determining the amount and type of income included in A's gross income and the amount and type of income in CFC's recapture account, the rules of paragraphs (e)(1) and (2) of this section apply. Under paragraph (e)(1) of this section, the amount of CFC's subpart F income in excess of earnings and profits for 1998, 75u, reduces the 100u of passive limitation foreign personal holding company income. Thus, A includes 25u of passive limitation foreign personal holding company income in gross income, and CFC has 75u in its passive limitation/foreign personal holding company income recapture account.

(iii) For purposes of computing post-1986 undistributed earnings in each separate category the rules of sections 902 and 960, including the rules of §1.960–1(i), apply. Under §1.960–1(i), the shipping limitation deficit of (200u) is allocated proportionately to reduce general limitation earnings of 400u and passive limitation earnings of 100u. Thus, general limitation earnings are reduced by 160u to 240u (400u general limitation earnings/500u total earnings in positive separate categories × (200u) shipping deficit=160u reduction), and passive limitation earnings are reduced by 40u to 60u (100u passive earnings/500u total earnings in positive separate categories × (200u) shipping deficit=40u reduction). Five-twelfths of CFC's post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by A under section 960 with respect to the subpart F inclusion (25u inclusion/60u passive earnings). After the inclusion and deemed-paid taxes are computed, at the close of 1998 CFC has 400u of general limitation earnings (275u opening balance + 125u current earnings), 75u of passive limitation earnings (100u of foreign personal holding company income −25u inclusion), and a (200u) deficit in shipping limitation earnings.

Example 4. (i) The facts are the same as in *Example 3* with the addition of the following facts. In 1999, CFC earns 50u of general limitation earnings that are not subpart F income and 75u of passive limitation income that is foreign personal holding company income. Thus, CFC has 125u of current earnings and profits. CFC distributes 200u to A. Under paragraph (f)(3)(i) of this section, the recapture rules are applied first. Thus, the amount by which 1999 current earnings and profits exceed subpart F income, 50u, is recharacterized as passive limitation foreign personal holding company income. CFC's total subpart F income for 1999 is 125u of passive limitation foreign personal holding company income (75u current earnings plus 50u recapture account), and the passive limitation/foreign personal holding company income recapture account is reduced from 75u to 25u.

(ii) CFC has 150u of previously-taxed earnings and profits described in section 959(c)(2) (25u attributable to 1998 and 125u attributable to 1999), all of which is passive limitation earnings and profits. Under section 959(c), 150u of the 200u distribution is deemed to be made from earnings and profits described in section 959(c)(2). The remaining 50u is deemed to be made from earnings and profits described in section 959(c)(3). Under paragraph (f)(3)(ii) of this section, the dividend distribution is deemed to be made first out of the passive limitation recapture account to the extent thereof (25u). Under paragraph (f)(2)(iii) of this section, the passive limitation recapture account is reduced from 25u to 0. The remaining distribution of 25u is treated as made out of CFC's general limitation earnings and profits.

(iii) For purposes of computing post-1986 undistributed earnings, the rules of section 902 and 960, including the rules of §1.960–1(i), apply. Thus, the shipping limitation accumulated deficit of (200u) reduces general limitation earnings and profits of 450u and passive limitation earnings and profits of 150u on a proportionate basis. Thus, 100% of CFC's post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by A under section 960 with respect to the 1999 subpart F inclusion of 125u (100u inclusion (numerator limited to denominator)/ 100u passive earnings). No post-1986 foreign income taxes remain to be deemed paid under section 902 in connection with the 25u distribution from the passive limitation/foreign personal holding company income recapture account. One-twelfth of CFC's post-1986 foreign income taxes with respect to general limitation earnings are deemed paid by A under section 902 with respect to the distribution of 25u general limitation earnings and profits described in section 959(c)(3) (25u inclusion/300u general limitation earnings). After the deemed-paid taxes are computed, at the close of 1999 CFC has 425u of general limitation earnings and profits (400u opening balance + 50u current earnings—25u distribution), 0 of passive limitation earnings (75u recapture account + 75u current foreign personal holding company income—125u inclusion—25u distribution), and a (200u) deficit in shipping limitation earnings.

(5) *Effective date.* Paragraph (e) of this section and this paragraph (f) apply to

taxable years of a controlled foreign corporation beginning after March 3, 1997.

(g) *Treatment of distributive share of partnership income*—(1) *In general.* A controlled foreign corporation's distributive share of any item of income of a partnership is income that falls within a category of subpart F income described in section 952(a) to the extent the item of income would have been income in such category if received by the controlled foreign corporation directly. For specific rules regarding the treatment of a distributive share of partnership income under certain provisions of subpart F, see §§1.954–1(g), 1.954–2(a)(5), 1.954–3(a)(6), and 1.954–4(b)(2)(iii).

(2) *Example.* The application of this paragraph (g) may be illustrated by the following example:

Example. CFC, a controlled foreign corporation, is an 80-percent partner in PRS, a foreign partnership. PRS earns $100 of interest income that is not export financing interest as defined in section 954(c)(2)(B), or qualified banking or financing income as defined in section 954(h)(3)(A), from a person unrelated to CFC. This interest income would have been foreign personal holding company income to CFC, under section 954(c), if it had received this income directly. Accordingly, CFC's distributive share of this interest income, $80, is foreign personal holding company income.

(3) *Effective date.* This paragraph (g) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

[T.D. 6795, 30 FR 938, Jan. 29, 1965, as amended by T.D. 6892, 31 FR 11144, Aug. 23, 1966; T.D. 7293, 38 FR 32802, Nov. 28, 1973; T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7862, 47 FR 56490, Dec. 17, 1982; T.D. 7893, 48 FR 22508, May 19, 1983; T.D. 7894, 48 FR 22516, May 19, 1983; T.D. 8331, 56 FR 2846, Jan. 25, 1991; T.D. 8704, 62 FR 18, Jan. 2, 1997; T.D. 9008, 67 FR 48023, July 23, 2002]

§ 1.952–2 Determination of gross income and taxable income of a foreign corporation.

(a) *Determination of gross income*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the gross income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a domestic corporation taxable under section 11 and by applying the principles of section 61 and the regulations thereunder.

(2) *Insurance gross income*—(i) *Life insurance gross income.* The gross income for any taxable year of a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a life insurance company to which part I (sections 801 through 820) of subchapter L of chapter 1 of the Code applies, shall, subject to the special rules of paragraph (c) of this section, be the sum of—

(*a*) The gross investment income, as defined under section 804(b), except that interest which is excluded from gross income under section 103 shall not be taken into account;

(*b*) The sum of the items taken into account under section 809(c), except that advance premiums shall not be taken into account; and

(*c*) The amount by which the net long-term capital gain exceeds the net short-term capital loss.

(ii) *Mutual and other insurance gross income.* The gross income for any taxable year of a controlled foreign corporation which is engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged only in such business, would be taxable as a mutual insurance company to which part II (sections 821 through 826) of subchapter L of chapter 1 of the Code applies or as a mutual marine insurance or other insurance company to which part III (sections 831 and 832) of subchapter L of chapter 1 of the Code applies, shall, subject to the special rules of paragraph (c) of this section, be—

(*a*) The sum of—

(*1*) The gross income, as defined in section 832(b)(1);

(*2*) The amount of losses incurred, as defined in section 832(b)(5); and

(*3*) The amount of expenses incurred, as defined in section 832(b)(6); reduced by

(*b*) The amount of interest which under section 103 is excluded from gross income.